



BOURNEMOUTH UNIVERSITY

**REFORMING THE CHINESE CORPORATE GOVERNANCE SYSTEM:
A COMPARATIVE LAW AND ECONOMIC ANALYSIS**

JIN ZHU YANG

DOCTOR OF PHILOSOPHY

JUNE 2006

Bournemouth University

Jin Zhu Yang

PhD

2006

**Reforming the Chinese Corporate Governance System:
A Comparative Law and Economic Analysis**

By

Jin Zhu Yang

A thesis submitted in partial fulfilment of the requirements of Bournemouth University for the degree of
Doctor of Philosophy

**June 2006
Bournemouth University**

COPYRIGHT STATEMENT

This copy of the thesis has been supplied on condition that anyone who consults it is understood to recognise that its copyright rests with its author and due acknowledgement must always be made of the use of any material contained in, or derived from, this thesis.

To My Mum

ACKNOWLEDGEMENTS

I would like to express my sincere appreciation to my PhD. supervisors, Professor Philip Hardwick for his excellent guidance, constant encouragement and continuous support throughout my PhD study at Bournemouth University and Dr. Stephen Copp for his insightful advice, ideas and comments which helped me keep in the right direction for the completion of the thesis. I would also like to thank Dr. Ann Robinson, Visiting Fellow in Corporate Governance at Bournemouth Law School and the former Director General of the National Association of Pension Funds for supporting me for the preliminary research of this study. I owe special thanks to Christopher A. Riley, Senior Lecturer at Newcastle Law School, University of Newcastle Upon Tyne for his inspiration and encouragement which raised my interests in corporate governance. Finally, I am deeply grateful to both Bournemouth University and the Institute of Chartered Secretaries and Administrators for offering me the Research Assistantship in Corporate Governance, and the School of Law, University of Hertfordshire, for providing me with precious time at the writing-up stage which enabled me to complete my PhD.

ABSTRACT

One of the major economic themes which characterised the development of modern company law was the well-documented separation of ownership from control and the increase in management control brought about by the wide dispersion of share ownership in large public companies. The growth and complexity of the modern corporation with diversified ownership created the need for governance mechanisms to facilitate the monitoring of managers and to restrain them from acting inappropriately, while not unduly restricting their ability to make decisions.

The issue of corporate governance has been fiercely debated in both the US and the UK for several decades. The impact of globalisation and the recent financial crises in East Asia and elsewhere have spurred on corporate governance reform, which is now being implemented in many jurisdictions around the world. In recent years, China appears to have adopted some of the basic corporate governance structures of the Anglo-American system. However, little comparative empirical work has so far been undertaken to document systemic differences in ownership structures, institutional arrangement and legal rules between the current Chinese corporate governance system and the systems in the UK and the US, or to determine how a corporate governance regime can best be designed to overcome the agency problems created by the separation of ownership from control in the Chinese context.

In this thesis, we investigate the characteristics of China's corporate ownership structure and assess how effective shareholders are in monitoring directors' activities; we examine

how boards are structured and function to ensure the efficient running of the company; and we consider the legal duties imposed on directors and how these duties are enforced in China, drawing comparisons and contrasts with the UK. Also, given the distinctive features of the Chinese corporate governance system, we estimate a regression model to investigate the relationship between corporate governance and corporate performance in China.

Our results indicate that the weakness of the Chinese corporate governance system is not only a consequence of the concentrated state-ownership structure. This weakness is also in part due to the ineffectiveness of internal monitoring rules, inadequate/incomplete law and poor law enforcement. Finally, we provide some suggestions for the Chinese government to improve the Chinese corporate governance system.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS	I
ABSTRACT	II
TABLE OF CONTENTS	IV
LIST OF TABLES AND FIGURES	VII
TABLE OF CASES	X
TABLE OF STATUTES AND REGULATORY MATERIALS	XIV
CHAPTER 1 INTRODUCTION	1
1.1 INTRODUCTION.....	1
1.2 THE EVOLUTION OF CHINA’S CORPORATE LAW AND CORPORATE GOVERNANCE.....	3
1.3 OBJECTIVES OF THE RESEARCH.....	9
1.4 SCOPE AND CONTRIBUTION OF THE RESEARCH	10
1.5 STRUCTURE OF THE RESEARCH	11
CHAPTER 2 CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES	13
2.1 INTRODUCTION.....	13
2.2 CORPORATE GOVERNANCE AND CORPORATE CONTROL MECHANISMS	14
2.2.1 <i>Definition of Corporate Governance</i>	14
2.2.2 <i>Corporate Control Mechanisms</i>	16
2.2.3 <i>Summary</i>	18
2.3 THEORIES OF CORPORATE GOVERNANCE.....	20
2.3.1 <i>Property Rights Theory</i>	20
2.3.2 <i>Incomplete Contracts Theory</i>	25
2.3.3 <i>Agency Theory Versus Organisational Theory</i>	30
2.3.4 <i>Legal Theory of Directors’ Duties and Enforcement</i>	35
2.3.5 <i>Shareholder Versus Stakeholder Theories</i>	38
2.4 CORPORATE GOVERNANCE AND CORPORATE PERFORMANCE.....	40
2.5 CORPORATE GOVERNANCE IN DEVELOPING COUNTRIES.....	42
2.6 CONCLUSION.....	48
CHAPTER 3 RESEARCH METHODOLOGY	49
3.1 INTRODUCTION.....	49
3.2 COMPARATIVE LAW RESEARCH METHOD	51
3.3 ECONOMIC ANALYSIS OF LAW	54
3.4 COMPARATIVE LAW AND ECONOMIC ANALYSIS	56
3.5 RESEARCH METHOD DESIGN.....	61
3.6 DATA SOURCES AND SAMPLE SIZES	64
3.7 SUMMARY	67
CHAPTER 4 THE ANATOMY OF OWNERSHIP STRUCTURE	69
4.1 INTRODUCTION.....	69
4.2 LITERATURE ON OWNERSHIP STRUCTURE AND CONTROL.....	70
4.3 CLASSIFICATION OF SHARES AND OWNERSHIP STRUCTURE	77
4.4 CONCENTRATION OF OWNERSHIP AND CORPORATE CONTROL	82
4.5 IDENTITIES OF SHAREHOLDERS	92

4.6	PROBLEMS ASSOCIATED WITH CONCENTRATED OWNERSHIP STRUCTURE IN CHINA	100
4.7	CONCLUSION	104
CHAPTER 5 SHAREHOLDER MEETINGS AND VOTING RIGHTS		108
5.1	INTRODUCTION.....	108
5.2	LEGAL STATUS AND FUNCTIONING OF SHAREHOLDER GENERAL MEETINGS	112
5.3	LEGAL PROCEDURAL RULES OF SHAREHOLDER MEETINGS	121
5.3.1	<i>Types of Meetings and Legal Requirements on Convening a Meeting</i>	121
5.3.2	<i>Notice of Shareholder Meeting</i>	127
5.3.3	<i>Quorum Requirements</i>	132
5.3.4	<i>The Rules of Voting and Proxy</i>	134
5.3.5	<i>Resolutions and Voting Restrictions</i>	142
5.3.6	<i>Shareholders' Resolutions</i>	145
5.4	VOTING PRACTICES: SOME EMPIRICAL EVIDENCE	149
5.5	CONCLUSION.....	163
CHAPTER 6 THE STRUCTURE AND ROLE OF THE BOARD.....		164
6.1	INTRODUCTION.....	164
6.2	THE LEGAL STATUS AND BEST PRACTICES OF THE BOARD.....	165
6.2.1	<i>The Roles of Boards of Directors</i>	166
6.2.2	<i>The Roles of the Non-Executive/Independent Directors</i>	176
6.2.3	<i>The Role of the Chairman</i>	182
6.2.4	<i>The Roles of Board Committees</i>	186
6.2.5	<i>Board Meetings</i>	195
6.3	BOARDS OF DIRECTORS: SOME EMPIRICAL EVIDENCE.....	196
6.3.1	<i>Size of the Board</i>	196
6.3.2	<i>Composition of the Board</i>	201
6.3.3	<i>Board Leadership Structure</i>	205
6.3.4	<i>Committees of the Board</i>	208
6.3.5	<i>The Frequency of Board Meetings</i>	211
6.5	DISCUSSION AND CONCLUSION	214
CHAPTER 7 DIRECTORS' DUTIES: THE LEGAL AND REGULATORY REQUIREMENTS		220
7.1	INTRODUCTION.....	220
7.2	THE DUTIES OF DIRECTORS IN THE UK	221
7.2.1	<i>The Fiduciary Duties</i>	221
7.2.2	<i>The Duty of Care and Skill</i>	226
7.2.3	<i>Statutory Statement of Duties</i>	231
7.3	DUTIES OF DIRECTORS IN CHINA.....	236
7.3.1	<i>The Duty of Loyalty</i>	236
7.3.2	<i>Duty of Care, Skill and Diligence</i>	243
7.4	CONCLUSION.....	247
CHAPTER 8 THE ENFORCEMENT OF DIRECTORS' DUTIES.....		248
8.1	INTRODUCTION.....	248
8.2	ENFORCEMENT OF DIRECTORS' DUTIES IN THE UK.....	250
8.2.1	<i>The Rule in Foss v. Harbottle</i>	250
8.2.2	<i>Fraud on Minority</i>	252
8.2.3	<i>Personal Actions</i>	257
8.2.4	<i>The Unfairly Prejudicial Remedy</i>	259
8.2.5	<i>A New Derivative Action</i>	261
8.3	ENFORCEMENT OF DIRECTORS' DUTIES IN CHINA.....	267
8.3.1	<i>Law Enforcement Problems under Incomplete Law</i>	267
8.3.2	<i>Private Securities Litigation against Misrepresentation</i>	271
8.3.3	<i>New Rules Governing Shareholder Actions</i>	275

8.4	CONCLUSION AND COMPARATIVE PERSPECTIVES	282
CHAPTER 9 CORPORATE GOVERNANCE AND CORPORATE PERFORMANCE: AN EMPIRICAL ANALYSIS.....		285
9.1	INTRODUCTION.....	285
9.2	LITERATURE REVIEW AND THE DEVELOPMENT OF HYPOTHESES	286
9.2.1	<i>Ownership Structure and Corporate Performance.....</i>	<i>286</i>
9.2.2	<i>Shareholder Activism and Corporate Performance.....</i>	<i>291</i>
9.2.3	<i>The Board of Directors and Corporate Performance.....</i>	<i>296</i>
9.3	DATA AND METHODOLOGY.....	301
9.3.1	<i>Data Sources</i>	<i>301</i>
9.3.2	<i>Variable Description</i>	<i>303</i>
9.3.3	<i>Correlation Matrix</i>	<i>310</i>
9.4	MULTIVARIATE ANALYSIS	312
9.4.1	<i>The Effects of Ownership Structure on Corporate Performance.....</i>	<i>312</i>
9.4.2	<i>The Effects of Shareholder Activism on Corporate Performance.....</i>	<i>315</i>
9.4.3	<i>The Effects of the Characteristics of the Board of Directors on Corporate Performance...316</i>	
9.4.4	<i>The Effects of the Strategic Corporate Governance Mechanisms on Corporate Performance</i> <i>318</i>	
9.5	DISCUSSION AND CONCLUSION	320
CHAPTER 10 ESTABLISHING EFFECTIVE CORPORATE GOVERNANCE IN CHINA		326
10.1	INTRODUCTION.....	326
10.2	SUMMARY OF FINDINGS	328
10.3	RECOMMENDATIONS	339
10.3.1	<i>Reforming Ownership Structure</i>	<i>339</i>
10.3.2	<i>Improvement of Law and Judicial Efficiency.....</i>	<i>342</i>
10.3.3	<i>Constructive Use of Shareholder Meetings, Resolutions and Shareholder Voting Rights...344</i>	
10.3.4	<i>Establishment of the New Board System.....</i>	<i>347</i>
10.4	LIMITATIONS AND SUGGESTIONS FOR FURTHER RESEARCH.....	349
REFERENCES		351
APPENDIX		379

LIST OF TABLES AND FIGURES

List of Tables

Table 3.1(a)	Size Distribution of the Chinese Sample Companies.....	66
Table 3.1(b)	Size Distribution of the UK Sample Companies.....	67
Table 3.2	Descriptive Statistics of Sample Companies.....	67
Table 4.1(a)	Ownership Structure in China (1992-2002).....	83
Table 4.1(b)	Ownership Structure in the UK (1992-2002).....	84
Table 4.2(a)	The Concentration of Ownership in China.....	85
Table 4.2(b)	The Ownership Concentration in the UK.....	85
Table 4.3	Frequency Distribution of Shareholdings Held by the Largest Shareholder in China and the UK.....	88
Table 4.4	Comparison of Shares Owned by the Top 5 Shareholders in China and the UK	89
Table 4.5	Independent Samples Test of the Distribution of Shareholding between China and the UK.....	90
Table 4.6	Distribution of the Largest Shareholder by Identity in China and the UK.....	96
Table 4.7	Distribution of the Controlling Shareholder and Ultimate Control Pattern in China and the UK.....	99
Table 4.8	Distribution of the Controlling Shareholder by Identity of Ownership in China and the UK.....	100
Table 5.1	Frequency Distribution of Shareholder Meetings in China.....	118
Table 5.2	Frequency of Companies Exercising Cumulative Voting Method to Elect Directors or Supervisors at Shareholder Meetings in China.....	137
Table 5.3	Descriptive Statistics of Attendance at the AGM in China.....	156
Table 5.4	Frequency Distribution of Attendance at the AGM in China	156
Table 5.5	Descriptive Statistics of Voting Level at the AGM in China.....	156
Table 5.6	Frequency of Companies whose Shareholders Exercise Voting Right Opposing Resolutions at the AGM in China.....	156
Table 5.7	Descriptive Statistics of Voting Against Resolutions at the AGM in China.....	156
Table 5.8	Frequency Distribution of Shareholder Resolutions Proposed at the AGM in China	158

Table 5.9	Shareholder Resolutions at the AGM in China.....	160
Table 5.10	Description of Voting Level on Shareholder Resolutions and Attendance at the AGM in China.....	161
Table 5.11	Distribution of Shareholder Resolutions by the Identities of Shareholders in China	161
Table 5.12	Frequency Distribution of Proposing Shareholders at the AGM in China.....	162
Table 6.1(a)	Descriptive Statistics of the Size of Board in China and the UK.....	199
Table 6.1(b)	Frequency Distribution of the Size of Board in China and the UK	199
Table 6.2(a)	Proportion of Non-executive/Independent Directors in China and the UK	205
Table 6.2(b)	Frequency Distribution of Non-executive/Independent Directors in China and the UK ...	205
Table 6.3	Chairman and CEO Duality in China and the UK	207
Table 6.4	Board Committees in China and the UK	211
Table 6.5	Frequency of Board Meetings in China and the UK	212
Table 9:1	Descriptive Statistics.....	309
Table 9.2	Pearson Correlation Matrix.....	311
Table 9.3	The Effects of Ownership Concentration and Corporate performance.....	313
Table 9.4	The Effects of Ownership Identity on Corporate Performance.....	315
Table 9.5	The Effects of the Shareholder Activism on Corporate Performance.....	316
Table 9.6	The Effects of the Characteristics of Board of Directors on Corporate Performance.....	317
Table 9.7	The Effects of the Strategic Corporate Governance Mechanisms on Corporate Performance.....	319

List of Figures

Figure 3.1	The relationships between corporate control mechanisms and corporate performance	64
Figure 4.1(a)	Frequency Distribution of Shareholdings Held by the Largest Shareholders in China.....	87
Figure 4.1(b)	Frequency Distribution of Shareholdings Held by the Largest Shareholders in the UK.....	87
Figure 4.2(a)	Frequency Distribution of Shareholdings Held by the Top Five Shareholders in China.....	89
Figure 4.2(b)	Frequency Distribution of Shareholdings Held by the Top Five Shareholders in the UK	89
Figure 4.3	Description of the Largest Shareholder by Identity.....	95
Figure 6.1	The Roles of the Boards of Directors in China.....	173
Figure 6.2	Frequency Distribution of Board Size.....	199
Figure 6.3	Comparison of the Frequency of Board Meetings	213
Figure 9.1	Estimate effect of the Largest Shareholder's Shareholding on ROA.....	314

TABLE OF CASES

<i>Aberdeen Railways Co & Blaikie Bros</i> (1845) 1 Macq 461	224
<i>Alexander Ward & Co Ltd v. Samyang Navigation Co Ltd</i> [1975] 1 WLR 673	262
<i>Allen v. Gold Reefs of West Africa Ltd.</i> [1900] 1 Ch 656	143, 260
<i>Allen v Hyatt</i> (1914) 30 TLR 444	221
<i>Arwood v. Merryweather</i> (1867) LR 5 Eq 464	253
<i>Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame</i> [1906] 2 Ch. 34, C.A..107.....	112, 250
<i>Bamford v. Bamford</i> [1970] Ch. D. 135 C.A.....	114
<i>Baillie v. Oriental Telephone and Electric Co Ltd</i> [1915] 1 Ch 503	258
<i>Bishopsgate Investment Ltd. v. Maxwell</i> (No.2) [1993] BCLC 1282	222, 229
<i>Breckland Group Holdings Ltd v. London & Suffolk Properties Ltd.</i> [1989] BCLC 100.....	250
<i>Bristol and West Building Society v. Mothew</i> [1998] Ch 1.....	221
<i>British Racing Drivers' Club Ltd. v. Hextall Erskine & Co.</i> [1997] 1 BCLC 182	114
<i>Burland v. Earle</i> [1902] AC 83 (PC)	253, 255
<i>Byng v. London Life Association Ltd.</i> [1990] Ch.170.....	132, 183
<i>Caiman v. National Association for Mental Health</i> [1971] Ch 317.....	222
<i>Carruth v. Imperial Chemical Industries Ltd.</i> [1937] A.C. 707	121, 143
<i>Charterbridge Corporation Ltd v. Lloyds Bank Ltd</i> [1970] Ch 62	222
<i>Criterion Properties PLC V. Stratford UK Properties LLC</i> [2003] BCC 50.....	222
<i>Cousins v. International Brick Co. Ltd.</i> [1931] 2 Ch. 90	139
<i>Cook v. Deeks</i> [1916] AC 554.....	225, 253, 255
<i>Cotter v National Union of Seamen</i> [1929] 2 Ch 58	258
<i>Daniels v. Daniels</i> [1978] Ch 406	254
<i>Don King Productions Inc v. Warren</i> [2000] 1 BCLC 607	225
<i>Dorchester Finance v. Stebbing</i> [1989] BCLC 498	222, 226
<i>Edwards v. Halliwell</i> [1950] 2 All ER 1064.....	252, 257, 258
<i>Equitable Life Assurance Society v. Bowley</i> [2004] 1 BCLC 180	229, 230

<i>Estmanco (Kilner House) Ltd v. Greater London Council</i> [1982] 1 All ER 437	253, 255, 256
<i>Extrasure Travel Insurance Ltd. v. Scottergood</i> [2002] All ER (D) 307	222, 223, 224
<i>Foss v Harbottle</i> (1843) 2 Hare 461.....	250, 252, 253, 254, 257, 258, 259, 260, 261, 262, 263, 269, 282
<i>Greenhalgh v Anderne Cinemas Ltd</i> [1951] Ch 286.....	260
<i>Guinness plc v. Saunders</i> [1990] 2 AC 663.....	224, 225
<i>Hely-Hutchinson v. Brayhead Ltd.</i> [1968] 1 QB 549.....	224
<i>Howard Smith Ltd. v. Ampol Petroleum Ltd.</i> [1974] AC 821.....	222, 223
<i>Hoole v Great Western Rly Co</i> (1867) 3 Ch App 262	258
<i>Industrial Development Consultants Ltd v Cooley</i> [1972] 1 WLR 443	221, 225
<i>Isle of Wight Railway v. Tahourdin</i> (1883) 25 Ch.D. 320, C.A	112
<i>JJ Harrison (Property) Ltd v. Harrison</i> [2002] 1 BCLC 162, CA.....	224
<i>John v. Rees</i> [1970] Ch 345.....	183
<i>John Shaw & Sons (Salford) Ltd. v. Shaw</i> [1935] 2 KB 113 C.A.....	113, 250
<i>Keech v. Sandford</i> (1726) Sel Cas Ch 61	225
<i>MacDougall v. Gardiner</i> [1875] 1 Ch 13	250, 262
<i>MacConnell v E Prill & Co</i> [1916] 2 Ch57.....	258
<i>Menier v. Hooper's Telegraph Works</i> (1874) 9 Ch App 350.....	254
<i>Oliver v Dalglish</i> [1963] 1 WLR 1274	259
<i>O'neill v Phillips</i> [1999] 1 WLR 1092.....	260
<i>Pavides v Jensen</i> [1956] Ch 565.....	254
<i>Pender v Lushington</i> (1877) 6 Ch. D. 7	251
<i>Peter's American Delicacy Co. Ltd v. Health</i> [1939] 61 CLR 457.....	142
<i>Percival v Wright</i> [1902] 2 Ch 421.....	221
<i>Phipps v. Boardman</i> [1967] 2 AC 46.....	225
<i>Piervy V. S Mill & CO Ltd.</i> [1920] 1 Ch 77.....	222
<i>Prudential Assurance Co Ltd v. Newman Industries Ltd (No.2)</i> [1982] Ch 204.....	252, 253, 256
<i>Quin & Axtens Ltd v Salmon</i> [1909] AC 442	258
<i>Punt v. Symons & Co Ltd.</i> [1903] 2 Ch 506.....	222

<i>Re a Company</i> (No 007623 of 1984) BCLC 362	259
<i>Re a Company</i> (No 002623 of 1984) [1985] BCLC 80.....	260
<i>Re a Company</i> (No.002612 of 1984) (1986) BCC 99.....	260
<i>Re a Company</i> (No. 00370 of 1987), ex parte Glossop [1988] 1 WLR 1068	260
<i>Re Astec (BSR) plc</i> [1998] 2 BCLC 556.....	251
<i>Re Barings plc</i> (No.6) [2002] 1 BCLC 523.....	229
<i>Re Blue Arrow plc</i> [1987] BCLC 585	259
<i>Re British Sugar Refining Co</i> (1857) 3 K&J 408.....	259
<i>Re British Union for Abolition of Vivisection</i> [1995] 2 B.C.L.C. 1.....	132
<i>Re City Equitable Fire Insurance Co Ltd</i> [1925] Ch 407	226, 227
<i>Re D' Jan of London Limited</i> [1993] BCLC 646	228
<i>Re DR Chemicals Ltd</i> [1989] BCLC 383.....	260
<i>Re El Sombrero Ltd.</i> [1958] Ch. 900.....	132
<i>Re Elgindata Ltd</i> [1991] BCLC 959	269, 260
<i>Re Five Minute Car Wash Service Ltd</i> [1966] 1 WLR 745.....	260
<i>Re Haden Bill Electrical Ltd</i> [1995] 2 BCLC 280	259
<i>Re Horsely v. Weight Ltd.</i> [1982] 3 All ER 1045.....	114
<i>Re Little Olympian Each-Ways Ltd (No.3)</i> [1995] BCLC 4.....	259
<i>Re London School of Electrics Ltd</i> [1986] Ch 211.....	259
<i>Re Macro (Ipseich) Ltd</i> [1994] 2 BCLC 354.....	260
<i>Re Ringtower Holdings plc</i> (1989) 5 BCC 82.....	251, 259
<i>Re Sam Weller & Son Ltd</i> [1990] Ch 682.....	260
<i>Re Saul D Harrison & Sons Plc</i> [1995] BCLC 14.....	259, 260
<i>Re Smith & Fawcett</i> (1942) Ch. 304	221, 222
<i>Re Stewarts (Brixton) Ltd</i> [1985] BCLC 4	259
<i>Re Western Mines Ltd.</i> [1975] 65 DLR (3d) 307.....	143
<i>Regal (Hastings) Ltd v Gulliver</i> [1942] 1 All ER 378	221, 225
<i>Regentcrest plc v. Cohen</i> [2001] 2 BCLC 80	222

<i>Runciman v. Walter Runciman plc</i> [1992] BCLC 1084.....	222, 224
<i>Sharp v. Dawes</i> (1876) 2 QBD 26	132
<i>Simpson v Westminster Palace Hotel Co</i> (1860) 8 HL Cas 712	257, 258
<i>Smith v Croft (No.2)</i> [1988] Ch 114.....	258
<i>Soden v British and Commonwealth Holding plc</i> [1998] AC 298	258
<i>Taylor v. National Union of Mineworkers</i> [1985] BCLC 237.....	262
<i>Wood & Odessa Waterworks Co</i> (1889) 42 Ch D 636.....	258, 259

TABLE OF STATUTES AND REGULATORY MATERIALS

China

Company Law 1904	3, 4, 5
Company Regulation 1911.....	5
Company Law 1929.....	5
Art. 129.....	5
Company Law 1994	
Art.11.....	270
Art.43.....	121
Art 59	237
Art.60	237
Art.61	238
Art.62.....	239
Art.63	267
Art103.....	116, 193
Art.103(2).....	193
Art. 104.....	121, 124
Arts 104(4)&(5).....	216
Art.105 (1)&(3)	129
Art 111.....	270, 271
Chinese Company Law 2006	
Art.13	186
Art 16	145
Art.37.....	345
Art 54 (2).....	216
Art.54(4)	217
Art.54(6)	217
Art.98.....	117
Art.99.....	117
Art. 100	117
Art.101 (3)	126
Art103.....	148
Art106	137
Art.123.....	219
Art.149.....	243
Art 150.....	280
Art.152.....	280, 281
Art 217(2).....	96
Chinese Securities Law 1999	
Art.63.....	272
Art.207.....	272

The Opinions on the Standardisation of Shareholder General Meeting (Zhengjiangongsi [2000] No.53)

Art.19.....	124
Art.20.....	124
Art.21.....	124
Art.23.....	124
Art.25.....	124

Code of Corporate Governance for Listed Companies in China (Zhangjianfa [2002] No.1)

cl.5.....	132
cl.8.....	130
cl.10.....	141
cl.31.....	136
cl.45.....	195
cl.52.....	186
cl.54.....	189
cl.55.....	190
cl.56.....	194
cl.58.....	187
cl.59.....	176
cl.60.....	176
cl.61.....	176
cl.62.....	176
cl.65.....	176
cls.77-79.....	193

The Directive of the Articles of Association of Listed Companies, (Zhenjian, [1997] No.16)

Art 41.....	96
Art.48.....	130
Arts52.....	140, 141
Art.57.....	147
Art.58.....	147
Art.59.....	147
Art.60.....	147
Art.61.....	147
Art.65.....	144
Art.72.....	144
Art.80(1).....	241
Arts80(7)&(8).....	241
Art.81.....	244
Art.81(1).....	244
Art.81(2).....	244
Art.81(3).....	244
Art.81(4).....	244
Art.81(5).....	244
Art.82.....	241
Art.83.....	242
Art.85.....	244

Guidelines for Introducing Independent Directors (Zhengjianfa, [2001] No.102)

s. I (1).....	181
---------------	-----

s.I.(2).....	181
s.I(3).....	204
s.II.....	181
s.IV(1).....	191
s.IV(3).....	191
ss.V & VI.....	181

Several Regulations Regarding the Adjudication of Civil Compensation of Securities Cases on the Ground of Misrepresentation (S.P.C. [2003] No.2)

Art.2.....	273
Art 6.....	274
Art.7.....	273
Art.8.....	273
Art.9.....	273
Art.10.....	273
Art.17.....	274
Art.18.....	275
Art.19.....	275
Art.30.....	274

Regulations on Some Issues Concerning Trials for Corporate Dispute Cases (S.P.C. [2003] Draft)

Art.36-43.....	276
Art.44(1).....	276, 278
Art.44(2).....	277
Art. 45.....	278
Art.45(1).....	278

United Kingdom

Limited Liability Act 1855.....3

Companies Act 1862.....3

Companies Act 1985

s.4.....	114
s.9.....	114
s.14.....	257, 258
s.35(2).....	258
s.80.....	114
s.95.....	114
s.121.....	114, 142
s.135.....	114
s.142(1).....	122
s.238(1).....	114
s.239.....	114
s.241.....	114
s.241(A).....	114
s.242.....	114
s.282.....	198
s.293.....	128
s.303.....	114, 128, 142
ss.312-314.....	191
s.317.....	225
s.319.....	191
s.320.....	112
s.320(1).....	226
s.324.....	226
s.366.....	121
s.367(1).....	122
ss.368(1), (2) & (3).....	114, 122
s.369(1).....	128
ss.369(2)&(3).....	128
ss.369(4B)&(4C).....	128
s.370(4).....	132
s.371.....	123, 125
s.372.....	121
ss.372(1)&(2).....	138
s.372(2A).....	139
s.373(1).....	134
s.374.....	121
s.375.....	121
s.376.....	145
s.376(2).....	145
s.377.....	145
s.377(3).....	146
s.378(1).....	142
s.378(2).....	128, 142
s.378(3).....	142

s.379.....	128
s.381.....	121
s.386.....	114
s.388(3)	128
s.390 (A)	114
s.391(A).....	128, 142
s.459(1).....	259
s.461 (2)(a).....	260
s.461 (2)(b).....	260
s.461 (2)(c).....	260
s.461 (2)(d).....	260

Companies (Table A) Regulations 1985

Art.2	81
Art.36.....	121
Art.37.....	122
Art.38.....	128
Art.40.....	128
Art.46.....	134
Art.52.....	114
Art.54.....	134
Art.59.....	134
Arts.60&61.....	139
Art.64.....	198
Art.70.....	113
Arts.73-80.....	114
Art.88.....	182, 195
Art.91.....	182
Art.102.....	114

Electronic Communication Act 2000

s.15.....	128
-----------	-----

Insolvency Act 1986

s.81(1) (c).....	142
s.214(4).....	228, 229

Company Law Reform Bill

cl.136 & 137	140
cl.154(3)&(4).....	232
cl.155.	232
cl.156.	232
cl.157.	233
cl.158.	233
cl.159.	234
cl.160.	235
cl.161.	264
cl.239 (2) and (3).....	264
cl.239 (3).	264
cl.239 (4).	264
cl.240 (1).	264
cl.240 (2).	264

cl.240.	265
cl.242 (2).	264
cl.242(3).	265
cl.269.	146
cl.279	122
cl.279 (2)	122
cl.279 (3).	123
cl.280 (1)	123
cl.282.	123
cl.283(2)	128
cl.283(4)	128
cl.288(1)	129
cl.285	129
cl.286.	129
cl.299.	140
cl.311.	122
cl.313.	146
cl.315.	136
cl.316.	136
cl.415	115
cl.416	115
cl.420(1b).	115
cl.512.	147
cl.866(1).	154
cl.866(2).	154

Combined Code 2003

A1.	170, 178
A 1.1.	195
A2.	184
A3.2.	180
A.4.1.	187, 190
A.4.3.	190
B1.	192
B.1.1.	192
B1.1-1.4	192
B1.5.	192
B.2.	193
B.2.1	187
B.2.2.	193
C.2.4.	128
C 3.1.	187

CHAPTER 1

INTRODUCTION

1.1 Introduction

Corporate governance is essentially concerned with the 'separation of ownership from management', a concept which was first recognised by Berle and Means in 1932.¹

Berle and Means' theory contends that managers do not have the same interest and motivation as the owners of a firm to make full and efficient use of corporate assets.

This is fundamental to the question of corporate governance because it means that without performing sufficient monitoring or control, the managers, who are potentially left in a position of unchecked power, may cause serious negative effects on corporate value and the proper functions of capital markets. Berle and Means' theory drew attention to this vitally important corporate governance problem that has succeeded in attracting a great deal of public concern and exponential growth in academic research because it has wider implications and is critical to economic and social well-being.²

The recent spate of various corporate scandals, financial market failures and massive financial losses to shareholders in the UK, the US and elsewhere³ has demonstrated

¹ Berle, A. A. and G. C. Means, 1932. *The Modern Corporation and Private Property*. New York: Macmillan.

² Clarke, T., 2004. *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, ed. London; New York: Routledge, p1.

³ In the UK, a number of companies collapsed unexpectedly in the 1980s and 1990s. These included Polly Peck International, the Bank of Credit and Commerce International, British and Commonwealth, the Mirror Group News International and the Barings Banks. In each case, they appeared to be caused by corporate internal control failure and financial reporting and auditing irregularities. In 2001 to 2003, the collapses of several major US companies, including Enron, WorldCom, Tyco, and Adelphia, attracted attention and criticism for their corporate governance failures. In 1997, the Asian currency crisis which led to widespread stock market crashes was

repeatedly the severity of the corporate governance problem that may not only arise between managers and shareholders, but also between the controlling and minority shareholders or other stakeholders. Following these scandals, there is a growing consensus around the world that it is important to strengthen corporate governance to protect shareholders from expropriation by the dominant majority/controlling shareholders or managers. In addition, there is a wealth of literature on comparative corporate governance systems (with the bulk of it focussing on the major economies, mostly the UK, the US, Germany, and Japan), which distinguishes between one legal system (e.g. the outsider-based system in the UK and US) and others (e.g. the insider-based system in Germany and Japan).⁴ Most of these works have been carried out by a comparative analysis of the systems of corporate governance from legal and historical perspectives.⁵ Unfortunately, the outcomes of these works are limited to establishing the differences among two or more nations with respect to particular dimensions and fail to identify why these differences exist or how they emerged.

Recently, some empirical studies have broadened the scope of corporate legal research, suggesting that the 'quality' of corporate law, as measured by a number of indicators of anti-directors' rights and law enforcement, is an important determinant

attributed by many observers to the lack of accountability of major corporate groups in the crisis countries.

⁴ For example, Mayer distinguishes 'insider' and 'outsider' systems on the basis that the outsider-based system of corporate governance relies on active external markets for corporate control through mergers and takeovers of listed companies, whereas the insider-based system does not have an active market for corporate control, which is usually vested with large shareholders including banks. Mayer, C. 1994. Stock-markets, Financial Institutions and Corporate Performance, in N. Dimsdale and M. Prevezer (eds.), *Capital Markets and Corporate Governance*, Oxford: Clarendon Press. pp179-94.

⁵ Franks, J and C, Mayer, 1995. Ownership and Control, in H. Siebert ed., *Trends in Business Organisation: Do Participation and Cooperation Increase Competitiveness?* Tübingen: Mohr (Siebeck).

of corporate value and a country's economic growth.⁶ The benefits of these comparative law and empirical studies are substantial and obvious, but there is not much research on corporate governance in the Chinese context, especially in-depth research of the operation and evolution of actual systems of corporate governance in China and the way in which corporate governance may be improved in the light of the theories and practices of the West.

1.2 The Evolution of China's Corporate Law and Corporate Governance

The legal concept of the corporation emerged in China in the late 19th century. In 1904, the Qing government enacted the first Chinese company law which gave recognition to company incorporation (*gongsi*) and limited liability. The law, which was based on the UK Limited Liability Act 1855 and Companies Act 1862,⁷ and the Japanese Commercial Code 1899, contained 13 articles in 11 sections and stipulated issues such as company organisational forms, ways to report a company's funding, methods of business management and shareholder rights etc, but in much abbreviated form.⁸ The law also provided heavy penalties for embezzlement of company funds and prohibited organisers of a company from 'clandestinely obtaining profits'.⁹

⁶ See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, 1998. Law and Finance, *Journal of Political Economy* 106, 1113-1154.

⁷ The Limited Liability Act 1855 was an Act of the Parliament of the United Kingdom that first allowed limited liability for corporations in the UK. In *Salomon v A. Salomon and Co Ltd* [1897] AC 22 the House of Lord applied the Companies Act 1862 and affirmed that the members of a company had limited liability. See Mayson, S., D. French and C. Ryan, 2005, Mayson, French & Ryan on Company Law. London: Oxford University Express. pp55-60.

⁸ Kirby, W. C., 1995. China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China, *Journal of Asian Studies*. 54: 43-63. Zhu Ying, 1993, Lun Qing Mo De Jingji Fagui, *Historical Research*, 1993:5, 92-109.

⁹ Ruskola, T., 2000. Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective. *Stanford Law Review* 52: 1599.

However, Chinese corporate practice during the initial stage lacked the experience that Western governments and legal systems had accumulated in relation to the operation of joint-stock companies. Stock trading capital was very limited.¹⁰ Consequently, the law did not function in the way the government expected in terms of promoting industrialisation in China.

In addition, although the Qing government transplanted the corporate system from the West, the 1904 Company Law failed to adopt the fundamental principle of the equitable treatment of all shareholders. For example, under the 1904 Company Law, the Qing government attempted to control and interfere in corporate practice by establishing a number of government-controlled companies in which the government as a shareholder had the right to dispose of corporate assets and to appoint directors and managers, while other shareholders only had the right to receive dividends.¹¹ As a result, the companies or enterprises which were formed in the name of shareholders but managed by the government, eventually encountered many governance problems, such as mismanagement, misuse of funds, bribes, and corruption.¹²

¹⁰ Lin, Cyril. 2001. Private Vices in Public Places: Challenges in Corporate Governance Development in China, Discussed at the Policy Dialogue Meeting on Corporate Governance in Developing Countries and Emerging Economics organised by the OECD Development Centre and the European Bank for Reconstruction and Development, held at OECD headquarters on 23-24 April 2001. Available from <https://www.oecd.org/dataoecd/9/60/2443639.pdf> [Accessed 25 March 2005].

¹¹ Faure, D., 1996. Company Law and the Emergence of the Modern Firm, in: R.A. Brown, *Chinese Business Enterprise*, Routledge, London, Vol. IV, Chapter II; Wei, Y., 2003. *Comparative Corporate Governance: A Chinese Perspective*. Kluwer Law International.

¹² Dou, J., 1999. Research on the History of Corporate Ideology in China, pp21-22, citing in Wei, Y. 2002, The History of the Corporation in China, 6 *University of Western Sydney Law Review*, 95-122, at 100. William Goetzmann and Elisabeth Köll, 2003, *The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control*, Yale ICF Working Paper No.04-29. June 2004.

In 1911, the Qing government was overturned by the republican government. Three years later, the republican government enacted the Company Regulation (*gongsi tiaoli*) which was based on the German model of corporate legislation. The Regulation was more detailed compared with the 1904 Company Law.¹³ It had a considerable effect on the promotion of corporate activities. However, the republican government attempted to promote state capitalism and in 1929 a new Company Law was promulgated. The Company Law 1929 showed a strong desire to protect small shareholders and limit the rights of large shareholders. The law stipulated that in a company limited by shares, a shareholder's voting rights could not exceed one-fifth of the votes over total company issued shares, regardless of their actual shareholding,¹⁴ but the law provided an exemption for the shares owned by the government. To give government-owned shares the privilege in exercising voting rights restricted private enterprises from monopolising important economic sectors, such as the banking, railway, electricity and water supply industries.¹⁵ Nevertheless, the law was not well implemented as a result of the instability of the legal and political environment.¹⁶ The Company Law 1929 was revised in 1946, then abolished in 1949 by the Chinese communist government.

¹³ For example, under the *gongsi tiaoli*, corporations were required to produce a detailed company report at least once a year. The annual report had to contain a profit and loss statement, a written statement on the company's commercial situations, the exact loss and profit figure, the amount of money paid out as dividends and set aside for reserves as well as a balance of the company's assets and liabilities. See, *ibid*, Goetzmann and Köll.

¹⁴ Art.129, Company Law 1929

¹⁵ Shun, Z., 1982. The Speech at Farewell Party for the members of Tongmeng Society, in Complete works of Shun Zhongshen, Vol.2, 322; Wei, Y., 2003. An Overview of Corporate Governance in China. *Syracuse Journal of International Law and Commerce*, Vol.30 23-48.

¹⁶ Wei, Y. 1998. A Chinese Perspective on Corporate Governance. *10 Bond Law Review*. 363-76.

After the establishment of the communist government, China adopted a socialist economic system with centrally planned management. Property was only owned by the State or by Collectives, and there were no private corporations until 1979.¹⁷ China's economic system did not allow any of the normal market mechanisms found in Western countries to function.¹⁸ Both state-owned enterprises (SOEs) and collective-owned enterprises (COEs)¹⁹ were operated by an administrative body with directors appointed by the government, and were not independent legal entities.²⁰ The governance structure in both types of enterprises created problems of low efficiency, slow technological progress, sectoral disproportions and sharp fluctuation in growth rates.²¹ Unified public ownership did not provide any advantage to overcome the principal-agent problem because of information asymmetries, the lack of incentives for improving performance and liabilities for business failure.²² The legal system was devoid of corporate governance.

Economic reform in China started in 1978. The initial purpose of the reform was to transform the planned economy into a market economy. The most significant event for China's economic reform was the inception and growth of China's stock markets

¹⁷ Torbert states, "[I]n one sense, China has had a company law since 1979, but only one that applied to joint ventures between foreign and Chinese entities." See Preston M. Torbert, P. M., 1993. *China's Evolving Company Legislation: A Status Report*, 14 *Northwestern Journal of International Law & Business*. 1, at 2.

¹⁸ Han, A. M. 1996. *China's Company Law: Practicing Capitalism in Transitional Economy*, 5 *Pacific Rim Law & Policy Journal*, 457. On Kit Tam, 1999. *The Development of Corporate Governance in China*, Edward Elgar, p90.

¹⁹ The main distinction between SOEs and COEs did not lay in the extent of control of the enterprises, but rather the ownership of the enterprises. The SOEs were owned by the central government but controlled by the local government, but COEs were owned and control by the local government.

²⁰ Gan, Z.P. 1998, *The Law of Enterprise and Companies*. Beijing University Publishing House.

²¹ Lin, C., *op cit.* fn.10.

²² Under the planned economic system, the state or local government could never obtain complete and accurate information of the enterprise to adjust its 'perfect' plan. There was no effective monitoring and control from the owner of the property and market competition. Managers did not have incentive to improve the performance of enterprise without sharing the allocation of profits and resources. There was no any legal duty to impose on directors even if business failure.

which marked the new stage of China's market economy in the 1990s. Two domestic stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, were established in 1990 and 1991 respectively, and have experienced remarkable growth since then.²³ However, all trading companies in the stock market were initially regulated by the Provisional Regulations on the Administration of Issuing and Trading of Shares, enacted by the State Council in 1993.

The first Company Law of the People's Republic of China (hereafter, the CCL1994) was passed by the People's Congress on 29 November 1993 and came into force in July 1994. The CCL 1994 was influenced by the German model,²⁴ but it is also indicative of China's own distinctive features such as the dominance of state-owned shareholdings, the superior power of the shareholder meeting and weak minority shareholder protection, and a poor legal enforcement system, etc.²⁵ The role of the CCL 1994 in supporting the stock markets and the growth of China's economy has been limited and ineffective. Indeed, during the past 12 years, China's corporate legal framework and institutions have been challenged by several high profile scandals, such as Yinguangxia Industry²⁶ and D'Long Group²⁷, dubbed as "China's Enron",

²³ There were 1,391 Chinese companies were listed on the Shanghai and Shenzhen stock exchanges by the end of July 2005, compared to only 183 listed companies by the end of 1993. See Yang, X., 2005. *The Proposed Amendments to Company Law and the Development of China's Capital Market*. KING&WOOD PRC LAWYERS.

²⁴ For example, the two-tier board structure which requires employees' representative seating in the supervisory board was followed German system.

²⁵ See Wei, Y., *op cit*, fn.16. pp366-67.

²⁶ According to CSRC report, Yinguangxia fabricated a huge sum of 754 million yuan of profit by way of counterfeiting purchasing and selling contracts, exportation declaration statements, value-added tax invoice, duty-free documents, financial notes and business revenue fabrication from 1998 to 2001. See Yan Li, 2001, CSRC: Yinguangxia Fabricated 745m Yuan Profits, *People's Daily*, 06 September 2001, available at http://blog.issproxy.com/2006/02/china_enacts_new_governance_ru_1.html. [Accessed 25 April 2005]

²⁷ D'Long Group acquired stakes from three listed companies – Shenyang Hejin, Torch Automobile, and Xinjiang Tunhe in 1996 and manipulated their share price to unprecedented highs (between 1997 to 2004, each increasing in value by 600% to 1900%) and used them to raise cash from investors and obtain bank loans. In May 2004, the D'Long collapse resulted in RMB 57 billion debts and several billion RMB in losses for stock market investors.

which had a considerable effect on China's stock markets. Although the Chinese government has emphasised that the reform of corporate governance structures is the core of the bid to establish a modern corporate system in Chinese enterprises, these corporate scandals indicate that the existing legal and financial system may not be efficient and effective for China's economic development. Indeed, there are many governance issues, such as shareholder rights, directors' duties, concentrated ownership structure, and enforcement of the laws, which have not been properly constructed to solve agency problems in China's corporate practice.

In 2000, China's government aimed to counter such weaknesses by providing various comprehensive corporate governance rules and mechanisms.²⁸ These rules and mechanisms, which were heavily imported from the OECD Principles on Corporate Governance and the UK Combined Code for the listed companies, sought to marry the best international standards with China's corporate practice.²⁹ However, they are apparently inconsistent with the CCL 1994 in various aspects, and in practice appear to have had limited impact in mitigating agency costs and improving economy efficiency. The CCL 1994 was amended at the 18th Meeting of the Standing

D'Long's scandal was dubbed by the People's Daily Online as the "biggest financial securities scandal" in Chinese history, involving alleged stock manipulation by management. See Hui Li, China – Measurement Problems, CG Watch 2004. p39. Available at http://www.empea.net/docs/research/thirdparty/CLSA_ACGA_CGWatch2004.pdf. Xinhua, 2006. Delong Mansion in Shanghai Put for auctions in Late January, *People's Daily Online*, available at http://english.people.com.cn/200601/07/eng20060107_233521.html. [Accessed 26 May 2006].

²⁸ For examples, "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies", Zhengquanfa [2001] No. 102. (hereafter, the Guidelines) Available from <http://www.csrc.gov.cn/en/jsp/detail.jsp?inford=1061947864100&type=CMS.STD> [Accessed 25 April 2006], and "Code of Corporate Governance for Listed Companies in China". Zhengjianfa No.1, [2002], (hereafter the CCGC) available from <http://www.csrc.gov.cn/en/jsp/detail.jsp?inford=1061968722100&type=CMS.STD>. [Accessed 25 April 2006]

²⁹ See Allen, J. and F. Roy, 2001. *Corporate Governance in Greater China: A Comparison between China, Hong Kong and Taiwan*. Asian Corporate Governance Association.

Committee of the Tenth People's Congress on 27 October 2005 and came into force on 1 January 2006. As expected, the amended Company Law (hereafter, the CCL 2006) has introduced comprehensive Western corporate governance rules and mechanisms, including the cumulative voting system, the role and responsibilities of directors and supervisors, and shareholder derivative action, etc. However, whether they can function in the same way as they do in western countries remains largely untested.

1.3 Objectives of the Research

Corporate governance refers to a system consisting of a set of laws, regulations, listing rules and voluntary best practices that enable corporations to achieve their objectives, to attract investments, to improve corporate performance, to meet both legal obligations and general social expectations.³⁰ In this thesis, the main research aim is to explore how the corporate governance system was formed and evolved in China compared with the UK and to identify the key factors that have significantly influenced the health of corporations and the institutional environment for better corporate governance in China. This constitutes the theoretical contribution of the study and will entail an extensive comparative study of the countries' corporate legislation, securities laws and bylaws dealing with some specific issues of corporate governance. This will reveal the fact that the transplanting of legal rules and regulations from one country to another does not necessarily result in a good

³⁰ This definition of corporate governance is due to Haly J. Gregory, in *The Globalisation of Corporate Governance*, Weil, Gotshal & Manges: New York 2003, Law Firm Publication, p.5. The term 'corporate governance' has many definitions and some others will be discussed in Chapter 2.

corporate governance system being established. Such legal rules and regulations are only effective in a country if they are properly enforced, which in turn fosters economic growth. The detailed objectives that guide the research process are:

- to review and analyse corporate governance theories and set out the major theme of the research
- to examine the key issues which may have significantly influenced the effectiveness of corporate governance in China compared with the UK
- to identify and explore the relationship between the current Chinese corporate governance system and corporate performance
- to suggest some solutions to the problems of creating a strong corporate governance environment for the success of China's economic reform.

1.4 Scope and Contribution of the Research

Following the nature of the research objectives, the scope of the research mainly focuses on the internal mechanisms of corporate governance because they form an important part of basic company law, corporate governance regulations and best practices in both China and the UK.³¹ In each chapter, we examine the various theoretical aspects including the economic, financial and legal environments within which corporate governance has developed in China and the UK. We compare the various aspects of the internal control mechanisms including the ownership structure, the shareholder general meeting, boards of directors, directors' legal duties and

³¹ For an explanation of what is meant by 'internal mechanisms' of corporate governance see section 2.2 of Chapter 2.

enforcement between China and the UK and discuss basic corporate governance principles in the context of their efficacy as governance mechanisms. Where applicable, empirical data are examined and analysed to demonstrate how corporate governance operates in China and the UK, and this allows us to penetrate many puzzling features of the Chinese corporate governance system by comparisons and contrasts with the UK. Finally, we draw together the many different facets of corporate governance that may have significantly influenced the effectiveness of corporate governance in China to examine empirically the relationship between corporate governance structures and corporate performance. To this end, this thesis will provide a wide range of recommendations to the Chinese government to improve the Chinese corporate governance system.

1.5 Structure of the Research

The thesis is structured as follows. Chapter 2 reviews the definition of corporate governance and the relevant theories of corporate governance to establish the key themes of the thesis to be investigated. Chapter 3 explains the methodology used in the thesis and describes the survey procedure and data collection process. Chapter 4 examines the distinctive features of the ownership structure of Chinese publicly listed companies compared with the UK and explores the specific ownership structure issues that can be linked to the development of good corporate governance in China. Chapter 5 provides a detailed comparative discussion of the legal and technical rules of shareholder meetings between China and the UK and assesses whether the actual

functioning of the shareholder meeting provides shareholders with sufficient powers to participate and engage in the corporate decision making process in China. Chapter 6 investigates the board systems and presents both legal and empirical findings on how boards are structured and function to ensure the efficient running of companies in China compared with the UK. Chapter 7 critically examines and analyses the quality of company law and securities regulations and assesses whether the legal duties can be effectively allocated on the directors and to what extent shareholders can be efficiently protected in China compared with the UK. Chapter 8 examines the role of shareholders in enforcing directors' duties and the current development of company law in respect of shareholder legal actions and assesses the uncertainty and ambiguity surrounding the civil proceeding regimes in China compared with the UK. Chapter 9 supplements our comparative analysis with an empirical investigation into the relationship between corporate governance and corporate performance in China. Naturally, this is the section that identifies the key factors that determine an effective corporate governance system. Chapter 10 summarises the main findings of the thesis and provides some suggestions for the Chinese government to improve the Chinese corporate governance system.

CHAPTER 2

CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES

2.1 Introduction

This chapter begins with an overview of the definition of corporate governance and the mechanisms of corporate governance. Section 2.3 then proceeds to a discussion of particular corporate governance problems from a variety of theoretical backgrounds, including property rights theory, incomplete contracts theory, agency versus organisational theories, the legal theory of director's duties and enforcement, and shareholder versus stakeholder theories. Then, section 2.4 provides a broad view of the relationship between corporate governance and corporate performance, and examines the contribution of some important internal governance mechanisms in dealing with corporate governance problems.³² Section 2.5 analyses the corporate governance in developing countries/transition economies. Finally, this chapter concludes by introducing the key themes of the thesis derived from the theoretical and empirical framework reviewed in this chapter.

³² Chapter 9 gives a detailed literature review on the relationship between corporate governance and corporate performance.

2.2 Corporate Governance and Corporate Control Mechanisms

2.2.1 Definition of Corporate Governance

Crucial to an understanding of the inherently distinctive conceptualizations of 'corporate governance' is the recognition that there is no single definition which has been universally accepted because there are substantial differences among countries and many factors have driven different institutions, interest groups and individuals with different perspectives to formulate 'a' definition of corporate governance.³³ The following definitions which are selected from the contemporary corporate governance debates are the most influential with regard to the development of corporate governance systems in different jurisdictions.

A basic definition of corporate governance, which has been frequently quoted or paraphrased, is provided by the Cadbury Report (1992), and states that

“[C]orporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.”³⁴

³³ See Solomon J. and A. Solomon, 2004. *Corporate Governance and Accountability*. John Wiley & Sons Ltd. p12, also see The Encyclopaedia about Corporate Governance. Available from: <http://www.encycogov.com> [Accessed 5 January 2006].

³⁴ See Report of the Committee on the Financial Aspects of Corporate Governance and the Code of Best Practice (hereafter 'the Cadbury Report'). London: Gee Publishing, December, 1992, at paragraph 2.5.

This definition provides a view of corporate governance as a set of internal arrangements to govern the relationship between the shareholders, board of directors and management of the corporation. However, this definition has been criticised as being too narrow. Many commentators argue that the concept of corporate governance should also encompass the relationship of the corporation to stakeholders and society.³⁵

A broader definition of corporate governance, provided by the OECD, states that:

“[C]orporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.”³⁶

³⁵ See Freeman, R. E. 1984, *Strategic Management: A Stakeholder Approach*, Ballinger, Boston, MA; Shleifer, A. and R. W. Vishny 1997. A Survey of Corporate Governance. *Journal of Finance*, 52, 737-783; Deakin, S. and A. Hughes, 1997. Comparative Corporate Governance: An Interdisciplinary Agenda, in Deakin, S. and A. Hughes, ed. *Enterprise and Community: New Directions in Corporate Governance*. Blackwell Publishers: Oxford, p2.; and Rose, C., 2004. Stakeholder Orientation vs. Shareholder Value – A Matter of Contractual Failures, *European Journal of Law and Economics*, 18: 77-97.

³⁶ OECD Principles of Corporate Governance (2004), p11. Available from: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>. [Accessed 22 February 2006]

This definition serves to illustrate that an effective corporate governance system should improve economic efficiency. The purpose of this definition is intended to assist the government in its efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance, and to provide suggestions for the stock exchange, investors, corporations, and other parties that have an interest in the process of developing good corporate governance.

By examining various definitions of corporate governance, Solomon and Solomon suggest that “corporate governance is the system of checks and balances, both internal and external to companies, which ensure that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity”.³⁷ This definition advocates that a corporate governance framework should be designed from both the internal and external aspects of a company to demonstrate a wide range of corporate accountability to all stakeholders and society at large.

2.2.2 Corporate Control Mechanisms

Despite the increasing amount of contemporary literature on corporate governance, there is considerable variation in its definition. Corporate governance embraces the combination of laws, regulations, listing rules, voluntary private sector practices, along with typical capital market and ownership features. Differences in the liquidity

³⁷ see Solomon J. and A. Solomon, *op cit.* fn33. p14.

of the capital market and ownership structure will shape different patterns of participation in corporate governance. For example, various studies indicate that the effectiveness of internal monitoring mechanisms and the market for corporate control is largely determined by the ownership structure of the corporation.³⁸ Different ownership structures are associated with different incentives for shareholders to monitor and scrutinize management decision making. In countries with a dispersed ownership structure, shareholders will often have little incentive to monitor management because the tiny stake owned by each individual gives them limited power to do so.³⁹ By contrast, in countries with more concentration of ownership and voting power the major shareholders have incentives and power to monitor managers, since cash flow and control interests equip shareholders with the necessary power to influence the decision-making process and to assure profit maximisation. However, the exploitation of the interests of minority shareholders by the large blockholders or majority shareholders is extensive.⁴⁰ In addition, given the public good characteristic associated with costly monitoring of managerial actions, free-rider problems and information asymmetries have also indubitably limited the incentives of individual shareholders to actually monitor and discipline the management.⁴¹ Furthermore, as regards the legal aspects of corporate governance, Shleifer and Vishny argue that the

³⁸ Morck, R., A. Shleifer, and R. Vishny, 1988. Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics* 20, 293-316; Shleifer, A., and R. Vishny, 1986. Large Shareholders and Corporate Control. *Journal of Political Economy* 95, 461-488. McConnel, J.J. and H. Servaes, 1990, Additional Evidence on Equity Ownership and Corporate Value, *Journal of Financial Economics* 27, 595-612.

³⁹ Berle and Means, *op cit*, fn.1. Also see, Shleifer, Adrei and Robert W. Vishny 1997. *op cit*. fn.35. Pettet, B. 2005. *Company Law*, 2ed. Harlow: Pearson Longman, p55.

⁴⁰ Klaus Gugler, 2001, *Corporate Governance and Economic Performance*, Oxford University Press. p6.

⁴¹ Ezzamel, M. and R. Watson, 2005. Boards of Directors and the Role of Non-executive Directors in the Governance of Corporations, in K.Keasey, S. Thompson and M. Wright ed. *Corporate Governance: Accountability, Enterprise and International Comparisons*. John Wiley & Son Ltd. p97.

ownership structure and the level of stock market development may be determined by the quality of the protection of shareholders and creditors.⁴² La Porta et al confirm this proposition empirically, showing that companies domiciled in countries with weak investor protection may have concentrated ownership as a substitute for legal protection.⁴³

It is clear that corporate governance mechanisms have developed over time in a specific economic, legal and political environment within a country, and there is no single mechanism that can provide a solution for the entire set of corporate governance problems, but rather certain mechanisms are interdependent and sometimes substitutes or complements.⁴⁴ This inevitably means that when we compare one country's corporate governance system with another's, it is necessary to consider not only the mechanisms or the best practices reflected in guidelines and the corporate governance code, but also the underlying ownership structure, voting powers and incentives, and related laws and judicial enforcement.

2.2.3 Summary

Although corporate governance can be defined in a variety of ways, generally it involves a set of internal and external mechanisms acting as a check on managerial self-serving behaviour and as a means of promoting the efficient operation of the

⁴² Shleifer and Vishny, 1997, *op cit.* fn.35.

⁴³ see La Porta et al, 1998. *op cit.* fn6.

⁴⁴ Kevin Keasey, Steve Thompson and Mike Wright, 2005. Introduction, in K. Keasey, S. Thompson and M. Wright. *Corporate Governance: Accountability, Enterprise and International Comparison*, eds. John Wiley & Sons, Ltd. p1.

company for the benefit of its shareholders and other stakeholders, and the company's contribution to society at large. Pettet explains that the internal mechanisms will involve "the extent to which the law puts in the hands of shareholders the ability to control or influence the board of directors, through voting in the meetings, or perhaps by the use of litigation to enforce the legal duties owed by directors" and the external mechanisms include the existence of the regulatory and institutional environments, as well as market mechanisms such as the disciplining effect of the possibility of a hostile takeover.⁴⁵ However, in China, as the market for corporate control is at its most primitive stage, and most mergers and acquisitions are policy-driven and controlled by the government, hostile takeovers are largely non-existent in publicly listed companies.⁴⁶ In addition, the managerial labour market does not function due to governmental administrative interference in the nomination process. Zhang criticises the problem of selecting and appointing management, stating that since the bureaucrats have no incentive to search for good directors or managers, the selection is often based on personal connections (*guanxi*) rather than merit.⁴⁷ Furthermore, since banks, securities and investment funds management firms are mainly established by the state, or government agencies, or state-controlled companies, the capital markets is far from being mature.⁴⁸ Thus, the role of external governance mechanisms in China is negligible.

⁴⁵ See Pettet, *op cit*, fn.39, p54.

⁴⁶ In October 2002, the CSRC released a M&A code for listed companies which clarified rules regarding tender offers and the nature of administrative approval needed for deals. See Stephen Green, 2003. *Better Than A Casino: Some Good News from the Frontline of China's Capital Market Reforms*. Asia Programme Working Paper, No.6.

⁴⁷ Zhang, W., 1999. Development in Chinese Corporate Finance and its Implication for Ownership Reform, *Asia Pacific Financial Development*, pp183-205, Routledge, London.

⁴⁸ Stephen Green, *op cit*. fn.46.

2.3 Theories of Corporate Governance

2.3.1 Property Rights Theory

Economic property rights have been broadly discussed for many decades. The pioneering paper on property rights was written by Coase, who assumed that property rights arose from mere use.⁴⁹ The Coase theorem gave rise to a fierce debate relating to the definition, allocation and protection of property rights among economic theorists. Alchian argues that Coase's theorem leaves unsolved the role played by other types of economic rights than use rights, such as income rights, rights to exclude or rights to alienate assets.⁵⁰ Alchian and Demsetz argue that the position of shareholders in a company is not based on an idea that they "own" the company, but stems from the supposition that they are its residual claimants.⁵¹

Demsetz also argues that property rights cannot simply be thought of as the possession of some vector of use rights over an asset, but also the right of sale or disposal of assets.⁵² Hart's property rights approach takes a step towards emphasising the importance of residual control rights over assets and argues that the essence of ownership is not the right to residual income or responsibility for monitoring, but

⁴⁹ For example, Coase takes the market mechanism as the benchmark and then examines whether an entrepreneur should form a firm or rely on the market mechanism in utilizing resources. See Coase, Ronald H. 1937. The Nature of the Firm, 4 *Economica* pp386-405. Coase also uses the condition of zero transaction costs as the benchmark and then explores how resources would be utilised both in this world of zero transaction costs and in the real world. See Coase, R. H., 1960. The Problem of Social Cost, *Journal of Law and Economics*, vol. 3, pp1-44.

⁵⁰ Alchian, A. A., 1965. Some Economics of Property Rights, *II Politico*, 30: 816-829.

⁵¹ Alchian, A. and H. Demsetz 1972. Production, Information Costs and Economic Organization, *The American Economic Review*, 62(5), 777-95

⁵² Demsetz, H. 1988. Profit as a Functional Return: Reconsidering Knight's Views, in Harold Demsetz, *Ownership, Control and the Firm: The Organisation of Economic Activity*, vol.1, Oxford and New York: Basil Blackwell, pp236-247.

rather the right to make decisions.⁵³ Indeed, the rights of sale or disposal of assets and the residual right of control over an asset are always the ultimate expression of an investor's ability to exercise control representing an essential part of what it means to own something.

According to the property rights theory as propounded by Furubotn and Pejovich, property ownership rights in a firm may be categorised as: "the right to use an asset, the right to enjoy an income flow generated by the asset, and the right to change an asset's form and substance."⁵⁴ Blair concludes that ownership normally entails "the right to possess or dispose of the asset, the right to use the asset, the right to claim the proceeds from the sale of the asset or the returns generated by the asset, and the responsibility for bearing certain risks associated with possession and control of the asset".⁵⁵ Rehman and Perry suggest that the shareholder rights in a modern corporation can be divided into two main bundles or categories.⁵⁶ The first bundle of rights derives from the legal aspects of ownership that includes "the right to information on the performance of the company, the right to an equitable distribution of profits in the form of the dividends, the right equitably and proportionately to participate in decision making, and the right to sell one's shares".⁵⁷ The second bundle of rights is concerned with the separation of ownership and management.⁵⁸ Because

⁵³ Hart, Oliver. 1989. An Economist's Perspective on the Theory of the Firm, *Columbia Law Review*, 89: 1757-74.

⁵⁴ Furubotn, E. and S. Pejovich, 1974. *The Economic of Property Rights*, Cambridge, Mass: Ballinger Publishing.

⁵⁵ Blair, M. 1995. *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*, the Book Institution Washington D. C.

⁵⁶ Rehman, S. S. and F. V. Perry, 2005. *Global Convergence of Corporate Governance Systems and Competitiveness*, Occasional Paper Series, the GW Centre for the Study of Globalization. Available from: <http://gstudynet.com/gwscg/publications/OPS/papers/CSGOP-05-35.pdf>. [Accessed 26 January 2006].

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

of the separation of ownership from control in a large company, it is impossible to allow all shareholders rationally to participate in the day-to-day management decision making process. The shareholders, especially minority shareholders of a company who wish to ensure the company's directors are sufficiently accountable to them need to have effective monitoring and incentive systems in place that provide a set of corporate governance mechanisms, such as "shareholder meeting procedures, election of directors; and approval of basic corporate actions", to solve the agency problem.⁵⁹ It is clear that the important empirical investigation by Berle and Means into ownership structures in public companies in the United States subjected the second bundle of rights to closer examination.

An understanding of property rights is a prerequisite for shareholders to exercise their rights as owners in a firm. Demsetz suggests that property rights derive their significance from the fact that they help people to form those expectations which they can reasonably hold in dealing with others.⁶⁰ Property rights confer a right on individual property owners to pursue their own self-interests in a competitive market. Analysing property rights within a firm helps to ensure that the management is generating shareholder value and aligning the interests of shareholder "owners", who provide the capital, and corporate managers who run the company.

Property rights define governance structures so that the shareholders' role in the

⁵⁹ *ibid.*

⁶⁰ Demsetz, H., 1976. Toward a Theory of Property Rights, *The American Economic Review*, Vol.57. 347-359, at 348.

governance structure of a company appears to be viewed as ancillary to their claim on its resources. They have certain powers over the affairs of the company, exercisable by them collectively through their right to vote on resolutions at shareholder meetings, for example. The most important is their ability to appoint and remove the members of the board of directors.⁶¹ Property rights tend to influence incentives and the behaviour of shareholders in a modern corporation.⁶² Shareholders' voting rights provide them with some economic incentive against mismanagement. If management fails to maximise the shareholders' residual claim, the aggregated votes might restrict managerial discretion or even vote out the incumbent board of directors.⁶³

Nevertheless, clearly defined ownership rights do not mean that those rights are distributed efficiently and consistently enforced because of the separation of ownership and control in the large modern corporation.⁶⁴ For example, the exercise of a particular right may depend on a decision process which many individuals share, such as the use of majority voting and proxy voting. Alchian and Demsetz observed that "the right to vote may be exercised individually, but it is the pattern of votes by many individuals that determines the way in which a right to use a resource will be exercised".⁶⁵ In addition, directors can bundle shareholders' decisions on particular corporate actions, such as removing or retaining incumbent directors, where a proxy

⁶¹ Their right to appoint or remove directors is a common rule adopted by many jurisdictions, e.g. Table A, arts 73 to 80, s.303 of Companies Act 1985 in the UK.

⁶² Coleman, J. 1966. Reward Structures and the Allocation of Effort in P. F. Lazarsfeld and N. W. Henry, eds. *Reading in Mathematical Social Science*. Cambridge: MIT Press, pp.159-73.

⁶³ Easterbrook, F. H. and D. R. Fischel, 1989. The Corporate Contract, 89 *Columbia Law Review*, pp1416-48.

⁶⁴ See Berle and Means, *op cit.* fn 1, p8.

⁶⁵ Alchian, A. A. and H. Demsetz, 1973. The Property Rights Paradigm, *The Journal of Economic History*, pp173-83.

reason for this is that when the state is the owner of the firm, bureaucrats are delegated with ownership rights to control the firm but bear no financial risk for their intervention.⁶⁷ Such pursuit of self-interest, or “shirking”, becomes a dominant theme as a typical cost associated with the agent-principal relation, and indicates that the central problem of corporate governance in China nonetheless arises out of the separation of ownership and control, but cannot be simply explained by the Berle and Means’ theory - the conflicts of interest between managers and shareholders in the Anglo-American phenomenon.

Therefore, to understand the aspects of corporate governance in China it is vital to investigate how the Chinese publicly listed companies are structured; who controls the Chinese publicly listed companies, how they are different from other jurisdictions and whether the conflicts of interest between the controlling shareholders and minority shareholders which is created by the existing ownership structure appears to be an important problem in the Chinese corporate governance system. These issues are the subject of investigation in Chapter 4.

2.3.2 Incomplete Contracts Theory

The theory of incomplete contracts, originally based on transaction cost arguments, contends that contracting parties often fail to write a ‘comprehensive’ contract in the sense that it will specify all parties’ obligations in all future states of the world, to the

⁶⁷ Zhang, W., *op cit.* fn. 47.

fullest extent possible.⁶⁸ Based on the observation that it is either impossible or too expensive to foresee, define, enumerate and contract upon all circumstances and contingencies which may occur in the future,⁶⁹ Grossman and Hart and Hart and Moore proposed the theory of incomplete contracts, which underscores the importance of the residual rights of control: the rights to decide the disposition of the assets under the contingencies that are not specified in a contract.⁷⁰ Hart argues that “contractual incompleteness” appears to be important to understanding why the structure of governance matters.⁷¹ Similarly, Maskin and Tirole note that contractual incompleteness is crucial to explaining the boundaries of the firm, corporate control and the governance system.⁷²

According to the theory of incomplete contracts, shareholders may utilise ex post bargaining power to judge for themselves whether the directors are using their managerial powers for their own benefit at the expense of the company. However, the allocation of bargaining power can be affected by the choice of an appropriate governance structure (e.g. the allocation of ownership rights or voting rights). For

⁶⁸ Hart, Oliver, 1995, *Firms Contracts and Financial Structure*, Clarendon Press, Oxford. p22.

⁶⁹ According to Tirole, the contracts may be incomplete for the following three reasons: *Unforeseen contingencies*: “parties cannot define ex ante the contingencies that may occur (or actions that may be feasible) later on. So they must content themselves with signing a contract such as an authority or ownership relationship that does not explicitly mention those contingencies, or with signing no contract at all”. *Cost of writing contract*: “even if one could foresee all contingencies, they might be so numerous that it would be too costly to describe them in a contract”. *Cost of enforcing contracts*: “court must understand the terms of contract and verify the contracted upon contingencies and actions in order to enforce the contract.” See Jean Tirole, 1999, *Incomplete Contracts: Where Do We Stand?* 67 *Econometrica*, pp741-81, at 743-44.

⁷⁰ Grossman, S. J. and Hart, O. 1986. The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration. *Journal of Political Economy*, 94(4), pp691-719. Hart, O and Moore, J. 1999. Property Rights and the Nature of the Firm. *Journal of Political Economy*, 98(6), pp1119-1158.

⁷¹ Hart states that “governance structure matters when some actions have to be decided in the future that have not been specified in an initial contract: governance structure provides a way for these actions.” See Oliver Hart, 1995. *Corporate Governance: Some Theory and Implications*. *The Economic Journal*, Vol.105, pp678-89, at 679.

⁷² Eric Maskin and Jean Tirole, 1999. Unforeseen Contingencies and Incomplete Contracts, *Review of Economic Studies*, 66, pp89-114.

example, the *de facto* separation of equity ownership from control changed the whole legal concept of property in a modern corporation and affected the investment incentives of the involved parties. When ownership rights are broken up, many shareholders are totally passive since the residual rights of control for those shareholders are attached only to their certificates and ownership is so widely dispersed that the typical shareholder may not exercise real power to oversee managerial performance. This issue has been labelled as the 'collective-action problem' or the 'free-rider problem'.⁷³

Forbes and Watson study the role of shareholders in a modern corporation and argue that the real problem is not the lack of formal powers, but rather of incentives to act and the difficulties in using what powers they have.⁷⁴ The incentive problem arises because of the 'public good' characteristic of monitoring and control activities. Typically, each shareholder has only a tiny proportion of the firm's equity. In the absence of an easily enforceable collective arrangement, it is impossible to exclude 'free riders' from the benefits arising from improved monitoring by an individual shareholder. Benefit, but not costs, will be shared with other 'free-riding' shareholders and, in consequence, the expected benefits accruing to the individual who incurred the full monitoring costs will only be in proportion to his or her equity holding. Similarly,

⁷³ The collective-action problem or the free-rider problem will inevitably arise because appropriate shareholder initiatives may benefit all shareholders, but only one or a small group has to pay all the costs. See R. Monks and N. Minow, 2004. *To Sell or Not to Sell: the Prisoner's Dilemma*, in R. Monks and N. Minow, *Corporate Governance*, Blackwell Publishing. p129. Fisch, J. E., 1994, Relationship Investing: Will It Happen? Will It Work?, *Ohio State Law Journal*, Vol.55, No5, 1009.

⁷⁴ Forbes, W and Watson, R. 1993. Managerial Remuneration and Corporate Governance: A Review of the Issues, Evidence and Cadbury Committee Proposals. 23 *Accounting and Business Research*, pp331-338.

Stiglitz argues, as with all public goods, that with the absence of a collective provision there may be too little recourse devoted to ensuring that sufficient monitoring takes place.⁷⁵ Griffiths emphasises that in a public company, the votes of any one shareholder are unlikely to carry much weight and shareholders face serious practical difficulties in acting collectively. He points out that a body as large and diverse as the shareholders of the typical public company cannot readily initiate activity and function as a decision-making organ, and this problem is compounded by each shareholder's lack of incentives to take the initiative.⁷⁶ As a result, if the shareholders are dissatisfied, their most likely course of action is to sell their shares and invest the proceeds elsewhere.

As observed, since complete contracts cannot be written, there has to be a mechanism to adapt the initial investment contract (e.g. company's memorandum, articles of association and by-laws) to changing circumstances or future contingencies of the corporation through a renegotiation process. Hart argues that contractual incompleteness matters because the renegotiation process imposes several transaction costs: some of these are ex post costs, incurred at the renegotiation stage itself, and other are ex ante costs, incurred in anticipation of renegotiation.⁷⁷ Although any fundamental issues and developments affecting the strategic direction or structure of the company will usually require shareholders' consent in annual shareholders'

⁷⁵ Stiglitz, J. E. 1985. Credit Markets and the Control of Capital, *Journal of Money, Credit and Banking*, 17(2):133-152.

⁷⁶ Griffiths, A., 1995. Shareholding and the Governance of Public Companies, in Saleem Sheikh & William Rees, ed. *Corporate Governance & Corporate Control*. Cavendish Publishing. p61.

⁷⁷ Oliver Hart, 1995. *op cit.* fn.68. p25.

meetings, voting as a safeguard for the residual risk-bearers of a corporation against *ex post* expropriation by the management is costly and often ineffective.⁷⁸ For example, on the general voting principle, “one share-one vote” and various forms of majority voting rules as the decision mechanisms must be followed in the voting process. On the one hand, because the equity shareholding is widely dispersed, it is impossible to expect all shareholders to participate in the renegotiations.⁷⁹ On the other hand, shareholders with small stakes are likely to be “rationally apathetic” when it comes to acquiring the information necessary for taking informed conclusions.⁸⁰ In practice, voting rights are normally exercised by the boards on shareholders’ behalf through a proxy voting process. However, in such cases, representations are more likely to be symbolic because most of resolutions are put forward by boards themselves.⁸¹

Despite the extensive evidence showing the importance of voting rights guided by incomplete contracts theory, the economic literature has rarely been able to analyse the legal rules that govern shareholder voting and to identify how the voting rights are exercised in the various legal systems. Easterbrook and Fischel argue that “the states’ legal rules generally provide investors with the sort of voting arrangement they could find desirable if contracts could be arranged and enforced at low cost.”⁸² It is worth

⁷⁸ *Ibid.*

⁷⁹ Bebchuk, Lucian Arye, 1989. Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 *Harvard Law Review*, pp1820-1860.

⁸⁰ Theodor Baums, Osnabrück. Shareholder Representation and Proxy Voting in European Union: A Comparative Study, in Hopt et al, 1998, *Comparative Corporate Governance*, Clarendon, p547.

⁸¹ On Kit Tam, *op cit*, fn.18, p27.

⁸² Frank H. Easterbrook and Daniel R. Fischel, 1983. Voting in Company Law. *Journal of Law and Economic*, Vol. 26, pp395-427, at 398.

noting at this point that the legal rules and contractual arrangement that determine who votes, on what issues, and using what procedures would be significant and examining the practices of the legal rules might provide helpful insights in relation to countries' corporate governance issues. Chapter 5 of the thesis provides a detailed comparative discussion of the legal and technical rules of shareholder meetings between China and the UK and assesses whether the actual functioning of the shareholder meeting provides shareholders with a platform which allows them to participate and engage in the corporate decision making process in China.

2.3.3 Agency Theory Versus Organisational Theory

According to the property rights theory of the firm, the reasons why shareholders should be involved in corporate control are straightforward. Putterman and Keoszner argue that the works on property rights and ownership by many theorists assume that the manager of the firm is the owner and residual claimant. However, in modern corporations, the agency problem has existed as long as shareholders have allowed others to act on their behalf. As Adam Smith observed,

“[D]irectors... being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own ...Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company”.⁸³

⁸³ Quoting from Adam Smith, 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations*, p700.

Jensen and Meckling draw attention to the principal-agent problem in the public corporation and explore 'agency theory'⁸⁴. They postulate that shareholders are the principals, managers are their agents in a firm, and management is the "continuous process of negotiating contracts".⁸⁵ Shareholders enter into contracts with management, which create an agency relationship between shareholders and directors. They define the problem of agency as:

"... a contract under which one or more persons (the principals) engage another (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interests of the principal..."⁸⁶

This statement emphasises that a firm is simply a nexus for contracting relationships, creating agency costs because of the divergence of interest between management and shareholders. In such cases, as Jensen and Meckling observed, the interests of the agent are likely to deviate from those of the principal. This deviation of interests requires the principal to employ various mechanisms to align the conflicts of interest and to monitor the behaviour of agents. Dealing with the agency problem between shareholders and directors, Jensen and Meckling suggest that shareholders have to prevent the directors from diverging from the shareholders' interests by incurring

⁸⁴ Jensen, M. and W. Meckling, 1976. Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure, *The Journal of Financial Economics*, 3: pp305-360.

⁸⁵ Alchian, A. and H. Demsetz, 1972, *op cit.* fn.51.

⁸⁶ See Jensen and Meckling, *op cit.* fn.84.

monitoring costs to mitigate the directors' aberrant behaviours and by devising appropriate incentives for directors.⁸⁷ Jensen and Meckling argue that agency costs – the monitoring costs by the principal, the economic bonding expenditures by the agent and the residual loss, are an unavoidable result of the agency relationship.⁸⁸

The key corporate governance mechanism developed under agency theory, suggesting that the board of directors may resolve agency problems through conflict monitoring, has been challenged by organisation theory (e.g. managerial hegemony theory and resource dependency theory). For example, from a resource dependence perspective, Smith notes that non-executive directors who have business relationships with a company or directors in related industries can serve as resources, contributing valuable expertise to the management of a company.⁸⁹ Hillman and Dalziel suggest that the non-executive directors provide much more than a monitoring function, but also a wide range of resources or capital to the corporation beneficial to business and strategic decision making.⁹⁰ However, Dallas points out that non-executive directors may not always be in a position to provide all of these resources and functions of boards and where non-executive directors are close associates of the managers they

⁸⁷ *ibid.* According to Jensen and Meckling's theory, bonding cost takes place when the managers' income is determined by the company's performance and thus discourages them from pursuing their own interests. In this case providing incentives through the contractual agreement will result in bonding costs. These could include determining a reward structure so that managerial incentives are aligned with the interests of owners. Such rewards are usually pecuniary and take the form of performance-related pay or share options. Realignment of interests can also be achieved through monitoring the activities of managers. This monitoring can consist of internal and external auditing, budget restrictions, the production of financial reporting information, etc. Bonding, monitoring and the residual loss are all characterised as agency costs.

⁸⁸ *ibid.*

⁸⁹ D.G. Smith, 1996. Corporate Governance and Managerial Incompetence: Lessons from Kmart, 74 *North Carolina Law Review*, pp1037-1139, at 1138.

⁹⁰ Amy J. Hillman and Thomas Dalziel, 2003. Board of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives. *Academy of Management Review*, 28: pp383-396, at 383-84.

may be unable to monitor management in shareholders' interests.⁹¹ From a managerial hegemony perspective, it has been argued that a board's ability and willingness to exercise its governance role effectively is dependent on its 'independence' and powers over the corporate management.⁹² Dallas argues that agency theorists have only paid attention to the occurrence and resolution of the conflicts of interest between the management and shareholders without considering the board's ability to monitor. Dallas advocates an extreme view which admits that the board of directors' control role is conceptually and normatively important, but argues that, in spite of their responsibilities to safeguard shareholder interests, many boards are effectively controlled by the full-time, better informed, and more experienced corporate management, while the independent directors acquiesce into a rather passive, rubber-stamping role.⁹³ In other words, the managerial hegemony theorists suggest that boards are dominated by executive directors and are, therefore, ineffective in performing conflict monitoring. Accordingly, solutions to agency problems include organisational arrangements which encourage independent overseeing and monitoring devices which reduce the costs of managerial opportunism or shirking.

It is clear that both agency and organisational theorists advocate that a fundamental function of boards of directors is to provide an important internal monitoring device to prevent management from opportunistic and self-serving behaviour. For agency

⁹¹ Dallas, L. L. 1996. The Relational Boards: Three Theories of Corporate Board of Directors, *The Journal of Corporation Law*, Vol.22, pp1-25

⁹² Pettigrew, A. and T. McNulty, 1998. Sources and Uses of Power in the Boardroom, *European Journal of Work and Organisational Psychology*, 7(2),197-214.

⁹³ *ibid.*

theorists, the central argument with agency theory is that a boardroom should contain more independent outside directors who are non-employees with no significant business relationship with corporations in order to improve the conflict monitoring function.⁹⁴ For managerial hegemony theorists, there has been great emphasis on the view that the non-executive/independent directors are ineffective in monitoring the performance of executive management if the CEOs play the main role in the nomination of board members. In contrast, resource dependence theorists focus on the role of the board as resource providers or boundary spanners between firms and their environments and emphasise the independence of board members as being critical to their ability to carry out the monitoring functions.⁹⁵ It is reasonable to assume that if a director has business ties to corporate management, he or she might too easily be influenced into rubber-stamping management decisions. Indeed, recent corporate governance developments seem to have focused more on the structure and the role of boards of directors to strengthen their accountability to shareholders. Chapter 6 of this thesis investigates the development of board systems and presents both legal and empirical findings on how boards are structured and function to ensure the efficient running of the company in China compared with the UK.

⁹⁴ Baysinger, B. D. and H. N. Bulter, 1985, Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition, *Journal of Law, Economics & Organisation*, 1. 101-124, Lorsch, J. W. and E. MacIver, 1989. *Pawns or Potentates: The Reality of America's Corporate Boards*. Harvard Business School Press, Boston, MA.

⁹⁵ Pfeffer, J. and G. Salancik, 1978, *The External Control of Organisations: A Resource-dependence Perspective*, New York: Harper & Row.

2.3.4 *Legal Theory of Directors' Duties and Enforcement*

In economic theory, a public corporation is an expression of the relationship between the principal who has entrusted property and the agents who manage the entrusted property. From a legal perspective, the company is an artificial legal entity, created and recognised by law,⁹⁶ and the directors who acts as agents of the company, therefore, have a duty of care to inform themselves reasonably before making a decision on the behalf of the principal and fiduciary duties to place the interests of the corporation and the principal above any self-serving motive.⁹⁷ Black concludes that the fiduciary construct enacts “a web of legal rules” that defines and governs in important ways what a fiduciary can and cannot do.⁹⁸ Macey and Miller explain that “fiduciary duties are the mechanism invented by the legal system of filling in the unspecified terms of shareholders’ contingent [contracts].”⁹⁹

Indeed, directors’ fiduciary duties and duty of care have been well recognised as the last resort, when the internal monitoring devices and the external market for corporate control mechanisms fail against directors who have not acted in the company’s and its shareholders’ interests. From this perspective, in most countries the tendency in recent years has been to draw up a statutory company law to define the duties of directors, but using different forms of expression and different phrasing. Most corporate statutes

⁹⁶ See *Saloman v Saloman & Co. Ltd.* [1897] A.C. 22.

⁹⁷ See Margaret M. Blair and Lynn A. Stout, 1999, A Team Production Theory of Corporate Law. 85 *Virginia Law Review*, pp247-328.

⁹⁸ Black, Bernard, 1994. Institutional Investors and Corporate Governance: The Case of Institutional Voice, 6 *Journal of Applied Corporate Finance*, pp19-32, at 23.

⁹⁹ Macey, Jonathan R., and Geoffrey P. Miller. 1993. Corporate Stakeholders: A Contractual Perspective. 43 *University of Toronto Law Journal*, 401 at 407.

provide that a director or officer must act with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner he or she reasonably believes to be in the best interests of the corporation. This is termed 'duty of care'. In addition, fiduciary principles constrain managerial discretion by governing the web of agency relationships constituting the corporate structure. Directors of the corporation must act in good faith, and in the honest belief that an action is in the best interests of the corporation, not allow their private interests to conflict with those of the company, and exercise the powers of the company for a proper purpose. Accordingly, if the duty of care and the fiduciary duties are breached, directors may be held personally liable for any damages caused by the breach, subject to the rules of enforcement.

Beyond the legal duties of directors, there is also a renewed emphasis on the enforcement of directors' duties. Minow suggests that the law should encourage shareholders with a meaningful stake to file lawsuits to enforce limits on corporate directors and managers who have neglected or abused their obligation to be candid about the company's current status and prospects.¹⁰⁰ By examining insider expropriation via 'tunnelling', Johnson et al advocate that the establishment of a stronger and more effective judiciary to enforce the general principles, such as duty of care and the duty of loyalty, by courts may influence how firms in different countries organise and finance themselves.¹⁰¹

¹⁰⁰ Nell Minow, 1995. *Putting Shareholders Back into Shareholder Litigation*. Available from: <http://www.lens-library.com/info/cgadvis.html>. [Accessed 11 December 2005]

¹⁰¹ Johnson et al. 2000. "Tunneling", *The American Economic Review Papers and Proceedings* 90: 22-27.

Comparative law and economics has recently taken a step forward with regard to the effectiveness of different systems of corporate governance by classification of the origin of legal systems. An outstanding contribution on how a country's legal and regulatory regime influences its corporate governance system is made by La Porta, Lopez-de-Silanes, Shleifer and Vishny.¹⁰² They argue that legal rules governing investor protection and the quality of enforcement of the law vary systematically across countries depending on the national legal system. Common law countries have the strongest, and French civil law has the weakest, and the German and Scandinavian civil laws are located in the middle in the protection of the investors. However, this study does not explain how a "good" law could actually be developed by a country and what sorts of accompanying institutions and norms have to be established to support this law.¹⁰³ This study has been criticized with regard to the reasonableness and credibility of classification of the legal families as it looks at the origin of the initial laws instead of any revisions of the law.¹⁰⁴ In addition to that, Coffee argues that common law countries, for example, the UK and the US, are quite different in the enforcement mechanisms employed to protect investors and the level of judicial activism.¹⁰⁵ This suggests that there will be uncertainty in measuring the law and institutional environment's influence on corporate governance without a sufficiently comprehensive observation across different regulatory regimes. To achieve an

¹⁰² La Porta et al., 1998. *op cit* fn.6; and La Porta et al., 1997. Legal Determinants of External Finance, 52 *Journal of Finance*. pp1131-1150.

¹⁰³ Pistor, Katharina Yoram Keinan, Jan Kleinheisterkamp, Mark D. West, 2002. The Evolution of Corporate Law: A Cross-Country Comparison, 23 *University of Pennsylvania Journal of International Economic Law*, pp791-871.

¹⁰⁴ John C. Coffee, Jr., 1999. Privatisation and Corporate Governance: The Lesson from Securities Market Failure, 25 *Journal of Corporate Law*, pp1-39.

¹⁰⁵ *ibid* at pp6-8

understanding of corporate governance and seek the merits and effectiveness of different systems, a country by country comparative approach may be more desirable.

According to the legal theory of directors' duties and enforcement, in Chapter 7 and 8, we critically examine the legal duties imposed on directors, and analyse the role of shareholders in enforcing directors' duties and the current development of the company law in respect of shareholder legal actions, and assess the uncertainty and ambiguity surrounding the civil proceeding regimes in China compared with the UK.

2.3.5 Shareholder Versus Stakeholder Theories

The focus of both shareholder and stakeholder theories has been articulated into some core questions in corporate governance. As Kirkbride et al have summarised: "what is the purpose of the corporation, for whose interests is the corporation run, and who should control the corporation and how they should control it?"¹⁰⁶ These questions have no universally accepted answers. In the Anglo-American corporate system, corporate governance identifies rights and responsibilities, legitimises actions and determines accountability where corporate entities are governed. The corporate objective has been traditionally defined as maximising the profits of shareholders. Therefore, shareholder value is assumed to be the ruling conception of corporate governance. The directors of the corporation are legally responsible to the shareholders and conduct the affairs of the corporation in the interests of the

¹⁰⁶ J. Kirkbride, S. Letza and X. Xun, 2005. Corporate Governance: Towards a Theory of Regulatory Shift. *European Journal of Law and Economics*. 20:57-70.

shareholders. However, some have argued that it is too narrow a perspective to treat shareholders as the sole owners of a corporation, since there are others who have interests in the corporation, such as employees, creditors, customers and so on, therefore the management must take a long-term view of the corporate commercial needs rather than pursue a short-term strategy to maximise shareholder value.¹⁰⁷

German and Japanese governance systems have received praise for their sustainability and superior capacity for long-term planning, as well as their practiced ability to include a stakeholder approach within the decision-making framework through structured interaction between the CEO and other stakeholders.¹⁰⁸

China's current corporate governance system was built upon stakeholder theory with a two-tier board system, but recently has reformed its law to provide for a system that approaches the Anglo-American model in a variety of ways. For example, increasing the number of outside independent directors on the board, strengthening the independent board system by the establishment of board sub-committees and the separation of the role of the chairman of the board from the CEO, and improving minority shareholder protection etc.¹⁰⁹ However, whether the current hybrid approach to the systematic development of corporate governance in China is likely to succeed in producing the

¹⁰⁷ Freeman defined a stakeholder as "any group or individual who can affect or is affected by the achievement of an organisation's objectives". See Freeman, *op cit*, fn.35, p46. According to stakeholder theory, Donaldson and Preston argue that "all persons or groups with legitimate interests participating in an enterprise do so to obtain benefits, and there is no prima facie priority of one set of interest and benefits one another". See Donaldson, T. and Lee E. Preston. The Stakeholder Theory of the Corporation, Evidence and Implications. *The Academy of Management Review*, Vol.20, 65-91, at 68.

¹⁰⁸ Detomasi, D., 2002, International Institutions and the Case for Corporate Governance: Toward a Distributive Governance Framework? *Global Governance*, 8(4), 421-442, at 431.

¹⁰⁹ The most notable response to these developments has been the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies and the Code of Corporate Governance for Listed Companies in China.

expected effects is a question of great interest and the main subject matter of the corporate governance research in the thesis.

2.4 Corporate Governance and Corporate Performance

An empirical investigation of the relationship between corporate governance and corporate performance essentially attempts to test whether 'better' corporate governance results in better corporate performance by preventing the management from pursuing their own objectives or the expropriation of minority shareholders in cases where there is a controlling shareholder. For example, a number of empirical studies examine the relationship between ownership structure and firm performance assuming that the differing ownership and control structures will have significant implications for the operation and performance of the firm.¹¹⁰ In addition, much of the empirical literature argues that if certain shareholders act as monitors of management behaviour, corporate performance will be better than in firms where monitoring does not occur.¹¹¹ Furthermore, the disciplining of the board of directors has also received considerable empirical attention, arguing that greater board independence, the establishment of board committees, and innovation of the executive remuneration

¹¹⁰ Demsetz, H. and Lehn K. 1985. The Structure of Corporate Ownership: Causes and Consequences, *Journal of Political Economy* 93, 1155-1177; Holderness, C. G. and Sheehan, D. P. 1988. The Role of Majority Shareholders in Publicly Held Corporations: an Exploratory Analysis, *Journal of Financial Economics*, 20, 317-346; Levin, S. G. and Levin, S. L. 1982. Ownership and Control of Large Industrial Firms: Some New Evidence, *Review of Business and Economic Research*, Spring, 37-49; McConnell, J. J. and Servaes, H. 1990. Additional Evidence on Equity Ownership and Corporate Value, *Journal of Financial Economics*, 27, 595-612; Morck, R., A. Shleifer and R. W. Vishny, *op cit.* fn. 38

¹¹¹ Gillian, S. and L. Starks, 1998. A Survey of Shareholder Activism: Motivation and Empirical Evidence, *Contemporary Finance Digest* 2(3), 10-34. Karpoff, J., 1998. *The Impact of Shareholder Activism on Target Companies: Survey of Empirical Findings*, University of Washington, School of Business, Seattle, Washington; Carleton, W. T., J. M. Nelson, and M. S. Weisbach, 1998. The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF, *The Journal of Finance*, Vol. LIII, No.4, 1335-1362, at 1356-1657.

regime will enhance corporate performance and valuation of shareholders.¹¹² Various arguments have been put forward, however, and there is little consensus because there are significant differences in corporate governance characteristics and too many other factors that impact on performance at the individual company level.¹¹³ Coles et al suggest that in order to understand the relationship between the typical agency theory constructs of monitoring, incentives and ownership structure and a firm's financial performance, it is necessary to examine a number of different governance mechanisms both individually and their interactions with firm performance because firms may use governance packages to deal with agency issues and enhance shareholder value.¹¹⁴ By reviewing the literature on the relationship between corporate governance and corporate performance, Chapter 9 of the thesis attempts to overcome the shortcomings identified in empirical studies which focus on only a single corporate governance characteristic to explain corporate performance, instead adopting and developing a broad view of corporate governance characteristics, including ownership structures, shareholder activism and board of director

¹¹² There is a considerable amount of literature examines the relationship between board size, board composition, board committee and director remuneration and corporate performance. See, Bhagat, S. and B. Black 1999. The Uncertain Relationship between Board Composition and Firm Performance, *Business Lawyer* 54, 921-963; Baysinger, B.D. and H.N. Butler 1985. *op cit.* fn.94. Hermalin, B. E. and M. S. Weisbach, 1991. The Effects of Board Composition and Direct Incentives on Firm Performance, *Financial Management* 20(4) 101-112; Core, J., Holthausen R. and Larcker, D. 1999. Corporate Governance, Chief Executive Officer compensation and Firm Performance. *Journal of Financial Economics*, 51, pp.371-406. Mehran, H., 1995. Executive Compensation Structure, Ownership, and Firm Performance, *Journal of Financial Economics*, 38, pp163-184. Klein, A. 1998. Firm Performance and Board Committee Structure, 41 *Journal of Law and Economics*, 275-303.

¹¹³ Leech and Leahy note that the performance of a firm reflects both internal influence, such as its internal organisation and factors which may modify incentives, and external constraints in the form of influences from, for example, the product market, the capital market and also the influence of life-cycle effects. See Leech, D. and J. Leahy, 1991. Ownership Structure, Control Type Classifications and the Performance of Large British Companies, *Economic Journal*, 101, 1418-1437.

¹¹⁴ Coles, J. W., V. B. McWilliams and N. Sen. 2001. An Examination of the Relationship of Governance Mechanisms to Performance. *Journal of Management* 27, 23-50.

characteristics, to identify the complex relationship between the corporate governance structure and the economic performance of corporations in China.

2.5 Corporate Governance in Developing Countries

Recent research on corporate governance has found systematic differences among nations in terms of ownership structure, the value of voting rights, the role and structure of the board of directors, law and legal enforcement, and the development of capital markets. More importantly, recent comparative corporate governance research suggests that the systems operating in developed western economies may not necessarily be transferable to developing countries (or emerging or transition economies), where the actual practices, institutional environment and behaviour of key participants in the corporate governance process, are not always consistent with the principles operated in the UK or the US.¹¹⁵ For example, a survey of corporate governance in Asia (including China) conducted by Claessens and Fan shows that conventional corporate governance mechanisms (takeovers and the board of directors) are not strong enough to relieve the agency problems in Asia. Also, alternative corporate governance mechanisms (e.g. employing reputable auditors, foreign institutional investors) can only have limited effectiveness in systems with weak institutions and poor property rights.¹¹⁶ By observing specific corporate governance

¹¹⁵ See Berkowitz, Pistor and Richard, 2002, Economic Development, Legality, and the Transplant Effect, *European Economic Review* 47(1): pp165-195; Ravi Dhareadkar, Gerard George and Pamela Brandes, 2000, Privatization in Emerging Economies: An Agency Theory Perspective, *The Academy of Management Review*, Vol.25, pp650-669. Pistor, K.. and C. Xu, 2002, Fiduciary Duties in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory, ECGI Working Paper Series in Law, working paper No.01/2002. Tam, O.K. 1997, *The Development of Corporate Governance in China*, Edward Elgar., p77.

¹¹⁶ Claessens, Stijn and Joseph P.H. Fan, 2003. Corporate Governance in Asia: A Survey, *International Review of Finance* 3(2), pp71-103.

issues in Asian firms, Claessens and Fan argue that “there are many corporate governance issues in Asia generic to other countries, most importantly the role of family ownership concentration and the degree of minority rights protection.”¹¹⁷

Indeed, there are two main features of corporate governance in developing countries:

(i) *The state or family (or family holding company) dominated ownership structure.*

The majority of the firms in developing countries are controlled and managed by either the state or families (or family holding company). For example, by examining corporate governance in India, Goswami finds that SOEs account for 20% of the market capitalisation of listed companies, and this has inevitably influenced their governance structures.¹¹⁸ Claessens et al examine the deviation of ownership and control rights in nine East Asian countries and report that a single shareholder controls more than two-thirds of publicly listed East Asian companies and most of them are families or family holding companies.¹¹⁹ Based on a recently published survey of the 100 largest non-financial companies in Brazil, the IIF Task Force Report notes that in about 52 per cent of firms, families or family foundations controlled over 50 per cent of the voting stock, while in another 40 per cent a family or other company owned often between 20 per cent and 50 per cent of voting shares and only 8 per cent of companies had a dispersed ownership structure.¹²⁰ In typical analysis of ownership structure in developing countries, research suggests that the nature of the

¹¹⁷ Ibid.

¹¹⁸ Omkar Goswami, *The Tides Rises, Gradually: Corporate Governance in India*, (CII/OECD), Informal Workshop on Corporate Governance in Developing Countries and Emerging Economies, April 2000.

¹¹⁹ Claessens, Stijn, Simeon Djankov and Larry H. P. Lang, 2000. *The Separation of Ownership and Control in East Asian Corporations*, *Journal of Financial Economics* 58:81-112.

¹²⁰ IIF Task Force Report, *Corporate Governance in Brazil: An Investor Perspective*, June, 2004.

agency problem is no longer the traditional agency problem of shareholder-manager conflicts, but rather the risk of expropriation of the minority shareholders by the controlling shareholder.

(ii) *Weakness in minority shareholder protection.* The absence of the rule of law and poor enforcement of the law are the central functional differences between developed market economies and developing economies.¹²¹ For example, Jesover argues that the importation of the Anglo-American form of governance using the rule of law and boards of directors was largely a failure for Russia, due to the lack of effective methods for adjudicating claimed violations of corporate law and the enforcement of the resulting judgement.¹²² The IIF Task Force Report claims that weak enforcement of rules and regulations has been a perennial concern for investors in emerging markets.¹²³ The experiences of the developing countries show that a weak legal enforcement system creates a unique set of governance concerns relating to the expropriation of minority shareholders. Clearly, this problem is rooted in the form of concentrated ownership, but evidence also suggests that such a problem cannot be resolved without the strengthening of the respective countries' legal infrastructures.

The research literature reviewed above has highlighted the weak governance and underdeveloped institutional context in developing countries and emerging or

¹²¹ La Porta et al, 1998, *op cit* fn.6 ; Claessens, Djankov and Lang 2002, *op cit* .fn.119 Berkowitz, Pistor and Richard, 2002, Economic Development, Legality, and the Transplant Effect, *European Economic Review* 47(1): pp165-195

¹²² Jesover, F. 2001, Corporate Governance in the Russian Federation: The Relevance of the OECD Principles on Shareholder Rights and Equitable Treatment, *Corporate Governance*: 9, pp79-88.

¹²³ IIF Task Force Report, 2004, *op cit*. fn.120.

transition economies. The nature of the ownership structure is a key determinant of the nature of agency problems. In addition, highly concentrated ownership also affects the development of corporate governance rules. For example, due to concentrated ownership, independent directors are often nominated by executive directors who represent controlling shareholders or who are controlling shareholders themselves, so that the independent directors have limited direct effect as the controlling shareholders will not allow them to have any real influence on the firm's board.¹²⁴ Hanazaki and Liu claim that ownership concentration and the divergence between the voting rights and cash flow rights of the controlling shareholders in firms which allowed insiders to exercise effective control, were associated with significantly worse corporate performance during the Asian crisis.¹²⁵

Recent literature on corporate governance also draws much attention to the issue of shareholder identity. It stresses that the objective functions and the costs of exercising control over corporate management vary substantially for different types of owners. For example, Goswami argues that as shareholders of private sector companies are direct beneficiaries of profitable activities, they have an incentive to monitor management and to maximise corporate value. In contrast, the directors of most government-controlled companies, because they do not have a substantial body of informed private shareholders whose income depends upon the performance of the

¹²⁴ Berglof, E and S. Claessens, 2006, Enforcement and Good Corporate Governance: Governance in Developing Countries and Transition Economies. *The World Bank Research Observer*, 21:123-150.

¹²⁵ Masaharu Hanazaki and Qun Liu, 2003. *The Asian Crisis and Corporate Governance: Ownership Structure, Debt Financing, and Corporate Diversification*, CEI Working Paper Series, No. 2003-18.

companies, are typically described as “agents without principals”.¹²⁶ Using data for more than 700 Czech firms listed on the Prague Stock Exchange over the period 1992-95, Claessens et al find that concentrated ownership by bank-sponsored investment funds is beneficial in improving firm management.¹²⁷ By investigating ownership concentration and corporate performance, Claessens and Djankov find that the presence of a significant foreign investor is associated with higher profitability in newly privatised Czech firms.¹²⁸ Similarly, Boubakri and Cosset’s research on 189 privatised firms in 32 developing countries, also finds that firm profitability and efficiency are associated with the presence of foreign investors.¹²⁹

The protection of investors is a fundamental objective of corporate governance. To achieve this objective requires both governance rules and enforcement mechanisms to be present within a country’s legal system. In fact, investor protection in developing countries has been gradually improving following the development of the Corporate Governance Code and the introduction of new corporate legislation. However, unfortunately, certain well-designed rules and corporate governance practices transplanted from Anglo-American system seems work poorly in developing countries.¹³⁰ One likely answer to this puzzle is that the effectiveness of law is not

¹²⁶ Omkar Goswami, op cit. fn.118.

¹²⁷ Stijin Claessens, Simeon Djankov and Gerbard Pobl, 1997, Ownership and Corporate Governance – Evidence from the Czech Republic, Notes No.111, Public Policy Journal, World Bank Group. Available at <http://rru.worldbank.org/Documents/PublicPolicyJournal/111pohl.pdf>, last visited 10 September 2006.

¹²⁸ Claessens, S. and Djankov, S. 1999, Ownership Concentration and Corporate Performance in the Czech Republic, *Journal of Comparative Economic*, 27: 498-513.

¹²⁹ Boubakri, N and Cosset, J. C. 1998. The Financial and Operating Performance of Newly Privatized Firms: Evidence from Developing Countries, *Journal of Finance*, Vol.53, pp1081-1110.

¹³⁰ See Justin Lu and Jonathan Batten, 2001, The Implementation of OECD Corporate Governance Principles in Post-Crisis Asia, *Journal of Corporate Citizenship*, 4: 47-62.

dependent on the content of the substantive law, but rather the adequacy of the enforcement mechanisms that underlie it.¹³¹ Thus, Beiglöf and Claessens stress that the enforcement of the rule of law, rather than regulations, laws on the books, or the voluntary code, is the most important determinant of the effectiveness of corporate governance in developing countries and transition economies.¹³² Marinov and Heiman argue that the objective of corporate law and corporate governance in transition economies should reflect the need for “relatively simple, highly credible rules that allow shareholders to protect themselves by their own voting decisions and by exercising transactional property rights”.¹³³

The discussion of corporate governance in developing countries is useful because China is facing corporate governance issues quite similar to most developing countries. Given the fact that the predominant governance problems in developing countries are related to ownership concentration and weak law enforcement, the thesis attempts to investigate if the ownership structure has an adverse effect on China's corporate governance system, and what China needs to do with its current corporate structure in order to improve the effectiveness of the corporate control mechanisms. And, if the legal enforcement is rather weak compared with that in the UK, what further legal reforms are required in China.

¹³¹ John, c. Coffee, 1999, Privatization and Corporate Governance: the Lesson from Securities Market Failure, *Journal of Corporate Law*, Fall, pp1-37.

¹³² Erik Beiglöf and Stijn Claessens, 2006, Enforcement and Good Corporate Governance in Developing Countries and Transition Economies, *The World Bank Research Observer*, Vol. 21, No.1, April 2006.

¹³³ Boeis Z. Marinov and Bruce A. Heiman, 1998, Company Law and Corporate Governance Renewal in Transition Economies: The Bulgarian Dilemma. *European Journal of Law and Economics*, 6:231-261.

2.6 Conclusion

Given the theoretical and empirical framework of corporate governance, the focus of the thesis can be classified into three major themes: (i) ownership structure and the role of shareholders in corporate governance; (ii) board structure and accountability; (iii) corporate governance and corporate performance. The first theme initially sets out the nature of the problem of the ownership structure, indicating that the ownership structure (i.e. the identities of the shareholders and the sizes of their positions) is potentially an important element of corporate governance, and then addresses the issues of the role of shareholders in exercising control over or in ensuring the accountability of the board of directors, in particular via shareholder general meetings. The second theme deals with the role and structure of the board of directors, directors' duties and the role of shareholders in enforcing directors duties, and emphasises that the institutional and legal regulatory framework are important in improving corporate governance. The last theme discusses the relationship between corporate governance and corporate performance. The underlying purposes of this theme are essentially to test the propositions of various corporate governance theories that, irrespective of the country and system of corporate governance concerned, better corporate governance results in better corporate performance.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 Introduction

In this chapter, we briefly review the literature on the comparative law method, the economic analysis of law and a combined comparative law and economic analytical approach recently employed in the corporate law and corporate governance research fields. While recognising that the ideas of economics have provided numerous insights into the operation of the firm, and have enriched our understanding of the phenomenon of the contemporary corporate governance debates and development, we have emphasised that many studies have not provided a close examination of the adequacy of the existing law of corporations and related legal enforcement of legislative controls over corporate practice which significantly impact on the efficient operation of corporations.

The research methods employed in this thesis attempt to make a substantive contribution to the literature, suggesting that corporate governance is an institutional framework defined in large part by law. The development of legal rights and the procedural mechanisms for their enforcement aim to promote the allocation of scarce resources in a way which maximises their value to society or minimises the costs which are involved in the use of resources.¹³⁴ Therefore, it is necessary to apply the

¹³⁴ See Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (1998, Law Com No 153, Scot Law Com No 105). Part 3.

comparative law method to examine substantive legal doctrines, the legal and institutional framework, and its court system in particular in enforcing the law, and employ the economic analysis of law to assess the governance mechanisms affecting the efficient operation of corporations. Pure empirical research and explanations of the governance function of ownership structure, the role of boards of directors, shareholder activism, without paying any attention to cross-country differences in law and its enforcement are far less conclusive.

The comparative law and economic analysis approach applied in this thesis, which is novel in studies of the Chinese corporate governance system, is intended to qualify or quantify each of the examined characteristics more comprehensively and compare them from the same perspectives, with similar details and depth, to explore how the corporate governance systems are formed, interact, and evolve in China and the UK. This approach shows that the development of a theoretical framework combining insights from economic, legal, political and historical backgrounds can be expected to improve methodical comparisons of governance systems. In addition, there are two distinctive features in our empirical approach to functional relations between corporate governance and corporate performance. First, we collect empirical data based on the ongoing debates in law and economics scholarship regarding the development of corporate governance and the relevant variables to the research issues identified by our functional comparative law analysis. Second, perhaps most importantly, the research approach of the study is distinguished from other studies in

that it not only examines an array of governance mechanisms used within corporations and their effects on corporate performance, but also takes into account the interdependence among these mechanisms. The following two sections explain the methodology used in the thesis, based on the contribution of both comparative law and the economic analysis of law literature.

3.2 Comparative Law Research Method

The main objective of a comparative law study incorporates the discovery, comparison, and analysis of the evolution of a particular legal issue in different legal systems. In this way, a comparative law study can give us fresh, exciting insights and a deeper understanding of issues that are of central concern in different countries. They can lead to the identification of gaps in knowledge and may point to possible directions that could be followed, directions that previously may have been unknown to observers or legal reformers, and they provide a source of information for improvement of legal systems.¹³⁵ As Riles observed, “the attraction of comparative law is not just the study of foreign law as such. It would also be the allure of a glimpse into the origins of legal norms; the prospect of a better understanding of the efficacy and limits of law; and the hope of insight into the connections among law, behaviour, ideas, and power.”¹³⁶ Drury and Xuereb suggest that a comparative analytical approach which goes beyond mere descriptive analysis is required if we are

¹³⁵ Zweigert K., and H. Kotz, 1998, *An Introduction to Comparative Law*, 3rd ed. Oxford University Press, p31-39; Reitz, J. C., 1998. How to Do Comparative Law, 46 *American Journal of Comparative Law* pp617-636.

¹³⁶ Riles, A. 1999. Wigmore's Treasure Box: Comparative Law in the Era of Information, 40 *Harvard International Law Journal*, 221-283 at 239.

to discover how different systems solve particular problems and why certain solutions are appropriate for one system but not for another. They argue that the underlying concepts, policy considerations and assumptions of each system need to be addressed before the real nature and relative importance of key matters which each system can be properly understood.¹³⁷ Indeed, comparative law has never been just describing the facts of foreign law. It is, in fact, a primary method of study of law providing a better understanding of the existing legal rules and institutions of a country, as well as giving us an understanding of the differences across jurisdictions. It may also help to sharpen the focus of analysis of the subject under study by suggesting new perspectives.

Reitz describes nine essentials of the comparative law method.¹³⁸ He insists that the field of comparative law depends on the study of foreign law and legal systems. He maintains that the comparative method will be much more effective if the study

¹³⁷ Drury, R. and P. Xuere, 1991. *European Company Law: A Comparative Approach*. Dartmouth.

¹³⁸ The nine methods are: 1) Comparative law involves drawing explicit comparisons, and most non-comparative foreign law writing could be strengthened by being made explicitly comparative; 2) The comparative method consists in focusing careful attention on the similarities and differences among the legal systems being compared, but in assessing the significance of differences the comparatist needs to take account of the possibility of functional equivalence; 3) The process of comparison is particularly suited to lead to conclusions about (a) distinctive characteristics of each individual legal system and/or (b) commonalities concerning how law deals with the particular subject under study; 4) One of the benefits of comparative analysis is its tendency to push the analysis to broader levels of abstraction through its investigation into functional equivalence. 5) The comparative method has the potential to lead to even more interesting analysis by inviting the comparatist to give reasons for the similarities and differences among legal systems or to analyze their significance for the cultures under study; 6) In establishing what the law is in each jurisdiction under study, comparative Law (and, for that matter, studies of foreign law, as well) should (a) be concerned to describe the normal conceptual world of the lawyers, (b) take into consideration all the sources upon which a lawyer in that legal system might base her opinion as to what the law is, and (c) take into consideration the gap between the law on the books and law in action, as well as (d) important gaps in available knowledge about either the law on the books or the law in action; 7) Comparative and foreign law scholarship both require strong linguistic skills and maybe even the skills of anthropological field study in order to collect information about foreign legal systems at first hand, but it is also reasonable for the comparative scholar without the necessary linguistic skill or in-country experience to rely on secondary literature in languages the comparatist can read, subject to the usual caution about using secondary literature; 8) Comparative law scholarship should be organized in a way that emphasizes explicit comparison. 9) Comparative studies should be undertaken in a spirit of respect for the other. See Reitz, J. C. *op cit.* fn.135. pp617-636.

makes comparisons by summarising the most important similarities and differences.¹³⁹ He argues that comparison starts by identifying the similarities and differences between legal systems or parts of the legal systems under comparison. However, Reitz emphasises that in performing the basic comparative job of identifying similarities and differences, one has to consider the scope of comparison - what is going to be compared with what? or how should comparisons be made?¹⁴⁰ Seeking to answer these questions, Reitz suggests that “a good comparative law study should normally devote substantial effort to exploring the degree to which there are or are not functional equivalents of the aspect under study in one legal system, in the other systems or systems under comparison”.¹⁴¹

Reitz also notes that because comparison focuses on both differences and similarities, comparative law studies need to cast light on (1) the special or unique natures of the legal systems being compared; and (2) their commonalities with respect to the issue in question. The first direction is a normative description which leads toward defining the distinctive features of each legal system. The second direction is positive (prescriptive) comparison which leads toward appreciation of commonalities, maybe even universal aspects, of legal systems and insight into fundamental aspects of the particular legal issue in question.¹⁴² Reitz suggests that comparative study could end with a delineation of relevant similarities and differences, but the goal of good

¹³⁹ *Ibid*, p619.

¹⁴⁰ *Ibid*, p620

¹⁴¹ *Ibid*, p622

¹⁴² *Ibid*, p623

comparative study requires significant legal analysis to investigate the reasons for the similarities and differences among legal systems or to assess the significance of such similarities or differences, such as whether one country's law functions well or which country's rules govern the legal issues better?¹⁴³ Zweigert and Kötz also contend that "the basic methodological principle of all comparative law is that of functionality."¹⁴⁴ They argue that different legal systems can be compared only if they solve the same factual problem, satisfying the requirement in adequate legal regulations.¹⁴⁵

3.3 Economic Analysis of Law

Comparative law is concerned with the way the law is and how it evolves, rather than how it ought to be. The problem with this approach is, however, that can be considered as being limited to essentially descriptive analysis which can only provide a legal analysis of similarities or differences and assess the reasons for the similarities and differences among legal systems, but does not call for any deeper argumentation to explain whether one country's law functions well or whether another rule governs the same or similar legal issues more effectively. Therefore, it is necessary for comparative law study to draw upon extra-legal methodologies (such as economics) to understand how the law evolves and adapts to change, how people react to legal rules and institutions, and how to evaluate the soundness of a legal proposition.¹⁴⁶

¹⁴³ *Ibid*, p627

¹⁴⁴ see K. Zweigert and H. Kotz, *op cit.* fn.135, p34.

¹⁴⁵ *Ibid*. p5

¹⁴⁶ Mattei describes that Law and Economics' scholars may be able to see a legal rule of one legal system is more or less efficient than another as they are concerned with "describing, explaining, and - why not? - predicting and leading legal changes and transplants", see Mattei, U. 1997. *Comparative Law and Economics*, the University of Michigan Press, p145. Also Posner argues that the basis of an economic approach to law is concerned with the efficiency of legal system and individual's reaction induced by the particular legal rules. See Posner, R. A. 1973.

The economic analysis of law applies the tools of microeconomic theory to the analysis of legal rules and institutions.¹⁴⁷ Posner argues that the basis of an economic approach to law is concerned with the efficiency of legal systems and individual's reaction induced by particular legal rules.¹⁴⁸ Mattei contends that comparative law and economics is an approach to build a model of an efficient institution and then compare it with alternative legal systems in the real world.¹⁴⁹ Typically, Mattei explains this approach departing from the standpoint of efficiency which explains why this inefficiency occurs, and attempts to establish whether the legal system under analysis possesses institutions that can work as efficiency-restoring substitutes.¹⁵⁰

The contribution of economic analysis has been summarised by the Law Commission in "Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties".¹⁵¹ This states that "[T]he economic analysis of law can fulfil two purposes: Firstly, it can be used to evaluate particular legal provisions in terms of how far they enhance efficiency, or, in other words, how far they contribute to the wealth or well being of society as a whole. Secondly, it can be employed to predict the effects of changes in the law".¹⁵² In recognising the importance of the economic analysis of law for achieving a better understanding of the consequences of legal rules, the Law

The Economic Approach to Law, 53 *Texas Law Review*, pp757- 761.

¹⁴⁷ Kornhauser, L., 2006, Legal Philosophy: The Economic Analysis of Law, *The Stanford Encyclopedia of Philosophy (Spring 2006 Edition)*, Edward N. Zalta (ed.), available from: <http://plato.stanford.edu/archives/spr2006/entries/legal-econanalysis/> [Accessed 20 April 2006].

¹⁴⁸ see R. A. Posner, *op cit*, fn.146.

¹⁴⁹ see U. Mattei, *op cit*. fn. 146, p94

¹⁵⁰ Mattei, U., 1995. The Comparative Law and Economics of Penalty Clauses in Contracts, 43 *American Journal of Comparative Law*. 427-45, at 430.

¹⁵¹ See, Law Commission, (Law Com No 153). *op cit*. fn.134.

¹⁵² *Ibid* part 3.3, p33.

Commission emphasises that the economic analysis of law “may not provide a conclusive answer in most cases, it can, nevertheless, inform policy makers of some of the possibly unintended consequences of changes to the law”¹⁵³.

3.4 Comparative Law and Economic Analysis

The comparative law and economic analysis combined approach is a rather new discipline located at the frontiers of contemporary legal research. However, it is easy to agree with the proposition that the reliance on combining the analytical tools of adjoining complementary social sciences, and in particular on economics, to conduct a critical approach to legal rules and institutions has been one of the major contributions of methodology for comparative law. This approach has been applied in a number of recent corporate law and corporate governance studies.¹⁵⁴

The comparative law and economics approach to corporate governance has recently emerged as a fruitful way to think about a number of questions on legal families, shareholder rights, minority shareholder protection and the quality of the enforcement of laws and the link with the economic performance of corporations. For example, La Porta et al conducted an empirical study on how laws protecting investors differ

¹⁵³ *Ibid* part 3.8, p34.

¹⁵⁴ See Easterbrook F. H. and D. R. Fischel, 1996. *The Economic Structure of Corporate Law*, Harvard University Press; W. Carlin and C. Mayer, 1999. How do Financial Systems Affect Economic Performance? Available from: http://www.finance.ox.ac.uk/file_links/finecon_papers/1999fe08.pdf [Accessed 12 September 2005]. Shleifer A. and R. W. Vishny, 1997, *op cit.* fn.35; La Porta et al. 2000. Investor Protection and Corporate Governance, 58 *Journal of Financial Economics*, 2-27. Claessens, S., S. Djankov and L. H. P. Lang, The Separation of Ownership and Control in East Asian Corporations, 58 *Journal of Financial Economics* 81; La Porta et al. 1999. Corporate Ownership around the World, 54 *Journal of Finance* 47; Lucian A. Bebchuk & Mark Roe, 1999. A Theory of Path Dependence in Corporate Governance and Ownership, 52 *Stanford Law Review* 127; La Porta et al., 1997. *op cit* fn.102; Roe, M. 1996. Chaos and Evolution in Law and Economics, 109 *Harvard Law Review*, pp641-68.

across 49 countries, how the quality of enforcement of these laws varies, and whether these variations matter for corporate ownership patterns around the world.¹⁵⁵ The methodology employed by this study was, typically, a comparative law and economics approach, in that it adjoined rigorous statistical tools for analysing the rules governing investor protection and the quality of law enforcement in a sample of countries in Europe, Asia, Africa, and North and South America.¹⁵⁶

In addition, in 2002 La Porta et al extended their study to testing the agency problems and dividend policies around the world by using data collected across 33 countries, for more than 4,000 firms.¹⁵⁷ They distilled information from the available literature on the basic mechanisms of how dividends could be used to deal with agency problems and predicted that dividends are an outcome of an effective system of the legal protection of shareholders.¹⁵⁸ The construction of the variables included a dummy variable of the 'country's legal origin and a dummy of the index of anti-director rights derived from La Porta et al's 1998 study on a proxy for the quality of

¹⁵⁵ See La Porta et al. 1998, *op cit.* fn.6.

¹⁵⁶ *ibid.* La Porta et al. classified the origin of laws into four legal families: English, or Common law; French civil Law; German civil law and Scandinavian law. This index reflects such aspects of minority rights as (1) the ease of voting for directors; (2) freedom of trading shares during a shareholder meeting; (3) the possibility of electing directors through a cumulative voting mechanism or proportion representation of minorities on the board; (4) the existence of a grievance mechanism for oppressed minority shareholders, such as class-action lawsuit or appraisal rights for major corporate decisions; (5) the existence of a pre-emptive rights to new security issues by the firm, (6) the percentage of votes needed to call an extraordinary shareholder meeting. The range for the index is from zero to six. To assess enforcement, the analysis uses five measures: efficiency of the judicial system; rule of law, corruption; risk of expropriation (outright confiscation or forced nationalisation) by government, and the likelihood of contract reputation by the government. In addition to these rule of law variables, the study uses an estimate of the quality of accounting standard.

¹⁵⁷ La Porta et al., 2000, Agency Problems and Dividend Policies around the World, *The Journal of Finance*, 55, 1-33.

¹⁵⁸ *Ibid* and La Porta et al. 1998, *op cit.* fn.6.

the legal protection of investors.¹⁵⁹ They found that stronger minority shareholder rights were associated with higher dividend payouts.¹⁶⁰

Furthermore, in 2002 La Porta et al also published an empirical analysis of investor protection and corporate valuation using a sample of 539 large firms from 27 wealthy economies.¹⁶¹ This study evaluated the influence on corporate valuation of investor protection and ownership by the controlling shareholders on corporate valuation.¹⁶²

They employed Tobin's Q to measure corporate valuation, and the origin of the country's law and an index of specific rules as an indicator of shareholder protection.¹⁶³ The corporate valuation and ownership data collected from the WorldScope database, companies' annual reports, proxy statements, and country-specific books on the ownership structure of their companies, Web-sites and other relevant company documents.¹⁶⁴ However, the origin of a country's law was limited on common law and civil law classification, and the legal variables of investor protection were still derived from La Porta et al's index of anti-director rights.¹⁶⁵ The

¹⁵⁹ *ibid.*

¹⁶⁰ The civil law dummy enters with a negative and significant co-efficient at the 1 percent level in regressions using all three measures of dividend payout – dividend – to – cash – flow; dividend – to earnings and dividend – to – sales. See *ibid.* La Porta et al., 2000. p19

¹⁶¹ The sample includes the largest 20 firms by market capitalisation in each of the 27 countries covered by La Porta et al.'s survey. See La Porta et al., 2002. Investor Protection and Corporate Valuation, *The Journal of Finance*, Vol.57, No.3, pp1147-1170.

¹⁶² The sample of controlling shareholders consists of a shareholder who controls over 10 percent of vote of the firm. See *Ibid.* p1154.

¹⁶³ The Tobin's Q defined as the ratios of the market value of assets to their replacement value at the most recent financial year, typically 1995. *ibid.*, p1156.

¹⁶⁴ The ownership data did not all come from the same year because of the limitation of disclosure in several countries. See La Porta et al. 2002, *op cit*, fn.161. p1154.

¹⁶⁵ La Porta et al. use a dummy variable (0, 1) to weight a firm comes from a country with a common law origin or civil law origin, and index of anti-directors remaining the same scores. See La Porta et al. 1998. *op cit* fn.6. and La Porta et al. 2002. *op cit*. fn.161.

result was consistent with their main prediction that better investor protection was associated with higher corporate valuation.¹⁶⁶

Although La Porta et al's economic approaches have made an influential contribution to comparative corporate governance research, the methodology they employed in their study is not free from criticism. Coffee criticises the reasonableness and credibility of the classification of legal origins and questions the causal relationship between legal origin and economic performance.¹⁶⁷ In addition to that, Coffee argues that even common law systems may not be that much alike - for example, the UK and the US, are quite different in the enforcement mechanisms employed on the protection of investors and the level of judicial activism.¹⁶⁸ This suggests that there will be uncertainty if we measure how the law and institutional environment influence corporate governance without a sufficient comprehensive observation across different regulatory regimes. To achieve a greater understanding of corporate governance by investigating the merits and effectiveness of different systems, a country to country comparative approach may be more desirable.

Pistor et al argues that La Porta et al's studies use the index legal rights variables to show how the effectiveness of legal institutions varies among legal families, but they

¹⁶⁶ *Ibid.* La Porta et al. 2002.

¹⁶⁷ See, Coffee, J. C., 1999, *op cit*, fn.104, Also see Coffee, J. C., 2001. The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, 111 *Yale Law Journal*, p1-82.

¹⁶⁸ For example, Coffee argues that "in the United states a highly entrepreneurial system of private enforcement which has evolved that largely overcomes the collective action problems that dissuade individual investors from suing nothing comparable exists in the United Kingdom." *Ibid.* John C. Coffee 1999, p7.

do not compare the variance between law on the book and law in action.¹⁶⁹ They claim that the differences in substantive law could be far less important than differences in enforcement practise.¹⁷⁰ A similar point to that of Coffee and Pistor is made by Licht et al who object to La Porta et al's choice of index components and the assignment of equal weight to different nations.¹⁷¹ Hoang also points out that it may not be possible to adequately reflect the actual performance of institutions by merely using perception data collected from private rating agencies.¹⁷² Hoang claims, for example, with regard to the efficiency of the judicial system, that respondents may rely on their experience with other parts of government, but not on any direct experience with the courts so that the available measures used to measure the effectiveness of law enforcement are general and indirect.¹⁷³ These limitations obviously have adverse effects on La Porta et al's conclusion regarding the legal system comparison.

¹⁶⁹ See Pistor, K., M. Raiser and S. Gelfer, 2000. *Law and Finance in Transition Economic*, CID Working Paper No.49, Center for International Development at Harvard University, and Berkowitz, D., K. Pistor and J. Richard, 2000. *Economic Development, Legality, and the Transplant Effect*, CID working paper No.39, Center for International Development at Harvard University.

¹⁷⁰ See Pistor, K., 2000. *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies*, European Bank for Reconstruction and Development, working paper No.49.

¹⁷¹ See Licht, A. N., C. Goldschmidt, and S. H. Schwartz, 2001. *Culture, Law, and Finance: Culture Dimensions of Corporate Governance Laws*. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=267190 [Accessed 12 September 2005].

¹⁷² It is important to note that all the data in measuring investor's rights, the quality of enforcement laws and the quality of accounting standard in La Porta et al.s' studies are collected from independent agencies – the Business International Corp. and International Country Risks. See Hoang, H. L., 2003. *The Effects of Judicial Efficiency on Credit Market Development*, IEE Working Paper, Volume 174, Institute of Development Research and Development Policy, RUHR University Bochum.

¹⁷³ *Ibid.*

3.5 Research Method Design

The comparative law method discussed above gives clear guidance for carrying out legal comparisons. Based on this guidance, the comparative law as a method utilised in this study will reveal both the legal and institutional framework to identify the allocation of key decision-making rights between shareholders and board of directors of the firm, including rights relating to the existence of the shareholding structure, its governance structure, voting rules, the issues of directors' accountability and protection of minority shareholders. Accordingly, the scope of this research focuses on the central issue for corporate governance in every jurisdiction, which is how to mediate the conflicts between shareholders and directors, and protect minority shareholders.

To understand how different countries address these competing claims, this research begins with, in the first instance, the investigation of the Chinese and the UK corporate legal and institutional systems in order to discover how corporate control power is distributed and whether the shareholders hold effective corporate control rights over management by a normative comparative approach. We then explore the functional equivalents by a positive comparison to investigate whether shareholders are able to exercise their corporate control mechanisms effectively to prevent management from pursuing their own interests and whether the legal duties imposed on the directors can be effectively enforced if the directors abuse their powers. In so doing, the comparative legal variables are identified through a close look at the legal

and institutional framework in three main areas – (i) share ownership and shareholder rights: including company share ownership structure, type of shares, identities of shareholders, shareholder general meetings, resolutions, shareholder voting rights and related certain procedures rules, and information disclosure; (ii) the role of the board and directors' accountability: including the structure and composition of boards, independent/non-executive directors, and board activities; (iii) directors' duties and enforcement: including common law fiduciary duties, duty of care, skill and diligence, and judicial efficiency in enforcing directors' duties. The primary sources for comparison include company law, securities regulations, listing rules, codes of corporate governance, and a number of cases dealing with specific issues of corporate governance. Empirical data are used to demonstrate the ownership structure patterns, general meetings and shareholder voting results, board characteristics and to explore how corporate governance mechanisms currently operate in practice in China and the UK. The detailed empirical data collection method is presented in section 3.6.

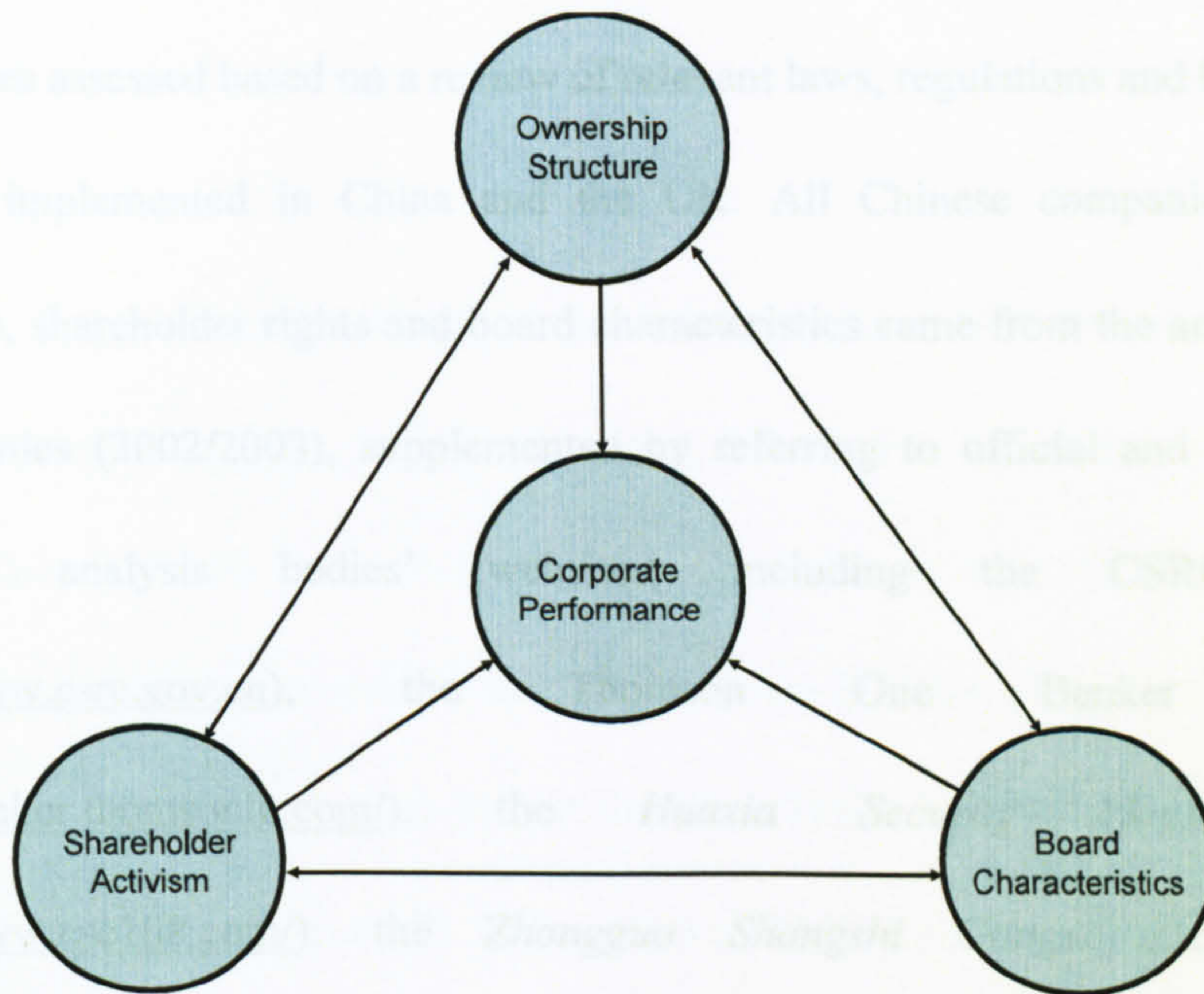
The economic analysis of law approach in this thesis attempts to test the relationship between corporate governance and corporate performance in China. This study overcomes the shortcomings identified in previous empirical studies which focus on only one or two corporate control mechanisms to explain corporate performance, instead adopting and developing a broad view of corporate governance characteristics, including ownership structures, shareholder activism and board of director characteristics, to identify the complex relationship between the corporate governance

structure and the economic performance of the firm in China. The theoretical underpinning behind this notion is that the correlation of the corporate governance structure with firm performance could be explained in several ways since various corporate control mechanisms coexist and possibly are interdependent within the company. Simply conducting regression analysis relating the use of any single mechanism to corporate performance may be spurious because of interrelations among the control mechanisms.¹⁷⁴ The research approach of the study is distinguished from other studies in that it not only examines an array of governance mechanisms used within corporations and their effects on corporate performance, but also analyses the interdependence among these mechanisms and investigates the triangle of strategic interactions in the corporate governance system, which combines the selected optimal corporate control mechanisms, to explore their relationship with corporate performance. Although the study is concerned with the interaction among control mechanisms and their relationship with corporate performance, which is not entirely new, it is the first to address directly the importance of shareholder meetings and voting control mechanisms on corporate performance. The relationships among the alternative corporate control mechanisms and, in turn, their relationships with corporate performance are designed in a diagrammatic presentation in Figure 3.1. The detailed research method involving the development of hypotheses, data and methodology for regression analysis are discussed in Chapter 9.

¹⁷⁴ Since various control mechanism coexist within a firm, greater use of one mechanism need not be positively related to firm performance. Where one specific mechanism operates less effectively, others may operate more effectively which can be expected to increase firm performance equally. Therefore, Agrawal and Knoeber insist that in a study that "fails to consider interrelationship among the corporate control mechanisms, any findings may be spurious." See Agrawal, A. and C. R. Knoeber, Firm Performance and Mechanisms to Control Agency Problems Between Manager and Shareholders, *Journal of Financial and Quantitative Analysis*, Vol. 31. No.3, p377, (1996).

Figure 3.1

The relationships between corporate control mechanisms and corporate performance



3.6 Data Sources and Sample Sizes

Each country has its unique corporate governance system, formed as a result of its own particular historical, economic, political, legal, social culture and technological influence. To enhance the understanding of how a country's system was evolved and developed, a documentary survey of corporate practice at the firm level in China and the UK was employed. Data were collected relating to corporate governance factors, including ownership structure (ownership pattern and identities of shareholders), shareholders' rights (voting rights and voting processes), and the main board characteristics (the size of the board, number of non-executive directors/independent directors, board leadership, the frequency of board meetings, etc.) from randomly

selected companies listed in China (Shanghai and Shenzhen Stock Exchange markets) and the UK (London Stock Exchange market) for the 2002-2003 financial year. These factors were assessed based on a review of relevant laws, regulations and best practice currently implemented in China and the UK. All Chinese companies' data on ownership, shareholder rights and board characteristics came from the annual reports of companies (2002/2003), supplemented by referring to official and professional securities analysis bodies' websites, including the CSRC website (<http://www.csrc.gov.cn>), the Thomson One Banker database (<http://banker.thomsonib.com/>), the *Huaxia Security House* website (<http://www.csc108.com/>), the *Zhongguo Shangshi Gongsi Zixun* website (<http://www.cnlist.com/search/search.htm>), and the *Hexun* company website (<http://www.hexun.com>). All UK companies' data on ownership structure and the characteristics of the boards of directors were extracted from the Fame database (<http://fame.bvdep.com>), the Thomson One Banker database (<http://banker.thomsonib.com/>), the companies' annual reports (2002/2003) and the Waterlow stock exchange yearbook. However, in the UK, there was no requirement imposed on the listed companies either under statutes or the Listing Rule to disclose the information on shareholder voting and voting processes at the shareholder meetings to the public, so we failed to gather these data through the documentary survey. We tried to collect these data directly from the companies through email, but only 20 companies responded to our survey. Nevertheless, surveys conducted by

PIRC, the Myners' Report and the TUC's survey¹⁷⁵ provide sufficient information to allow us to compare how shareholders' rights are exercised in practice between China and the UK.

The initial samples included a total of 300 listed companies selected from China and 300 listed companies from the UK. However, the number of companies dropped to 267 for China and 196 for the UK (see appendix), due to the unavailability of data with respect to certain governance factors. As shown in Tables 3.1(a) and (b), there is a wide range of company sizes in our samples. Table 3.2 shows that the Chinese company sizes ranged from RMB 5.07 million to RMB 7,427.87 million, with a mean of RMB 295.75 million. The UK company sizes ranged from £0.11 million to £86,555.77 million, with a mean of £1,607.40 million. The fact that the survey samples were in part determined by data availability rather than a probability criterion may limit to some extent the generalisability of the results. However, the remaining samples are reasonably large and we have no reason to suppose that they are unrepresentative of the population.

Table 3.1 (a) Size Distribution of the Chinese Sample Companies

Total assets (RMB Million)	Frequency	Percent
Less than 50	23	8.6
50 – less than 100	46	17.2
100 – less than 500	167	62.5
500 – less than 1000	25	9.4
1000 – less than 5000	4	1.5
5000 or more	2	.7
Total	267	100.0

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets.

¹⁷⁵ See PIRC Proxy Voting Annual Review (2004), Institutional Investment in the United Kingdom: A Review, Myners' Report, Review of the Impediments to Voting UK Shares, Report by Paul Myers to the Shareholder Voting

Table 3.1(b) Size Distribution of the UK Sample Companies

Total assets (£ Million)	Frequency	Percent
Less than 50	32	16.3
50 – less than 100	29	14.8
100 – less than 500	69	35.2
500 – less than 1000	25	12.8
1000 – less than 5000	30	15.3
5000 or more	11	5.6
Total	196	100.0

Source: the survey of 196 companies listed in London Stock Exchange market.

Table 3.2 Descriptive Statistics of Sample Companies

	N	Minimum	Maximum	Mean	Median	Std. Deviation
China	267	5.07	7427.87	295.75	167.60	614.59
UK	196	.11	86555.77	1607.40	234.45	6858.52

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

3.7 Summary

In this chapter we have explained the research methodology which combines the comparative law research method and the economic analysis of law research method. The comparative law method allows us to understand the existence and meaning of legal rules, the structure of institutions, and the effects of legal rules and institutions as realities. The economic analysis of law emphasises the evaluation of legal rules and institutions, and testing hypotheses on the effects of changes in the law. Research following the comparative law and economic analysis in this study aims at explaining the legal, economic and financial environments that shape the development of corporate governance systems in China and the UK. The empirical part of our approach involves collecting and analysing data and enables us to isolate the

underlying problems and thereby recognise the weakness of the Chinese corporate governance system with reference to the UK system. In approaching corporate governance from the perspective of economic analysis, the study also includes hypothesis tests on the relationship between corporate governance and corporate performance in China to deepen our understanding beyond that available from casual observation and comparison, and appreciate the effectiveness of the Chinese corporate governance system.

CHAPTER 4

THE ANATOMY OF OWNERSHIP STRUCTURE

4.1 Introduction

The property rights theory discussed in Chapter 2 suggests that the structure of share ownership may have an important role to play in corporate governance. This chapter examines the literature on ownership structure and control, and then focuses on three key aspects of corporate ownership structure in the UK and China – the type of ownership, ownership concentration and the identities of the shareholders. Research of the different types of ownership, the degree of ownership concentration, and the different identities of share-owners allows us to clarify the nature of corporate governance problems and to identify the ability of different owners to deal with these problems. The empirical research presented in this chapter demonstrates that there are substantial differences in the ownership and control of companies between China and the UK. The findings suggest that the agency problem in China is not the classical Berle and Means problem which is of dispersed shareholders not being able to control management, but rather the potential expropriation of minority shareholders by the controlling shareholders. This chapter explores the various means that the controlling shareholders have used to expropriate corporate interests, and discusses the issue of the protection of minority shareholders as one of the key determinants of the development of corporate governance in China.

4.2 Literature on Ownership Structure and Control

When Berle and Means first raised the issue of the relationship between ownership (shareholders) and control of the corporation (directors) in their influential book '*The Modern Corporation and Private Property*',¹⁷⁶ they identified five major control types based on ownership structure, namely, (1) control through almost complete ownership;¹⁷⁷ (2) majority control;¹⁷⁸ (3) control through a legal device without majority ownership;¹⁷⁹ (4) minority control;¹⁸⁰ and (5) management control.¹⁸¹ Regarding the above classification of corporate control, Berle and Means concluded that 44 per cent of the largest 200 corporations in the US were subject to management control in 1929.¹⁸² Berle and Means argued that as the dispersed ownership and control was concentrated in the hands of directors, they might possess uncontrollable powers to pursue their own interests or social objectives rather than maximise profits for the shareholders.¹⁸³ Berle and Means theory indicates that ownership patterns potentially influence the evolution of the country's corporate governance system.

¹⁷⁶ See Berle and Means, *op cit.* fn.1.

¹⁷⁷ This was where a single individual or a small group of individuals owned all or practically all of shares. See *ibid*, p70

¹⁷⁸ This was considered by Berle and Means as the first step towards the separation of ownership from control, and involves the ownership of a significant part of the assets. See *ibid*, pp70-72.

¹⁷⁹ Berle and Means referred to the process of 'pyramiding' which would involve the ownership of a majority of shares in one company which, in turn, would hold a majority of shares in another. See *ibid*, pp72-80

¹⁸⁰ This existed where an individual or small group held sufficient stock interest so as to be in a position to dominate a corporation. Such a group is often said to have a working control of the company. In general, their control rests upon their ability to attract from scattered owners, to control a majority of the votes at the annual elections. See *ibid*, pp80-84.

¹⁸¹ This existed where ownership was so widely distributed that no individual or small group had an interest significant enough to dominate the affairs of the company. See *ibid*, pp84-90.

¹⁸² See *ibid*, p94.

¹⁸³ See *Ibid* p121.

Following Berle and Means's analysis of corporate control problems, in 1963, Lerner claimed that the figure on management control of a corporation had risen to 84 per cent in the US.¹⁸⁴ In a study conducted in the mid-1970's, Herman found that 82.5 per cent of the top 200 non-financial corporations in the US were controlled by management.¹⁸⁵ In comparison, in the UK, the matter of ownership and control has been less extensively researched than in the United States. Florence reported in 1961 on the basis of data from 1936 that two-thirds of the 'very largest' companies were controlled by management and that the tendency towards the dispersal of shareholdings was increasing.¹⁸⁶ However, Nyman and Silberston's study cast some doubt on the growth of management control, reporting that 56.25 per cent of the top 250 companies in the UK were still controlled by shareholders, and concluding that 'the extent of managerial control is more limited than has been thought and may not have an inexorable tendency to increase'.¹⁸⁷ Cubbin and Leech also found that 47 out of a sample of 85 large UK companies were under management control and the rest were owner-controlled.¹⁸⁸

Inevitably, the pattern of the dispersion of shareholdings based on Berle and Means theory no longer reflects today's ownership structure in the US and the UK.

According to the statistics, in 1950, institutional investors owned merely eight per

¹⁸⁴ Lerner, R. J., 1966. Ownership and Control in the 200 Largest Non-Financial Corporations, 1929 and 1963. *American Economic Review*, 56:777-87.

¹⁸⁵ Herman, E. S., 1981. *Corporate Control, Corporate Power: A Twentieth Century Fund Study*, Cambridge University Press, p66.

¹⁸⁶ Florence, P. S., 1961. *Ownership, Control and Success of Large Companies: An Analysis of English Industrial Structure and Policy 1936-1951*, Sweet & Maxwell, p85.

¹⁸⁷ Nyman, S. and A. Silberston, 1978. The Ownership and Control of Industry, 30 *Oxford Economic Papers* p74.

¹⁸⁸ Cubbin, A. D. and D. Leech, 1983. The Effect of Shareholder Dispersion on the Degree of Control in British Companies: Theory and Measurement, 93 *Economic Journal*, pp351-369.

cent of the equity in US corporations. By 1980, institutions held 33 per cent of all publicly held shares, and by 1988, institutional holdings owned 45 per cent. By 1990, institutional shareholdings had reached 55 per cent in the 100 largest corporations in the US.¹⁸⁹ In the UK, institutional shareholders also increased from 17.9 per cent in 1950 to about two-thirds of the total shares in the UK equity market in the 1990s.¹⁹⁰ In comparison, the individual ownership of shares in UK listed companies had declined from 54 per cent in 1963 to only 14.3 per cent in 2002.¹⁹¹ The concentration of holdings in institutional hands makes it possible for corporate monitoring and corporate governance by the resurgence of shareholders. Indeed, the pattern that emerges not only shows the transformation of ownership structure, but also the possibility for institutional investors actively to participate in corporate affairs and intervene in the management of the company through shareholder activism.¹⁹²

Meanwhile, another dimension of ownership structure concerning the identity of shareholders has also received considerable attention from the transferral of ownership from individuals to institutions. The basic Berle and Means theory, concerned with the problem in typical US corporations, regarding widely-dispersed

¹⁸⁹ Benjamin T. Lo, 1993. *Improving Corporate Governance: Lessons from the European Community*, *Indiana Journal of Global Legal Studies*, Vol.1, Issue 1, p219.

¹⁹⁰ Company Law Review Consultation Document, *Modern Company law for a Competitive Economy: Company General Meetings and Shareholder Communication* (October 1999) states that 70-80 of shares in listed companies are registered in the names of financial institutions. See para.20. The Hampel Report: Committee on Corporate Governance, Final Report, (Hereafter Hampel Report) s.5.1 states that 60% of shares in listed UK companies are held by UK institutions – pension funds, insurance companies, unit and investment trust. Of the remaining 40%, about half are owned by individuals and half by overseas owners mainly institutions. January 1998, Gee Publishing Ltd. More details see: *Share Ownership – Share Register Survey Report 2002*. (hereafter *Share Ownership Report 2002*). Available from: http://www.statistics.gov.uk/downloads/theme_economy/ShareOwnership2002.pdf. [Accessed 8 March 2005].

¹⁹¹ See *ibid*, *Share Ownership Report 2002*.

¹⁹² Paul L. Davis, 1993, *Institutional Investors in the United Kingdom*, in D.D. Prentice and P.R.J. Holland, ed. *Contemporary Issues in Corporate Governance*, Oxford University Press, pp69-96. Also see Solomon J. and A. Solomon, *op cit.* fn. 33, p91.

share ownership, is that individual shareholders own a very tiny fraction of the company's shares and therefore have little or no incentive to expend significant resources to monitor or scrutinize management decision-making within the company.¹⁹³ However, the dispersion of share ownership among private individuals, which had the effect of reducing the impact of shareholder control, has to some extent been countered by the growing concentration of shareholding in the hands of institutional investors. In fact, today, in the UK and the US, to some extent the control of corporation is dominated by institutional investors, such as pension funds, mutual funds and insurance companies. Compared with individual shareholders, institutional investors are in a better position to access corporate information and to exercise their voice because they have professional expertise and lower costs of intervention.¹⁹⁴

Monks points out that institutions could influence managerial behaviour in three important ways in Western capitalist economies: "(a) they are fiduciaries, subject to the standard of conduct devised by their legal system, and therefore obliged to take any action that is "prudent" to protect and enhance value; (b) they are full-time, knowledgeable, sophisticated investors, in close touch with trends, transactions, and markets; and (c) they are large enough to make their involvement in monitoring and other corporate governance initiatives meaningful and effective."¹⁹⁵ For these reasons

¹⁹³ See Berle and Mean, *op cit.* fn.1.

¹⁹⁴ see C. A. Riley, 1994. Controlling Corporate Governance Management: UK and US Initiatives, *Legal Studies*, Vol.14, pp244-256.

¹⁹⁵ Monks, R. A.G., 1995. *Sleeping Giants: Expectations of Institutional Investors and Their Voting Behaviour, Corporate Governance - Structural Reforms in the American and German Corporation Law*, Heidelberg, Available from: http://www.ragm.com/archpub/ragm/sleeping_giants.html [Accessed 13 November 2005].

it is realistic to expect that institutional investors will play an active role in corporate governance.¹⁹⁶

Research on ownership and control in countries outside the US and the UK has been growing rapidly in recent years. Most studies suggest that the dispersed ownership structure identified by Berle and Means is not the norm elsewhere. For example, in 1999, La Porta et al utilised the ultimate ownership of the 20 largest corporations in 27 countries and found that only about one-third of countries were characterised by dispersed ownership structure, whereas the rest had a concentrated ownership structure and family and state control were relatively common in many emerging markets (e.g. Argentina, Mexico, South Korea and Israel).¹⁹⁷ However, when ownership is concentrated, the controlling shareholders may act in their own interests at the expense of minority shareholders.

La Porta et al 1999 recognised the proposition that corporate ownership structure is important in corporate governance.¹⁹⁸ By examining corporate governance and ownership around the world, they concluded that in many economies the principal agency problem is the risk of the expropriation of minority shareholders by the controlling shareholders, rather than the conflict of interest between managers and

¹⁹⁶ It noteworthy that although the institutional investors are large, with knowledge and expertise, this does not necessarily imply that they will be aggressive monitors. On the contrary, institutional investors may have weak incentives to engage in managerial monitoring of their portfolio companies because of the cost of monitoring, collective action or the fear of insider dealing. See Coffee, J. C. 1994. The SEC and the Institutional Investor: A Half-Time Report, 15 *Cardozo Law Review*. 837-907. For example, evidence shows that there is a much lower level of voting by institutional investors in the UK than might be expected. This issue will be discussed in Chapter 5.

¹⁹⁷ See La Porta et al. 1999, *op cit.* fn.154.

¹⁹⁸ *ibid*

shareholders.¹⁹⁹ More recently, Claessens et al examined evidence of the expropriation of minority shareholders for 2,658 corporations in nine East Asian countries in 1996.²⁰⁰ They affirmed that the risk of expropriation is the major principal-agent problem for large corporations, as suggested by La Porta et al. Their study concluded that the degree to which certain ownership structures were associated with expropriation depends on country-specific circumstances. Lemmon and Lins investigated 800 listed firms in eight East Asian countries and also found that ownership structure plays an important role in determining whether insiders expropriate minority shareholders.²⁰¹

As we have seen, the ownership structure has changed from a dispersed pattern to a concentrated pattern because institutional investors have emerged as the largest owners of equity in the US and the UK over the past 40 years. In comparison, the Asian Development Bank Briefing Notes (No.13 & 14, hereafter the Briefing Notes) on 'Some Conceptual Issues of Corporate Governance' report that in most East Asian countries, family and family groups are usually ultimate controlling shareholders of many corporations.²⁰² The Briefing Notes point out that in family-controlled firms, the chairman of the board of directors and chief executive officer are often the same individual or from the same family. The controlling shareholders appear capable of conducting expropriation by paying themselves special dividends, exploiting business

¹⁹⁹ *ibid.*

²⁰⁰ Claessens, S., S. Djankov, J. P. H. Fan, and L. H. P. Lang, 1999. *Expropriation of Minority Shareholders: Evidence from East Asia*, Working Paper No.2088, World Bank.

²⁰¹ M. L. Lemmon and K. V. Lins, 2003. Ownership Structure, Corporate Governance and Firm Value: Evidence from the East Asian Financial Crisis. *The Journal of Finance*, Vol. 54(4), 1445-1468.

²⁰² Zhuang, J., 1999. Some Conceptual Issue of Corporate Governance, Economics and Development Resource Center Brief Notes 13 and 14.

opportunities for other companies they control, and taking on excessively risky projects at the expense of minority shareholders and other investors.²⁰³

There was recent similar research regarding the matter of ownership and control in China. Liu found that, among the 1,412 enterprises reformed into limited liability companies with multi-shareholder or limited liability stock companies, 65.7 per cent are companies absolutely controlled by state-ownership.²⁰⁴ For public companies that have significant shareholdings by the state, however, the matter is more complicated. Based on Berle and Means' classification of control where about 70 per cent of the value of the issued capital of China's listed companies is held in the form of state-owned shares and legal person shares, majority control seems to be the dominant form of control in China's industrial world. However, who actually plays the role of a shareholder of the state is more complicated in China's corporate practice.

Indeed, Peev argues that a dominant ownership stake by some individual or group is only one of the relevant signals to yield effective control of the firm, but it does not automatically determine who has real decision-making authority in a given company.²⁰⁵ In China, the state or the SOEs own a significant proportion of shares in most publicly listed companies. Unlike private blockholders, state ownership is funded with money that ultimately belongs to the state as a whole and is controlled by

²⁰³ *Ibid.*

²⁰⁴ Liu, D., 2000. *Corporate Governance of the State-owned Enterprises in China*. Available from: <http://www.oecd.org/dataoecd/47/59/1929582.pdf>. [Accessed 25 February 2005].

²⁰⁵ Peev, E., 2001. Corporate Governance Transformation in Transition Economics: Evidence from Bulgaria. *Quarterly Journal of Economic Research*, Vol.1, pp.290-301.

the government or its agents who have no ownership rights personally. In this regard, it is still unclear whether the state shareholder will be able to effectively monitor the companies under the Chinese corporate system. Therefore, we set out to examine the following questions in the remaining sections: what is the legal form of ownership for creating a corresponding classification of shares? What is the key feature of ownership concentration and its effects on corporate governance in China? Does ownership structure need to be changed toward dispersed ownership compared with the UK? These questions are extremely important for the understanding of corporate ownership and control in China and the development of the Chinese corporate governance system.

4.3 Classification of Shares and Ownership Structure

There is a unique classification of shares in China which differs quite substantially from that observed in the Anglo-American system. Shares are categorised into four main groups on the basis of the characteristics of the investors and the transferability of the different types of shares in China's Shanghai and Shenzhen stock exchange markets. They are: 1) state shares; 2) legal person shares; 3) tradable A shares; and 4) B shares.

State shares are company issued shares held by the state. These shares include (1) the shares converted from the net assets of SOEs which have been transferred into listed companies; (2) shares initially issued by the companies and purchased by government

departments investing on behalf of the state; and (3) shares initially issued by companies and purchased by investment companies, assets management companies, and economic entities authorised to make investments on behalf of the state.²⁰⁶

Legal person shares are company issued shares held by domestic institutions, including “industrial enterprises, securities companies, trust and investment companies, foundations and funds, banks, construction and real estate development companies, transportation and power companies, and technology and research institutes”.²⁰⁷ The shareholder identity in legal person shares has become more complex as a result of foreign investor involvement since November 2001.²⁰⁸

However, both state and legal person shares are not allowed for trading at the two stock exchange markets. They are only transferable to other SOEs, domestic institutions, or certain foreign institutional investors,²⁰⁹ upon approval of the CSRC and the State Assets Supervision and Administration Commission. The original purpose of barring state shares and legal person shares from free trading was to maintain the government’s leading role in the Chinese economy.

²⁰⁶ See “Interim Measure for Administering the Rights of State shares in Joint Stock Limited Liability Companies”, promulgated by the State Assets Bureau and SCRES. *China Securities Daily*, Nov 5, 1994, at 2, citing in Fang, L. 1995. China’s Corporatization Experiment, 5 *Duke Journal of Comparative and International Law*, pp149-269, at 203.

²⁰⁷ Tenev, S. and C. Zhang, 2002. *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*. World Bank and the International Finance Corporation Washington, D.C. p76.

²⁰⁸ See ‘Some Opinions Concerning Foreign Investment in Listed Companies’ issued by the CRSC and Ministry of Foreign Trade and Economic Cooperation 2001, and ‘Measures on the Takeovers of Listed Companies’ issued by the CSRS, and ‘Circular on the Transfer of State Shares and Legal Person Shares to Foreign Investors’ issued by the CRSC, ZhengJianFa [2002] No.83, November 2002. Available from: http://www.ec.cn/pubnews/2003_02_16/200616/1000747.jsp [Accessed 15 March 2005].

²⁰⁹ *Ibid.*

Tradable A shares are also called individual shares. Under China's company law, they are issued by companies to Chinese citizens and domestic institutions and the total amount of tradable A shares has to exceed 25% of total outstanding shares when a company is listed.²¹⁰ However, the CSRC and the People's Bank of China jointly issued "Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors" (Hereafter, the QFII) on 5 November 2002, which came into effect on 1 December 2002. The new rule defines four types of QFII, which are (1) fund management institutions; (2) insurance companies; (3) securities companies; and (4) other asset management institutions, and all are allowed to trade A shares in China's stock markets.²¹¹

B-shares are created for foreign investors with the aim of raising funds in foreign currency for companies involved in international trade. B shares issued by companies listed on the Shanghai stock exchange market are denominated in US dollars, while those listed on the Shenzhen stock exchange market are in Hong Kong dollars. Until 2001, Chinese citizens were also allowed to trade B shares through their foreign currency accounts.²¹² However, as A shares and B shares are issued by the same companies, how the various shareholders who own A shares or B shares or both exercise their voting rights is an open question in corporate practice.²¹³

²¹⁰ Section 4 of Article 152, the CCL 1994.

²¹¹ See Art.2 of the QFII.

²¹² See the Circular of the China Securities Regulatory Commission and the State Administration of Foreign Exchange, Notice on Issues Concerning Individual Domestic Residents' Investment in Foreign Currency Stocks Listed in the Domestic Stock Markets, CSRC No.22 2001.

²¹³ The CCL 1994 provides no indication of whether A shares and B shares should vote as a common group or be separated by class. However, because the shares are issued in different currencies, there are potential conflicts with the value of A and B shares. As a result, how these two shares' voting rights are actually exercised in practice is unclear.

In addition to the four types of shares listed in China's two stock exchange markets, there are also other types of shares – employee shares and overseas listing shares. Employee shares are only issued to the incumbent workers and management of a listed company with a substantial discount. In fact, they are usually designed much like an incentive stock scheme and can only be traded 6 – 12 months after the date of granting in the stock exchange markets upon approval of CSRC.²¹⁴ However, directors, supervisors and managers are required to report their shareholding in the company they serve and are not allowed to transfer their shares during their tenure.²¹⁵ Overseas listing shares are issued by companies which are listed outside China. These shares include those issued in Hong Kong (H shares), New York (N shares), London (L shares) and Singapore (S shares).

A typical listed company in the Chinese stock markets has a mixed ownership structure comprising three predominant groups of shareholders – the state, legal person and tradable A shareholders.²¹⁶ Despite the incredible growth in China's securities' markets over the last decade, its stock issuing activities are still very limited because only one-third of shares in listed companies can be freely traded in the Chinese stock markets [see table 4.1(a)]. By the end of 2002, there were a total of 1,224 companies listed in China's two stock exchange markets. 47.2% of total equity was held by the state, 16.41% was held by legal persons, 25.69% were tradable A shares, and only 2.85% were B shares. A further investigation by Green shows that by

²¹⁴ Xu, X. and Y. Wang, 1999. Ownership Structure and Corporate Governance in Chinese Stock Companies, *China Economic Review* 10, pp75-98, at79

²¹⁵ Article 147 of the CCL 1994.

²¹⁶ See Xu and Wang, *op cit.* fn.214, p80

the end of 2002, only 6% of listed companies had non-tradable shares accounting for less than 40% of total equity capital, while only 0.4% of listed companies had no non-tradable shares at all.²¹⁷ The large proportion of non-traded state and legal person shares has created a number of problems. Russell claims that in early 2004 nearly two-thirds of companies' issued shares were held by controlling shareholders in the form of state bodies and other legal persons in China, and this has had the effect of distorting share prices and creating a conflict of interest between the large and small shareholders.²¹⁸

In contrast, shares under UK company law may be classified as ordinary shares, preference shares, deferred shares, non-voting and multiple voting shares, share warrants, or depositary receipts etc.²¹⁹ A special share class may have special rights which depend on the particular terms of issue of the class as set out in the company's articles of association or in particular contracts of allotment. Article 2 of the Companies (Table A) Regulations 1985 provides that "subject to the provisions of the Act and without prejudice to any rights attaching to existing shares, any share may be issued with such rights or restrictions as the company may by ordinary resolution determine".²²⁰ However, the London Stock Exchange encourages public listed companies to restrict themselves to one class of shares, favouring the equality of treatment and the transparency of rights which such a capital structure ensures.²²¹

²¹⁷ Green, S. 2003. *'Two-third Privatisation': How China's Listed Companies are – Finally – Privatising*, Chatham House Briefing Note, The Royal Institute of International Affairs, Asia Programme.

²¹⁸ Russell, M. E. 2004. *The People's Republic of China-Visit Report: Banking on Reform*. Available at http://www.citlon.co.uk/pdf/features/China_Report2.04.pdf [Accessed 23 March 2005].

²¹⁹ See Pettet, *op cit.* fn.39. pp286-288.

²²⁰ Art. 2, Table A.

²²¹ Hannigan, B., 2003. *Company Law*, LexisNexis UK, p389

In addition, section 182 (1) (b) of the Companies Act 1985 (hereafter, the CA 1985) provides that shares in a company are to be transferable. The relevant rules are also set out in Chapter 3 of the Listing Rules which requires all the securities to be freely transferable as far as the issuer is concerned.²²² Ownership patterns in the UK are unusual in that a high proportion of the equity in listed UK companies is owned in aggregate by financial institutions such as pension funds, insurance companies, unit trusts and investment trusts (see Table 4.1 (b)). At the end of 2002, the largest institutional beneficial owners of UK shares were insurance companies with 19.9% and pension funds with 15.6% respectively. Nevertheless, individuals are also major shareholders with 14.3% in listed companies in the UK.

4.4 Concentration of Ownership and Corporate Control

Property rights theory provides useful insights stressing that shareholders, who provide the share capital, are the ultimate owners of companies. The role of shareholders in exercising corporate control is closely linked with the proportion of shares owned. Despite the fact that the official classification in China provides a clear view about ownership structure, which is highly concentrated in the hands of state bodies and other legal persons, the data do not reveal a clear picture about the identity of the large shareholders. The official statistical data on ownership structure are still rather poor and comparability is limited.

²²² See Para 3.15, Chapter 3: Conditions for Listing, the Listing Rule, UKLA, December 2003.

Table 4.1(a) Ownership Structure in China (1992-2002)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total Number of listed companies	53	180	290	322	529	744	851	949	1088	1160	1224
Total capitalization (100 million RMB)	1,048	3,531	3,691	3,474	9,842	17,529	19,506	26,471	48,091	43,522	38,329
Negotiable share	31.9	28.8	32.9	41.3	35.2	34.6	34.0	35.2	36.6	36.6	34.67
A-share	15.4	16.8	20.9	21.0	21.9	23.0	24.1	26.9	29.0	25.26	25.69
B-share	16.5	6.4	6.1	6.7	6.4	6.4	5.4	4.3	4.2	3.1	2.85
H-share	0.0	5.7	6.0	7.7	6.9	5.2	4.5	3.9	3.5	6.4	6.13
Nonnegotiable share	68.1	71.2	67.1	64.6	64.8	65.4	66.0	64.8	63.3	65.3	65.33
State share	44.6	48.2	42.7	38.9	37.7	35.4	34.3	31.6	37.1	46.2	47.20
Legal person share	22.1	21.3	24.5	24.9	26.7	28.2	29.6	24.9	24.9	18.3	16.41
Others	1.5	1.7	1.3	1.2	2.2	3.3	3.4	3.6	1.3	0.8	1.72
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: Zhongguo Shanshi Gongsi Jiben Fenxi 2000, edited by Zhongchenxin Guoji Xinyong Pingji Ltd, China Science and Technology Publisher, 2000; China Securities and Futures Statistics (2003), and the Official Website for the China Securities Regulatory Commission at

http://www.csrc.gov.cn/en/statinfo/index1_en.jsp?path=ROOT>EN>Statistical%20Information>Listed

Table 4.1(b) Ownership Structure in the UK (1992-2002)

	1992	1993	1994	1997	1998	1999	2000	2001	2002
Rest of the world	13.1	16.3	16.3	24	27.6	29.3	32.4	31.9	32.1
Insurance companies	19.5	20.	21.9	23.5	21.6	21.6	21	20	19.9
Pension funds	32.4	31.7	27.8	22.1	21.7	19.6	17.7	16.1	15.6
Individuals	20.4	17.7	20.3	16.5	16.7	15.3	16.	14.8	14.3
Unit trusts	6.2	6.6	6.8	6.7	3	2.7	1.7	1.8	1.6
Investment trusts	2.1	2.5	2	1.9	1.9	1.9	2.1	2.2	1.8
Other financial institutions	0.4	0.6	1.3	2	4.1	5.1	4.6	9.9	10.5
Charities, churches, etc	1.8	1.6	1.3	1.9	1.4	1.3	1.4	1	1.1
Private non-financial companies	1.8	1.5	1.1	1.2	1.4	2.2	1.5	1	0.8
Public sector	1.8	1.3	0.8	0.1	0.1	0.1	--	--	0.1
Banks	0.5	0.6	0.4	1.0	0.6	1.0	1.4	1.3	2.1
Total	100	100	100	100	100	100	100	100	100

Sources: National Statistics, Share Ownership: A report on ownership of shares as at 31st December 2002. http://www.statistics.gov.uk/downloads/theme_economy/ShareOwnership2002.pdf

In this study, we take a static view of the relationship between ownership and corporate control by looking at the proportion of shares held by the five largest shareholders, to examine how corporate control is distributed in our samples of listed companies in China and the UK and to describe their differences. As explained in Chapter 3, the Chinese sample consists of 267 companies randomly selected from the Chinese Stock Exchange markets and the UK sample consists of 196 companies randomly selected from the London Stock Exchange market. Table 4.2(a) and 4.2(b) show the mean, median, and the standard deviation of the top five shareholders' shareholdings in China and the UK respectively.

Table 4.2(a) The Concentration of Ownership in China

	Minimum	Maximum	Mean	Std. Deviation
The largest shareholders	.39	85.00	45.39	18.57
The second largest shareholders	.07	33.00	7.81	7.62
The third largest shareholders	.06	18.42	3.08	3.40
The fourth largest shareholders	.05	9.04	1.64	1.74
The fifth largest shareholders	.04	8.88	1.12	1.29

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets.

Table 4.2(b) The Ownership Concentration in the UK

	Minimum	Maximum	Mean	Std. Deviation
The largest shareholder	3.50	53.90	15.12	8.59
The second largest shareholders	1.80	25.04	9.31	3.88
The third largest shareholders	1.29	16.22	6.72	2.54
The fourth largest shareholders	.10	12.98	5.38	2.11
The fifth largest shareholders	.05	12.77	4.39	1.84

Source: the survey of 196 companies listed in London Stock Exchange market.

Table 4.2(a) shows the overall proportion of firm equity held by the five largest shareholders in the Chinese sample. The largest shareholder in each company owns on average 45.39%; the second largest owns on average 7.81%; the third largest owns on average 3.08%, the fourth largest owns on average 1.64%, and the fifth owns on average 1.12% of the total shares listed in China's stock exchange markets. Comparing the concentration pattern we can see the largest shareholder owns about 5.8 times more than the second largest shareholder and about 3.3 times more than the aggregate shareholding owned by the second, third, fourth and fifth shareholders combined together. The picture indicates that the voting power which is concentrated on the largest shareholder cannot easily be challenged by a coalition of the remaining shareholders in China.

Table 4.2(b) reports the overall proportion of firm equity held by the five largest shareholders in the UK. The largest shareholder in each company owns on average 15.12%; the second largest 9.31%; the third largest 6.72%, the fourth largest 5.38%, and the fifth largest 4.39%. Comparing the concentration pattern, we can see that the gap between each shareholding owned by the top five shareholders is much less than in China. On average, there is no single shareholder which has sufficient power to discipline management.

Figures 4.1(a) and 4.1(b) present histograms showing a comparison of the distribution of the shareholdings held by the largest shareholder in China and the UK respectively.

Further inspection of the cumulative ownership data set out in Table 4.3 reveals that the concentration of share ownership in China's companies is much higher than in the UK companies. For example, there are 184 cases, representing 69% of the companies, in which the largest shareholders own a stake of more than 30% of total shares in China. In contrast, there are only 6 cases, represent 3.1% of the companies, in which the largest shareholders own more than 30% of total shares in the UK.

Figure 4.1(a) Frequency Distribution of Shareholdings Held by the Largest Shareholder

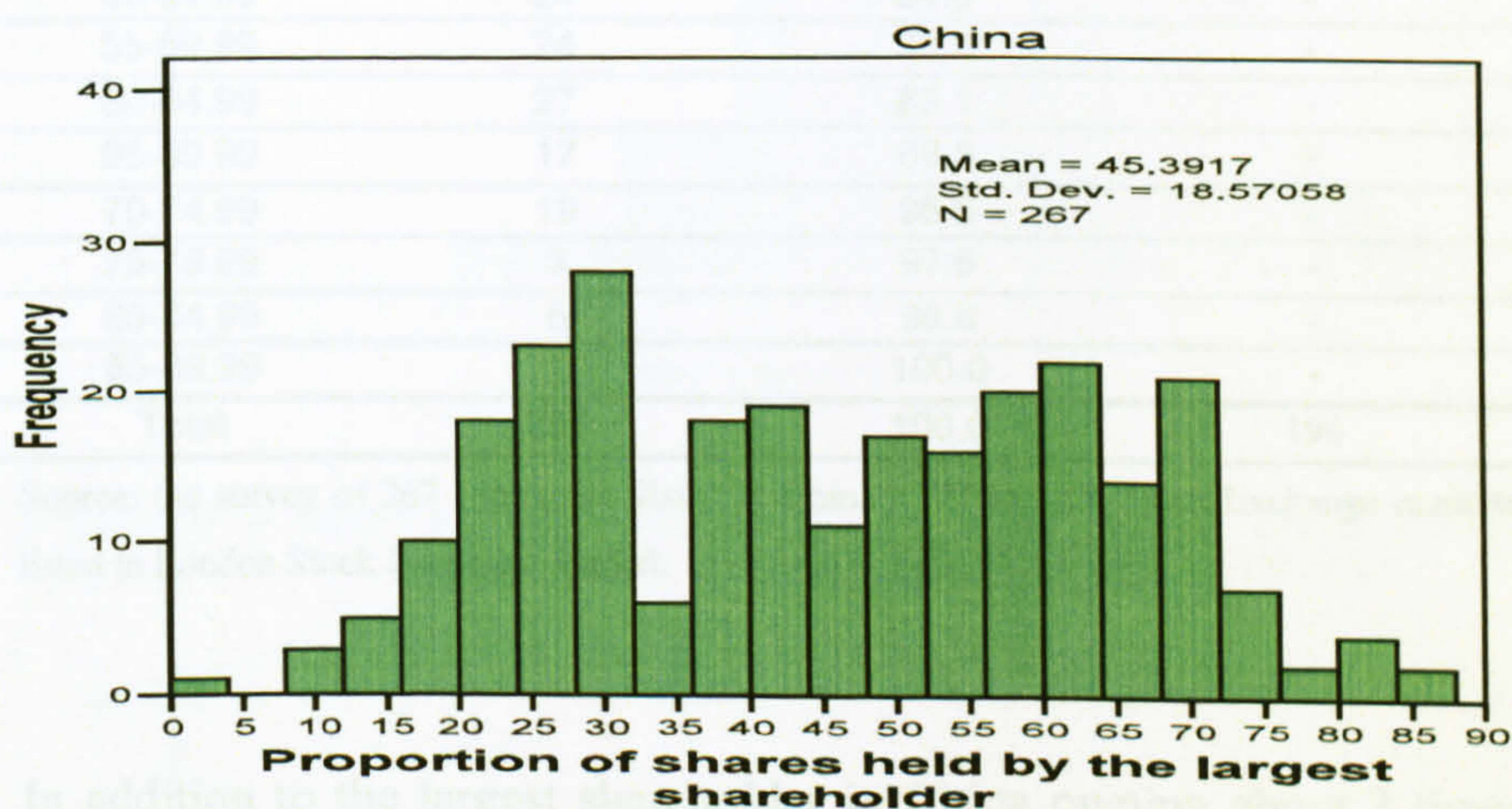
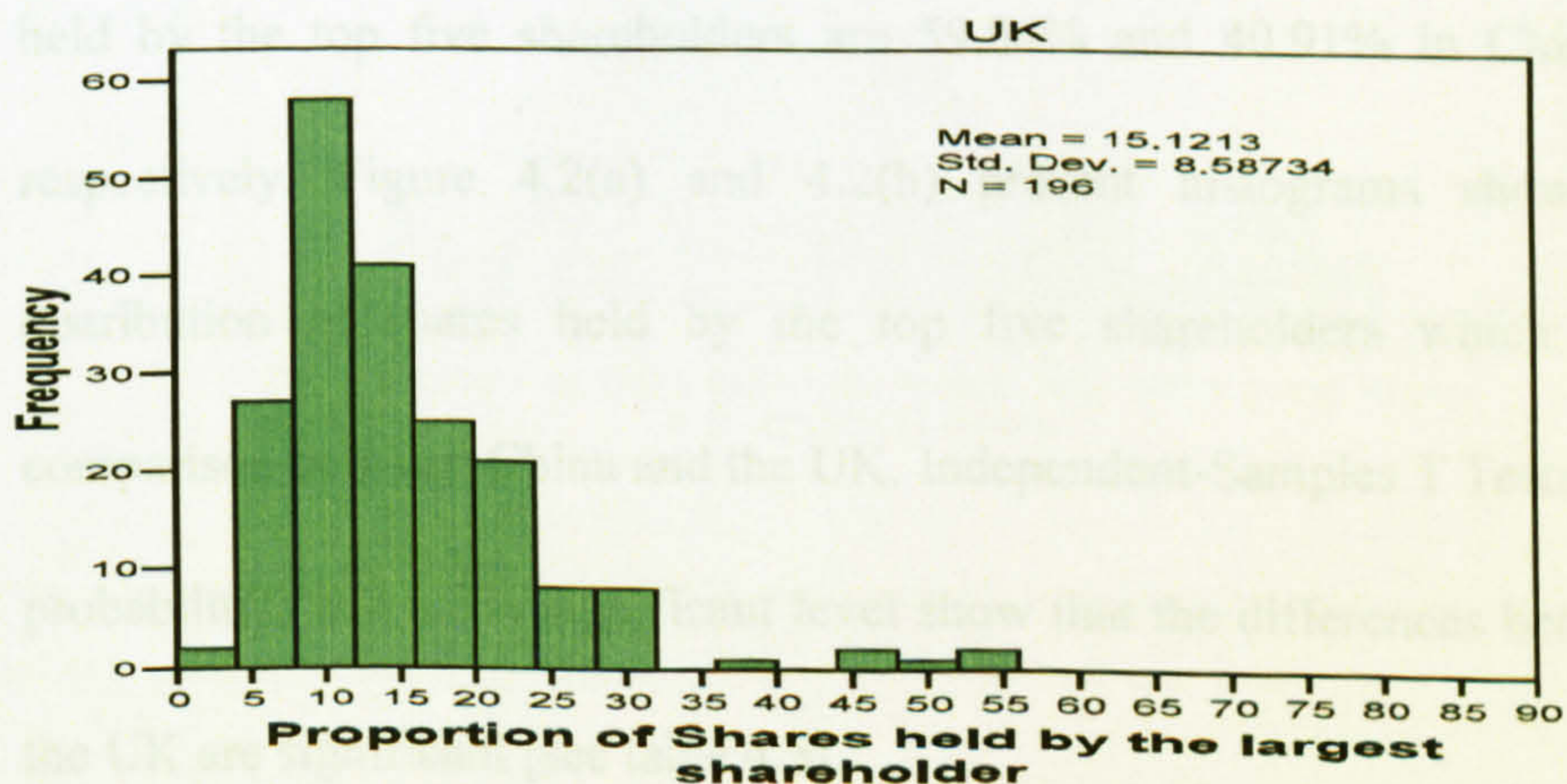


Figure 4.1(b) Frequency Distribution of Shareholdings Held by the Largest Shareholder



Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Table 4.3 Frequency Distribution of Shareholdings Held by the Largest Shareholder in China and the UK

Range	China		UK	
	Frequency	Cumulative Percent	Frequency	Cumulative Percent
0-4.99	1	.4	5	2.6
5-9.99	1	.7	54	30.1
10-14.99	6	3.0	61	61.2
15-19.99	11	7.1	33	78.1
20-24.99	23	15.7	22	89.3
25-29.99	41	31.1	15	96.9
30-34.99	9	34.5	1	97.4
35-39.99	20	41.9	3	99.0
40-44.99	20	49.4	2	100.0
45-49.99	15	55.1	-	-
50-54.99	24	64.0	-	-
55-59.99	24	73.0	-	-
60-64.99	27	83.1	-	-
65-69.99	17	89.5	-	-
70-74.99	19	96.6	-	-
75-79.99	3	97.8	-	-
80-84.99	5	99.6	-	-
85-89.99	1	100.0	-	-
Total	267	100.0	196	100

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

In addition to the largest shareholder in China owning about 3 times more than the largest shareholder in the UK, Table 4.4 shows that the average proportion of shares held by the top five shareholders are 59.04% and 40.91% in China and the UK respectively. Figure 4.2(a) and 4.2(b) present histograms showing the visual distribution of shares held by the top five shareholders which makes a clear comparison between China and the UK. Independent-Samples T Tests with two-tailed probabilities and a 5% significant level show that the differences between China and the UK are significant [see table 4.5].

Table 4.4 Comparison of Shares Owned by the Top 5 Shareholders in China and the UK

Country of origin	N	Minimum	Maximum	Median	Mean	Std. Deviation
China	267	1.18	86.54	62.11	59.04	13.89
UK	196	14.50	88.02	39.6550	40.91	14.21

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Figure 4.2(a) Frequency Distribution of Shareholdings Held by the Top Five Shareholders

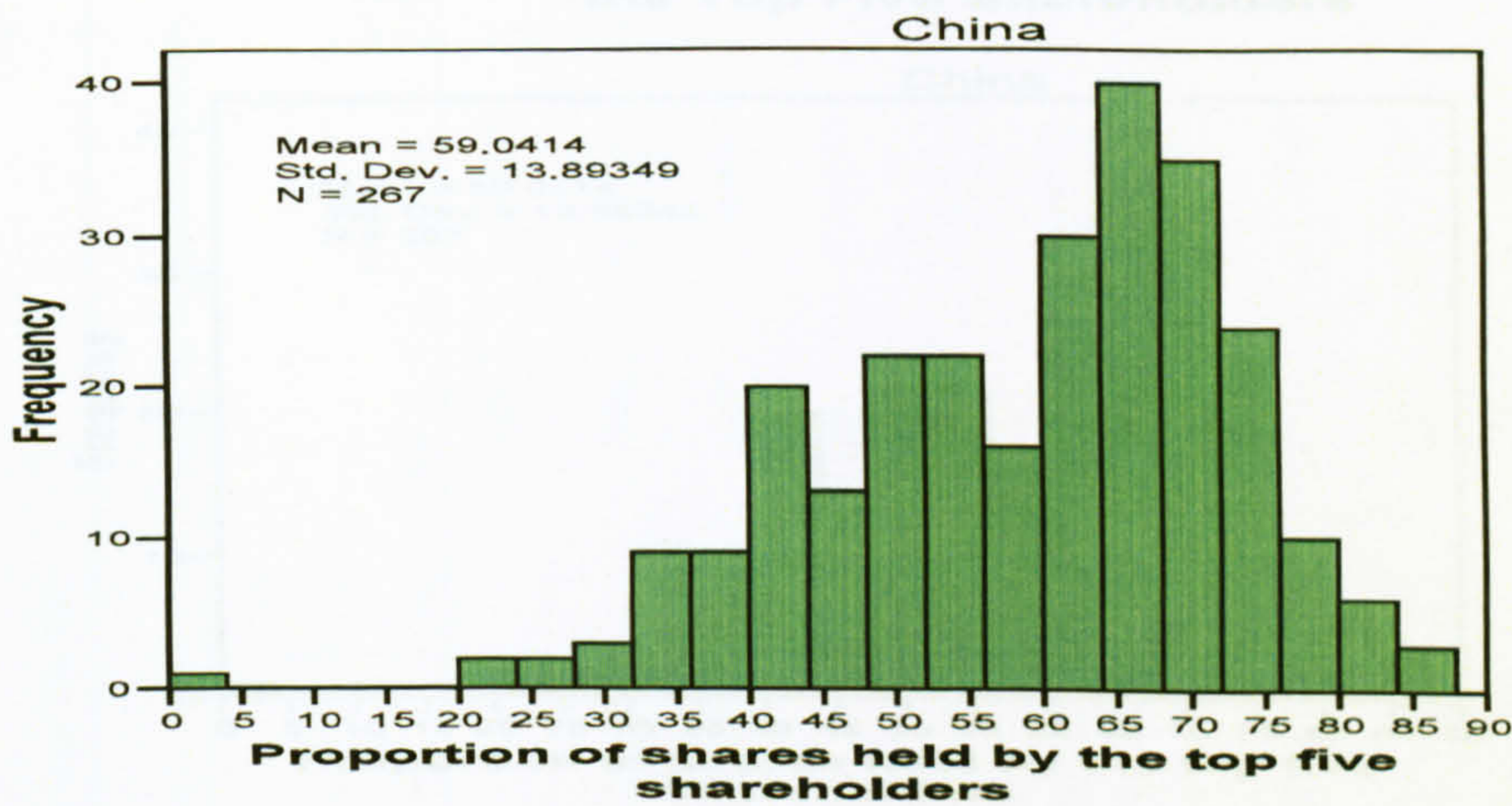
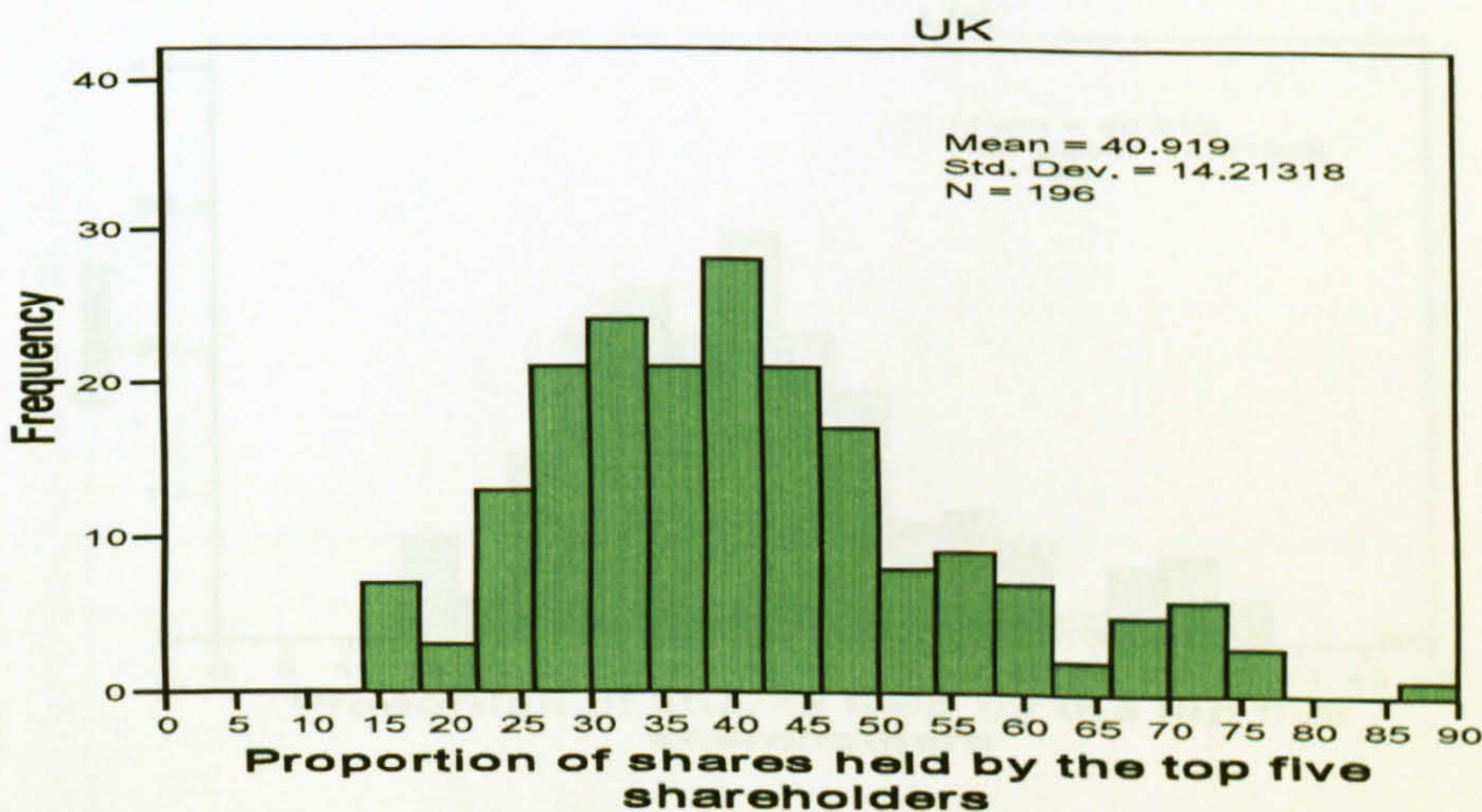


Figure 4.2(b) Frequency Distribution of Shareholdings Held by the Top Five Shareholders



Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Table 4.4 Comparison of Shares Owned by the Top 5 Shareholders in China and the UK

Country of origin	N	Minimum	Maximum	Median	Mean	Std. Deviation
China	267	1.18	86.54	62.11	59.04	13.89
UK	196	14.50	88.02	39.6550	40.91	14.21

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Figure 4.2(a) Frequency Distribution of Shareholdings Held by the Top Five Shareholders

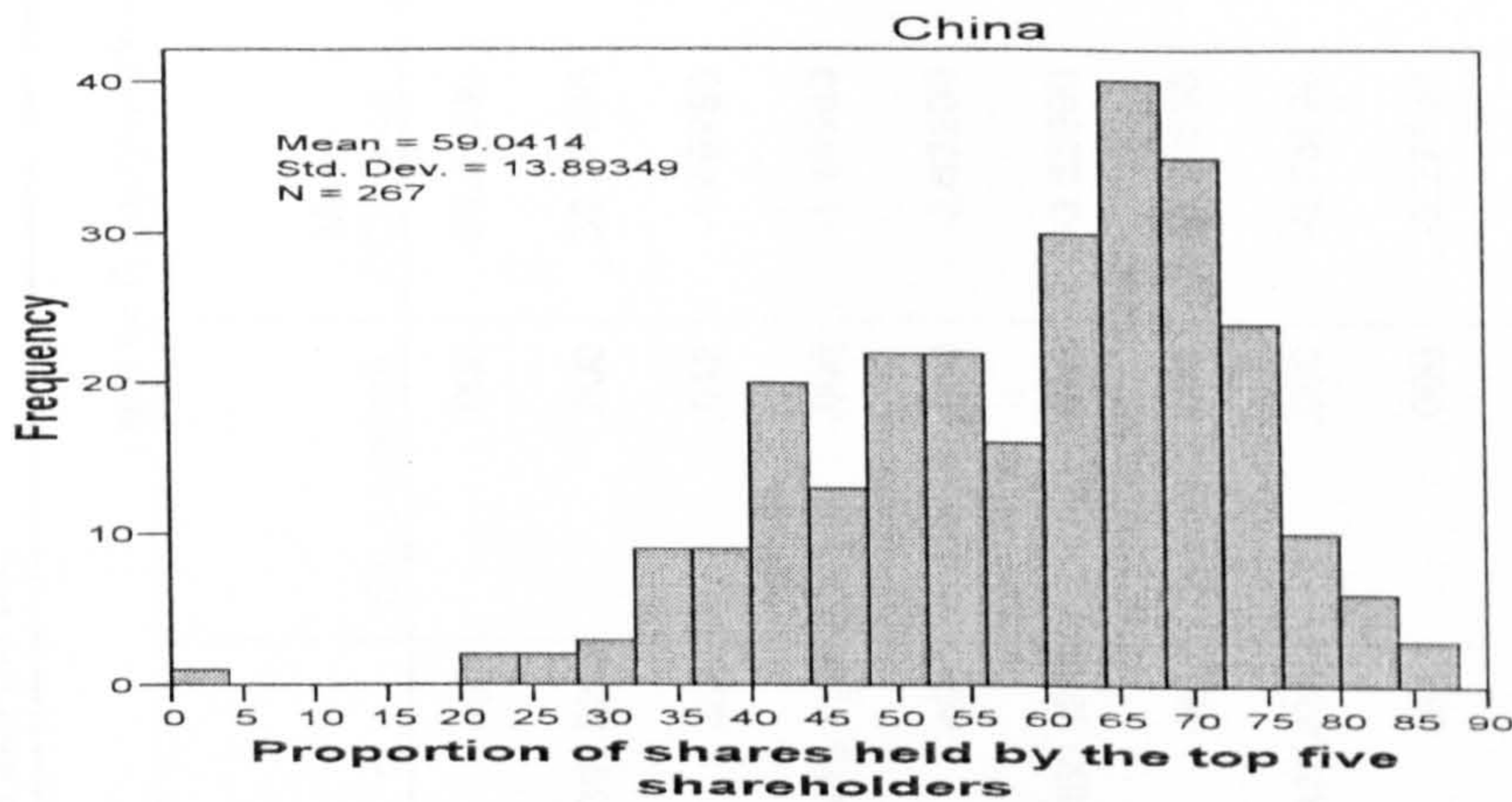
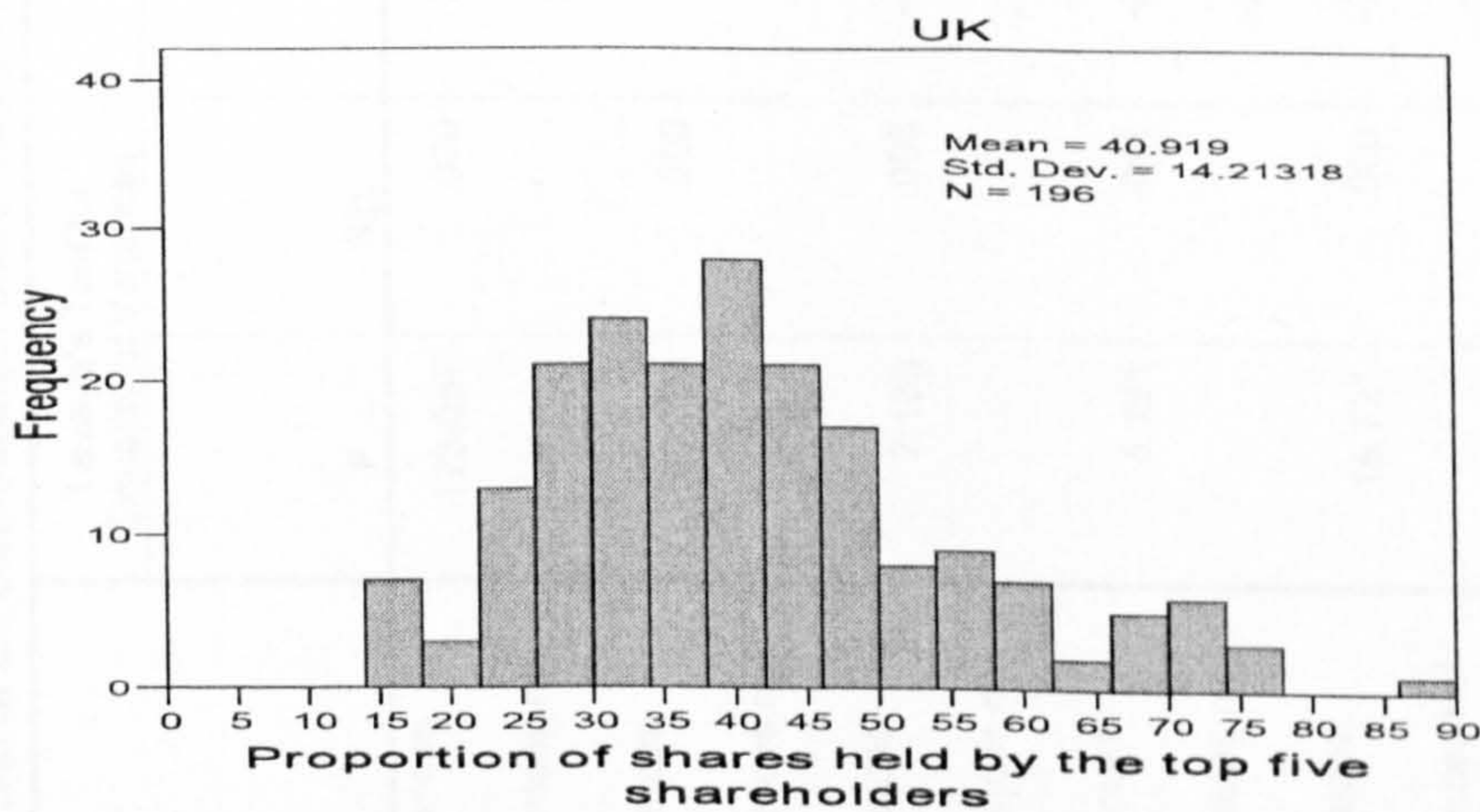


Figure 4.2(b) Frequency Distribution of Shareholdings Held by the Top Five Shareholders



Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Table 4.5 Independent Samples Test of the Distribution of Shareholding between China and the UK

		Levene's Test for Equality of Variances		t	df	Sig. (2-tailed)	t-test for Equality of Means			95% Confidence Interval of the Difference	
		F	Sig.				Mean Difference	Std. Error Difference	Lower	Upper	
The largest shareholder	Equal variances assumed	173.057	.000	21.212	461	.000	30.27036	1.42706	27.46600	33.07471	
	Equal variances not assumed			23.439	397.524	.000	30.27036	1.29146	27.73141	32.80931	
The second largest shareholders	Equal variances assumed	90.708	.000	-2.527	461	.012	-1.49983	.59353	-2.66619	-.33348	
	Equal variances not assumed			-2.767	416.119	.006	-1.49983	.54207	-2.56536	-.43430	
The third largest shareholders	Equal variances assumed	7.138	.008	-12.620	461	.000	-3.63990	.28842	-4.20668	-3.07312	
	Equal variances not assumed			-13.188	460.891	.000	-3.63990	.27601	-4.18229	-3.09751	
The fourth largest shareholders	Equal variances assumed	4.191	.041	-20.811	461	.000	-3.73698	.17957	-4.08985	-3.38411	
	Equal variances not assumed			-20.209	370.475	.000	-3.73698	.18491	-4.10059	-3.37337	
The fifth largest shareholders	Equal variances assumed	15.721	.000	-22.492	461	.000	-3.27133	.14544	-3.55715	-2.98552	
	Equal variances not assumed			-21.327	328.378	.000	-3.27133	.15339	-3.57308	-2.96959	
The top five shareholders	Equal variances assumed	.220	.639	13.733	461	.000	18.12231	1.31963	15.52907	20.71555	
	Equal variances not assumed			13.685	414.865	.000	18.12231	1.32425	15.51923	20.72539	

The statistical comparisons above allow us to see that corporate control is largely concentrated in the hands of the largest shareholder in China. However, it does not indicate who is the ultimate owner of these shares. Gugler argues that judging separation of ownership and control on the basis of ownership concentration alone is misleading because holding companies, banks, institutional investors, other non-financial corporations, and family owners may have different business objectives. Managers of corporations under governmental, quasi-governmental, or even under direct state control are likely to have different incentives and behave differently from corporations owned by the private sector.²²³

Liu and Sun claim that the Chinese official classification of shareholding in China fails to identify the ownership identity of the legal person shares which makes unclear who will be the ultimate owners of the firm and actually exercise the corporate control rights over management.²²⁴ They also argue that the ambiguous nature of the identification of ultimate owners in publicly listed companies, in turn, has misled a large number of previous empirical studies on the ownership structure and firm performance for Chinese corporations.²²⁵ It becomes apparent that the source of capital of state shares and legal person shares which are from different legal entities and the identity of these share owners is uncertain and puzzling. Liu and Sun's arguments set out a caveat that tracing the identity of state and legal person shares is

²²³ See K. Gugler, *op cit.* fn. 40. p24.

²²⁴ Liu, G. S. and S. P. Sun, 2003. *The Class of Shareholdings and Its Impacts on Corporate Performance – A case of State Shareholding Composition in Chinese Publicly Listed Companies*, The Royal Institute of International Affairs, Asia Programme Working Paper No.2.

²²⁵ *Ibid.*

crucial for studying the Chinese corporate governance system. Keeping this caveat in mind, therefore, in this study, we tackle the problem of the identities of shareholders by comparing our sample of Chinese listed companies with our sample of UK listed companies to identify the distinctive features of the Chinese ownership structure in the next subsection.

4.5 Identities of Shareholders

By the observation and discussion of corporate ownership and control, we have seen that the nature and character of the ownership structure within each country's corporate system is unique. This calls for an examination of the exact nature of ownership – the identities of the shareholders. It is not possible to discover the identities of all shareholders in a company because of the difficulty of obtaining information, but the rules of information disclosure allow this study to detect some information concerning the identity of the largest shareholder and the controlling shareholder of a company through examining the company's annual report or other public sources. Under the corporate system, it is apparent that the largest shareholder or the controlling shareholder normally has the power and incentive to exert influence on a company's operational management or general and specific policies. Therefore, identification of the largest shareholder and the controlling shareholder is a particularly important factor in evaluating the role they play in corporate governance.

As we have seen, high ownership concentration is a distinctive feature of China's companies compared with UK companies. It is also evident that the shareholders' identities vary in the listed companies between the two countries. One natural question for China in relation to the fundamental characteristics of the different types of shareholders involved with companies is about who is an ultimate owner of the 'state', 'legal person' and 'tradable A' shares. In China, the state shares are either held by the central and local government agencies, including central government ministries and commissions, local government bureaux and departments which manage the state's assets, or by state owned enterprises (SOEs) which are ultimately controlled by the government, or its agencies. The legal person shares are generally held by domestic corporations or institutions including private limited companies, public limited companies, joint ventures and unincorporated partnerships. However, most of them are SOEs or corporative enterprises which are partially owned by the local governments.

So ownership structures assessed on the basis of information provided by the listed companies or by the official reports may not be adequate to present an accurate picture of the exact control pattern of the company. Therefore, this section discusses six classes of shareholder's identities, namely: SOEs; government agencies; financial institutions; non-financial companies; individuals; and foreign investors.²²⁶ This

²²⁶ Gugler categorises common share holdings into several groups, namely families, households, and individuals; non-financial corporations; banks; other financial firms; the state; foreign holdings; and pension funds, mutual funds, and dispersed holdings. See K. Gugler, *op cit.* fn.40, p47. However, this thesis does not take pension funds, mutual funds, and dispersed holdings as a group because these are relative small in Chinese stock exchange markets.

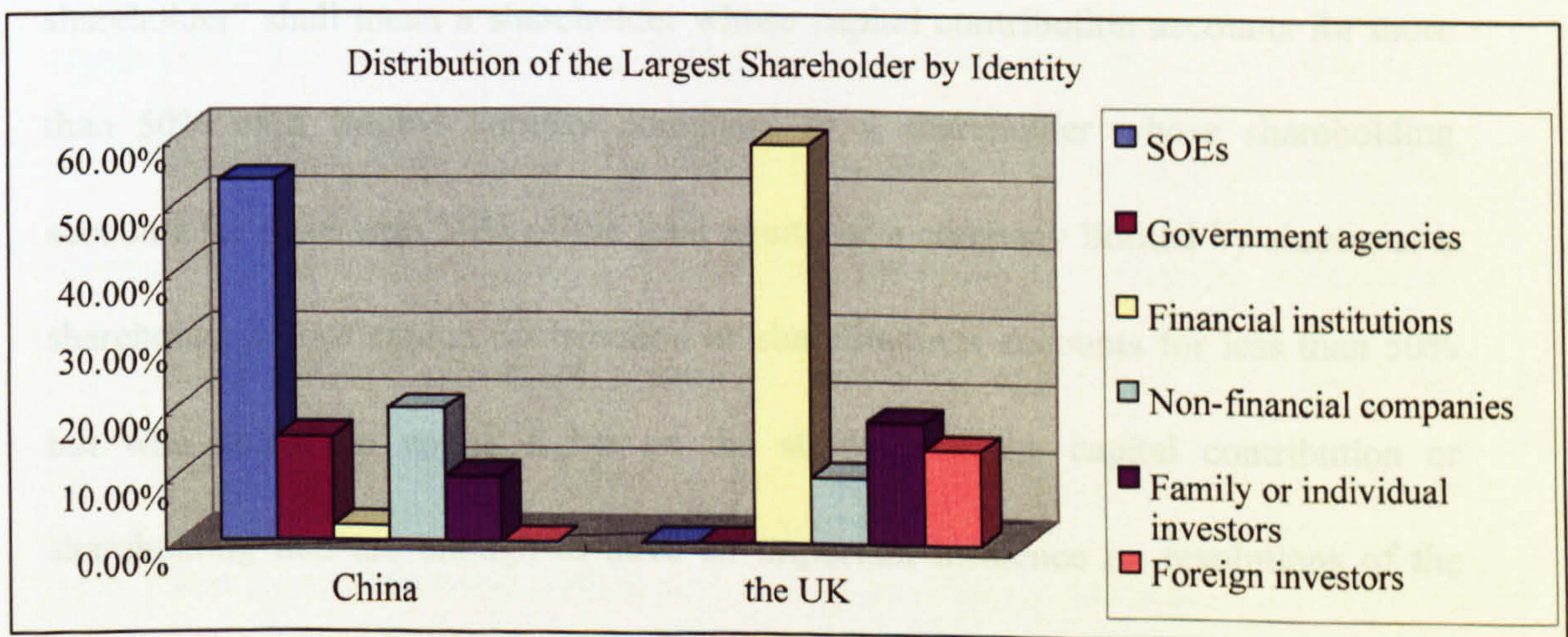
classification contributes to a better understanding of the different corporate control structure in China compared with the UK. The detailed method of classification of the share-owners is as follows:

- SOEs are business entities which are owned by the central government or local government.
- Government agencies comprise central government ministries and commissions, local government bureaux and departments which exercise the ultimate control rights over the state's assets in a listed company.
- Financial institutions include all banks, insurance firms, pension funds, investment trusts, and other security brokers, dealers, and venture capital companies etc.
- Non-financial companies contain all domestic corporate entities or institutions including private limited companies, public limited companies, joint ventures and unincorporated partnerships which are not classified as SOEs or financial institutions.
- Families and individuals include all families, householders, and individual persons who are resident in the UK or China. This group also includes shares held for employee share-ownership and shares held in trusts with named individual beneficiaries.
- Foreign investors include all individuals or institutions resident outside the territories of China or the UK.

Visual inspection of Figure 4.3 suggests that the major shareholders are often SOEs, government agencies and non-financial companies in China, whereas the major

shareholders are often financial institutions, families and individuals and foreign investors in the UK. For example, in the 267 companies randomly selected from the Chinese stock exchange markets, approximately 54% of the largest shareholders are SOEs, 15% of the largest shareholders are government agencies and 20% are non-financial companies. Family or individual investors and financial institutions are less than 10% and 3% respectively. Interestingly, there was no foreign investor as the largest shareholder in our sample of Chinese firms in 2002. In contrast, in the 196 companies randomly selected for the UK London Stock Exchange market, approximately 59% of the largest shareholders are financial institutions, 18% are the families or individual investors, 14% are foreign investors, and 10% are non-financial companies. However, listed companies where SOEs or government agencies own a substantial block of the shares do not exist at all in the UK sample. (see table 4.6)

Figure 4.3



Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange.

Table 4.6 Distribution of the Largest Shareholder by Identity in China and the UK

Identity of the largest shareholders	SOEs	Government Agency	Financial Institutions	Non-Financial Companies	Family and Individual Shareholders	Foreign Investors
China	142 (53.6%)	40 (15.0%)	6 (2.2%)	52 (19.5%)	26 (9.7%)	0
UK	0	0	115 (58.7%)	19 (9.7%)	35 (17.9%)	27 (13.8)

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange.

There is no unanimous definition of the controlling shareholders. In China, a controlling shareholder is defined by Section 41 of the Directive on the Article of Association of Listed Companies as any person (or persons acting jointly) who is able to appoint more than half of the members of board of directors; or entitled to exercise, or control the exercise of 30% of the voting rights; or owns 30% of the company's shares; or able to exercise *de facto* control over the listed company by other methods.²²⁷ Although the term "controlling shareholder" does not appear in the CCL 1994, Article 217 (2) of the CCL 2006 provides that the term "controlling shareholder" shall mean a shareholder whose capital contribution accounts for more than 50% of a limited liability company, or a shareholder whose shareholding accounts for more than 50% of the total equity of a company limited by shares, or a shareholder whose capital contribution or shareholdings accounts for less than 50% but who holds the voting rights on the strength of the capital contribution or shareholding that are enough to have an important influence on resolutions of the shareholder meetings.²²⁸ In the UK, the Listing Rules specify that a controlling

²²⁷ The Directive of the Article of Association of Listed Companies, No.16, Zhenjian [1997], (hereafter, the Directive 1997) art.41.

²²⁸ See Art.217 (2) of the CCL 2006.

shareholder is any person or persons acting jointly by agreement whether formal or otherwise, who is entitled to exercise, or to control the exercise of 30% or more of the rights to vote at a general meeting of the applicant; or able to control the appointment of directors who are able to exercise a majority of votes at board meetings of the applicant.²²⁹ However, whether persons may act jointly to exercise their control rights or be able to exercise *de facto* control by other activities, it is not possible to investigate due to the difficulties of obtaining such information.

Thus, the focus of the study in this section is to describe and compare the average number of controlling shareholders who actually held more than 30% of company's shares and its identities in China and the UK. In seeking to present a clear picture of the relative position of the controlling shareholder, with more than 30% of company's shares, the controlling shareholders have been divided into three different groups: *de facto* controlling shareholder; legal controlling shareholder; and absolute controlling shareholder. A *de facto* controlling shareholder, is defined as one who holds more than 30%, but less than or equal to 50% of a company's shares; a legal controlling shareholder is defined as holding more than 50% but less than or equal to 75%; and an absolute controlling shareholder is defined as holding more than 75%. Since the investigation of the ultimate owner of these controlling shareholders, the ultimate control structure may change if different cut-off levels are considered.

²²⁹ See Listing Rules, *op cit* fn. 222. Para.3.12 & 3.13.

The actual extent to which the concentration of power is held by the largest shareholder has been explored in China and the UK in section 4.4. As Figure 4.3 shows, the largest majority shareholders are the SOEs in China. More striking still, however, is the ratio held by the controlling shareholders and their identity in Chinese listed companies. Table 4.7 gives a clear picture of the distribution of the controlling shareholders and the average of the ultimate control power in China compared with the UK. There are a total of 184 companies, accounting for 69% of the sample companies, in which a controlling shareholder holds more than 30% of company issued shares in China. In contrast, the figures show that dispersed share ownership is the norm in the UK, where only 3.1% of the sample of listed companies have the largest shareholder with more than 30% of company's shares. Further analysis by breaking down the proportion of shares held by the controlling shareholder, shows that approximately 24% of companies in China have a *de facto* controlling shareholder; 41% have a legal controlling shareholder; and 3% have an absolute controlling shareholder. In contrast, there are only 2% of companies in the UK with a *de facto* controlling shareholder; 1% with a legal controlling shareholder; and no listed company in the UK sample has an absolute controlling shareholder.

As compared with the UK companies, it is apparent from these figures that a considerable portion of controlling shareholders exist in the listed companies in China. However, these figures appear to be no adequate basis for estimating who has ultimately control of the companies in both countries. To find who is the ultimate

controlling shareholder it is necessary to examine in greater detail the identity of the controlling shareholders in the listed companies.

Table 4.7 Distribution of the Controlling Shareholder and Ultimate Control Pattern in China and the UK

Country	Types of the controlling shareholder	Shares owned by the controlling shareholder	Distribution of the controlling shareholder
China (267)	<i>De facto</i> controlling shareholder (DCS)	30% < DCS ≤ 50%	65 (24.3%)
	Legal controlling shareholder (LCS)	50% < LCS ≤ 75%	110 (41.2%)
	Absolute controlling shareholder (ACS)	ACS < 75%	9 (3.4%)
	Total controlling shareholders		184 (68.9%)
The UK (196)	<i>De facto</i> controlling shareholder (DCS)	30% < DCS ≤ 50%	4 (2.0%)
	Legal controlling shareholder (LCS)	50% < LCS ≤ 75%	2 (1.0%)
	Absolute controlling shareholder (ACS)	ACS < 75%	0
	Total controlling shareholders		6 (3.1%)

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Table 4.8 reports that in all 267 Chinese companies, there are 115 companies (approximately 43%) in which the controlling shareholders are SOEs; 30 companies (approximately 11%) in which the controlling shareholders are non-financial companies; 28 companies (approximately 10%) are government agencies; and only 11 companies (approximately account for 4%) in which the controlling shareholders are families or individual investors. In contrast, in the UK, although approximately 59% of the largest shareholders are financial institutions, only 2 companies (approximately 1%) have an institutional investor as a controlling shareholder holding more than 30%. Similarly, there are only 3 companies (less than 2%) having controlling shareholders

who are from non-financial companies, and only 1 company (less than 1%) in which the controlling shareholder is a family or individual investor.

Table 4.8 Distribution of the Controlling Shareholder by Identity of Ownership in China and the UK

Country	Identity of the Controlling Shareholder	SOEs	Government Agency	Financial Institutions	Non-financial companies	Family and Individual Shareholders	Foreign Investors
China	Total controlling shareholders	115 (43.07%)	28 (10.49%)	0	30 (11.24%)	11 (4.12%)	0
	<i>De facto</i> controlling shareholder	33 (12.36%)	14 (5.24%)	0	11 (4.12%)	7 (2.62%)	0
	Legal controlling shareholder	75 (28.09%)	13 (4.87%)	0	18 (6.74%)	4 (1.50%)	0
	Absolute controlling shareholder	7 (2.62%)	1 (0.37%)	0	1 (0.37%)	0	0
UK	Total controlling shareholders	0	0	2 (1.02%)	3 (1.53%)	1 (0.51%)	0
	<i>De facto</i> controlling shareholder	0	0	2 (1.02%)	1 (0.51%)	1 (0.51%)	0
	Legal controlling shareholder	0	0	0	2 (1.02%)	0	0
	Absolute controlling shareholder	0	0	0	0	0	0

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

4.6 Problems Associated with Concentrated Ownership Structure in China

On the basis of the statistics for the identities of shareholders and the actual control of listed companies, the listed companies in China are typically differentiated by the absence of significant ownership by financial institutions and foreign investors, and the extent to which the state is in *de facto* control of most corporations compared with

the UK. These differences can be explained by the theory of path dependence²³⁰ as China's traditional public economic structure (structure-driven path dependence) and the preference for public ownership under China's legal system ensure the continued dominance of state-owned or controlled companies in the national economy (rule-driven path dependence). Zheng argues that the path dependence of the Chinese ownership structure manifests itself in the government or its agencies having their own benefits and immediate interests in the ownership and governance structures of listed companies. Unless the low efficiency of the current ownership structure and governance structure have threatened its own benefits and immediate interests, there is no reason to suppose that the government wants to achieve the aim of diversifying the concentrated equity structure and improving the governance structure and the quality of the company through reducing state shares.²³¹ However, since most listed companies are directly or indirectly controlled by the government or its agencies, there are many problems created by the abnormal conduct of state shareholders within its current corporate governance system.²³² The problems are essentially attributed to a lack of ownership and a misplacement of the role of government in the position of

²³⁰ Path dependence is the idea that "what we are today is a result of what has happened in the past". See Margolis, S. J. and S. J. Leibowitz, 1998. Path Dependence, in Peter Newman ed. *New Palgrave Dictionary of Law and Economics*. Bebchuk and Roe applied path dependence to the study of comparative corporate governance. They distinguished two source of path dependence: one is called structure-driven path dependence which concerns the direct effect of initial ownership structure on subsequent ownership structures. They show that the ownership structures are influenced by the initial ownership structure that the country's economy had earlier. Another source of path dependence is called rule-driven path dependence which arises from the effect that initial ownership structures have on subsequent structures through their effect on the legal rules governing corporations. The corporate rules are path dependent. They contend that corporate structure might vary among countries and continue to do so over time. See Bebchuk, L. A. and M. J. Roe, *op cit.* fn.161.

²³¹ Zheng, J., 2001. Agency Conflict, Equity Value and Path Dependence in Reducing State-held Shares. Available from: http://www.cipe.org/china/p4_JiangHuai.htm [Accessed 12 March 2005].

²³² The problems are summarised as: (1) there is inappropriate government interference and dominance by a single shareholder with government background; (2) the state shareholder exceeds the level of intervention in personnel issues permitted by the Company Law; (3) state-owned and legal person shares are not circulated on the capital market; and (4) the listed company has inappropriate connections with the parent company. Chen, Q., State Shareholders Should Become an Active Force in Establishment of Effective Corporate Governance, Shanghai OECD Corporate Governance Forum, Feb. 26, 2004.

corporate governance, in such a way that either the government exerts too much influence on listed companies and the company's objectives are affected by political considerations, or a lack of monitoring of the shareholders, resulting in insider control in the form of misusing of their position or power against the interests of shareholders and pursuing of private objectives by the government officials or its appointed company's directors.²³³

Although much corporate governance literature suggests that large shareholders possess a greater incentive as well as ability to serve as a check on management, whether this incentive can be translated into reality in Chinese publicly listed companies is far from clear. Without a clear definition of the controlling ownership, the SOEs mean that the company's assets are owned by all people of the state, but controlled by the government and its agencies. The government and its officials, unlike private shareholders, have no direct economic connection with the performance of the company. Consequently, their role in corporate governance largely depends on political incentives and individual utility maximisation instead of shareholders' value.²³⁴ Furthermore, if the controlling shareholder is an SOE, the appointment of the company's managers is not usually determined by managerial market forces and expertise related to the company's development, but by the relationship with government officials. Inevitably, this approach to appointments has resulted in the government becoming a key figure of corporate governance in China. As a

²³³ Shanghai Stock Exchange, China Corporate Governance Report (2003), Shanghai: Fudan University Press.

²³⁴ *Ibid.*

consequence, on the one hand, the government is able to use administrative measures to directly affect the business and burden the management with public welfares; on the other hand, the members of the management also usually have political incentives to take an active role to satisfy the government's public interests or government official's private welfare for the benefit of their future political or business career, instead of the interests of shareholders as a whole.

However, the quantitative differences in ownership structure and corporate control between China and the UK may hide other important differences. The agency problem created by the separation of ownership from control in Chinese publicly listed companies is more qualitative. In practice, many members of the board of listed companies who are from the board of other companies have a dual directorship role to play. This situation has been named a 'big brother directorship' (yigu duda) in which the same batch of people service two separate companies at the same time, and this inevitably results in conflicts between the controlling shareholder and minority shareholders. This dual directorship also induces and facilitates controlling shareholders to tunnel the listed companies' assets through related transactions. For example, in some cases, listed companies and the controlling shareholder are often in the same business sector so that it is a common occurrence for the controlling shareholder to take advantage of a privileged position to gain additional benefit through distributing products, supplying raw materials, sharing resources or other

related business transactions.²³⁵ In some cases, even where the non-financial corporation as the controlling shareholder is in a different business sector from the listed company, it can still abuse its power through occupying the funds of listed companies for an indefinite period.²³⁶ In some cases, the listed companies help the controlling shareholder to gain additional benefit in a disguised form, such as offering loan guarantees to the controlling shareholder, or leasing the controlling shareholder's facilities at a high price to exploit the minority shareholders of the listed company.²³⁷ Some listed companies suffer from being what is sometimes referred to as 'ATMs' of the controlling shareholder and the "tunnelling" activities of the controlling shareholders.²³⁸

4.7 Conclusion

In this Chapter, ownership structure has been analysed in terms of the types of ownership, ownership concentration and the identities of shareholders. One important result arising from this research is that in Chinese publicly listed companies the

²³⁵ The associated trading between listed companies and large shareholders is popular in China. Statistics shows that nearly 40% of listed companies have associated trading with the top ten large shareholders in sales, procurement, providing services, acquirement or leasing assets. See Jiang, Q., Vice Minister of the State Economic and Trade Commission, Standardizing Behavior and Deepening Reform, to be Creditworthy and Responsible Shareholders of Listed Companies, Speech at the Meeting on Summarising the Experience of Establishing Modern Enterprise System in Listed Companies, December 27, 2002.

²³⁶ ST Monkey King (000535) is a typical case in which the controlling shareholder – Monkey King Group occupies as much as RMB 0.19 billion from 1995 to 1999, but pays only about RMB 0.3 -0.4 million fees per years as return. According to the statistics of 2002 from CSRC, the problem of controlling shareholders diverting the capital for other uses exists in 676 listed companies with total RMB 96.669 billion. See *ibid*, Q. Jiang's speech.

²³⁷ About 20% of listed companies in China provide loan guarantees for the controlling shareholders and associated parties, see *ibid*, Q. Jiang's speech.

²³⁸ See Tong, D., 2001. Current Conditions, Problem of Listed companies and How to Exercise Regulation: Positioning of the Responsibilities of Regulatory Department and Regulatory Measures, in Corporate Governance Reform: China and the World. Available from: http://www.cipe.org/china/cg_book_toc.htm. [Accessed 12 March 2005]. Johnson et al. use the term "tunneling" to describe the transfer of resources out of firms for the benefits of their controlling shareholders. Such transactions include outright theft or fraud, transfer of assets from a firm to its controlling shareholder at non-market price, excessive executive compensation, loan guarantees, expropriation of corporate opportunities, an so on. See Johnson S. et al. *op cit* fn.101.

problem of separation of ownership and control is not the classical Berle and Means problem, which is of dispersed shareholders not being able to control management, but rather the potential expropriation of minority shareholders by the controlling shareholders. Though the model of corporate ownership seems to be widespread and shareholders have limited influence over company's affairs in the UK, a large liquid stock market undoubtedly makes the market for corporate control become quite dynamic and its functions can be effectively brought into play. In contrast, both research and the practical situation described in this chapter have shown that state-owned assets in a publicly listed company in China remain non-tradable in the stock markets and these shares have almost exclusively become concentrated in the government bureaucratic agencies or SOEs. This means that the minority shareholders have little possibility and ability to takeover a company through acquiring sufficient shares in the stock markets. As a result, the market for corporate control, which is an important corporate control mechanism, is largely non-existent in China.

In addition, the stock market is dominated by institutional investors in the UK. In fact, by the end of 20th century, institutional shareholders had increased dramatically and many had been prominently involved in challenging management over matters of corporate governance through the exercise of voting rights at general meetings. This takes the form of ongoing dialogue, meetings, information transfer and informal discussion with managers, and the attachment of conditions to further injections of

funds etc.²³⁹ It is apparent that the role played by institutional shareholders in monitoring corporate management is based on their shareholdings and the responsibilities of institutional shareholders in relation to the companies in which they invest. In China, the existing law stipulates that a mutual fund is not allowed to invest more than 10% of its net asset value in a single company, and that it is also not allowed to hold more than 10% of a listed company's shares. These provisions limit the voting shares of institutional investors and discourage them from actively participating in uplifting the corporate governance of listed companies.²⁴⁰ Some SOEs such as "state authorised investment institutions" are supposed to manage the state owned assets on behalf of the people of the state. To some extent, such investment companies are comparable with the fund management companies in the UK. However, the managers of the state authorised investment company have no contract specifying their obligations for financial returns and the appointment of managers is also constrained by the government administrative system. The situation does, however, mean that institutional investors have no interest in corporate governance. Some institutional investors even collude with listed companies to manipulate stock prices through insider information and false financial information to generate their own interests at the expense of the minority shareholders of these listed companies.

All the problems mentioned in this chapter, which are associated with the state ownership controlling structure, raise some interesting questions in relation to the

²³⁹ See Armour, J, S. Deakin and S. J. Konzelmann, 2003. *Shareholder Primacy and the Trajectory of UK Corporate Governance*, ESRC Centre for Business Research, University of Cambridge, working paper No.266.

²⁴⁰ Shanghai Stock Exchange, *op cit*, fn.233.

rules governing controlling shareholders and minority shareholder protection. What is the legal basis for corporate control in China? Does China have an effective legal system to mitigate the conflicts of interest between the controlling shareholder and the minority shareholders? Do the highly concentrated ownership structure and state/government-dominated control have detrimental effects on corporate performance? These questions will be discussed in the following chapters.

CHAPTER 5

SHAREHOLDER MEETINGS AND VOTING RIGHTS

5.1 Introduction

The potential influence of the separation of ownership and control in corporations, as identified by Berle and Means, suggests that the objective of corporate governance systems depends very much on what type of ownership structure the countries have.²⁴¹ In countries where the ownership of the company is dispersed, internal control mechanisms should ensure that managers do not pursue their own interests, rather than those of the shareholders.²⁴² In countries with a concentrated ownership structure, the internal mechanisms of corporate governance should not only ensure that the interests of the managers of the company are aligned with those of the shareholders, but should also prevent the expropriation of minority shareholders in cases where there is a controlling shareholder. The explorative approach to ownership structure which was discussed in Chapter 4 gave rise to a number of practical and theoretical research questions that are related to the corporate governance structure in China and in the UK. Given highly concentrated ownership in the hands of controlling shareholders, such as the state and the SOEs, in China compared with a relatively dispersed ownership held by institutions and family and individual investors in the UK, the central research question of this chapter is: how do the countries' corporate governance systems ensure that the shareholders can exercise residual control rights

²⁴¹ See Berle and Means, *op cit.* fn.1.

²⁴² See B. Pettet, *op cit.* fn.39. p157.

to prevent management from pursuing their own agenda rather than the interests of shareholders and that the controlling shareholders do not expropriate the interests of the minority shareholders?

According to incomplete contracts theory discussed in Chapter 2, voting is an important means of dealing with the incomplete contracts concerning the conflicts of interest between managers and owners of the firm. In the Anglo-American corporate system, the voting of shareholders in the corporate governance structure of a company is viewed as ancillary to their claim on its investments.²⁴³ Therefore, the shareholder general meeting is perceived as the ultimate source of corporate power which allows shareholders to challenge in a meaningful way the performance of the board of directors in a company.²⁴⁴ Theoretically, from a governance point of view, the shareholder meeting is a core corporate control mechanism for providing shareholders with an opportunity to exercise their voice in the management of a company's business. Farrar et al argue that shareholder general meetings are often described as the key mechanism whereby shareholders have an opportunity to participate in the decision-making process and hold the directors of companies accountable to them.²⁴⁵ Easterbrook and Fischel contend that voting provides a mechanism by which shareholders can fill gaps in their contract with the managers of the corporation.²⁴⁶

The Pensions and Investment Research Consultants (PIRC) highlight three reasons

²⁴³ Griffiths, Andrew, 1995. Shareholding and the Governance of Public Companies, in Saleem Sheikh and William Rees ed. *Corporate Governance and Corporate Control*, p61, Cavendish Publishing Ltd.

²⁴⁴ Butcher, Donald B. 1995. Reform of the General Meetings. In Saleem Sheikh and William Rees ed. *Corporate Governance and Corporate Control*, p231, Cavendish Publishing Ltd.

²⁴⁵ See John Farrar et al, 1998. *Farrar's Company Law*, 4th ed. p308

²⁴⁶ Easterbrook, F. H. and D. R. Fischel, 1983. *op cit.* fn.82, pp401-02.

why the company AGM is a key forum for exercising good corporate governance: “(i) It is vital that shareholders have a formal means to hold company boards to account for the stewardship of the company’s business. (ii) The AGM should also enable shareholders to make representations on a range of governance matters for discussion and approval by their fellow owners. (iii) It should be seen as a democratic mechanism for a company board to secure a shareholder mandate for key policy proposals and practical matters on the way the company is governed.”²⁴⁷

However, in practice, it seems that the shareholder general meetings do not usually achieve these objectives very satisfactorily.²⁴⁸ If the general meetings are to assume their intended role as important components of corporate governance structures, it is essential for the law to set out a comprehensive list of rules to enhance their effectiveness, to ensure that shareholders are heard and to facilitate the information for the purpose of debate and decision taking served by the meetings.²⁴⁹ A question of major interest is therefore: does the existing corporate legal system adequately provide mechanisms for enhancing the effective conduct of the shareholder meetings? Despite persistent and widespread concerns that have been given to issues of shareholder meetings and the voting process in both China and the UK regulatory framework, by some institutions, as well as by corporate governance academics, there

²⁴⁷ See PIRC, *The AGM: A Focus for Shareholder Involvement*, PIRC’s Response to the Consultation Document from Company Law Review Steering Group on Shareholder General Meetings and Shareholder Communications, January 2000.

²⁴⁸ See *Company Law Review, Modern Company Law for a Competitive Economy, Company General Meetings and Shareholder Communication*, A consultation from the Company Law Review Steering Group, Department of Trade and Industry, October 1999 [URN 99/1144], p1.

²⁴⁹ See Brenda Hannigan, *op cit.* fn.221, p476

is no systematic, empirically informed assessment of whether shareholder meetings have functioned as a forum in the expression of shareholders' rights and in ensuring transparency and the accountability of directors to investors.

This chapter covers a detailed comparative discussion of the legal and technical rules on shareholder meetings, because in practice many arguments about the effectiveness of the shareholder meetings depend on whether these rules can be or have been applied. This chapter asserts that the traditional comparative test which was applied by some scholars in reviewing shareholder general meetings examining 'law on the book' is inadequate.²⁵⁰ As an alternative, the study proposes two approaches to this test. One is to review the legal requirements on publicly listed companies to hold an Annual General Meeting (AGM) and Extraordinary General Meeting (EGM) for promoting transparency and accountability in the management of company affairs. The other is to examine how these legal rules are applied in relation to publicly listed companies in practice. The empirical evidence on the voting behaviour of shareholders (e.g. the turnout ratio of shareholder meeting, the number of shareholder resolutions presented at the shareholder meeting) and voting results delivered at the shareholder meetings provides helpful insights in relation to corporate governance issues in China compared with the UK. The findings demonstrate that the shareholder general meeting under a country's corporate system may not play the role envisioned

²⁵⁰ Wei, Y., 2001. Seeking a Practical Chinese Model of Corporate Governance, 10 *Michigan State University – DCL Journal of International Law*, 393, at400-01. Hong, T. L., 2000. Corporate Governance Issues in PRC Companies, *International Company and Commercial Law Review*, 11(3), pp87-95, at89-90. Ong, K. and C. Baxter, 1999. Comparative Study of the Fundamental Elements of Chinese and English Company Law. *International and Comparative Law Quarterly* Vol.48, pp88-127, at108.

by the legal model in the real world. By examining a variety of factors and some extensive statistical data, the chapter concludes that further company law reform to improve the voting system is fundamental for the development of corporate governance in China.

5.2 Legal Status and Functioning of Shareholder General Meetings

It is difficult to describe concisely what the legal status of shareholder general meetings constitutes within a corporation in the UK.²⁵¹ At the end of the nineteenth century, the concept of general meeting sovereignty seems to have been adopted by the common law system. In *Isle of Wight Railway v. Tahourdin*²⁵² the court states:

“...if you want to alter the management of the affairs of the company go to a general meeting, and if they agree with you they will pass a resolution obliging the directors to alter their course of proceedings.”²⁵³

In 1906, however, the division of powers between the board and the shareholder general meeting was clearly established with respect to the evolution of large-scale modern companies. The Court of Appeal in *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame*²⁵⁴ held that the general meeting could not interfere with the directors' decision if the powers had been vested to the board in the construction of

²⁵¹ Davis, P. L. and D. D. Prentice, *Gower's Principles of Modern Company Law*, 6th ed. 1997, p188. also see Ben Pettet, *op cit.* fn.39. p164.

²⁵² (1883) 25 Ch.D. 320, C.A.

²⁵³ *Ibid* at p329

²⁵⁴ [1906] 2 Ch. 34, C.A.

the articles of association. In *John Shaw & Sons (Salford) Ltd. v. Shaw*²⁵⁵ the modern doctrine of the legal status of the shareholder general meeting was expressed by Greer L.J. as follows:

“A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other powers may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering the articles, or...by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders.”²⁵⁶

The typical division of powers within a company has now been defined by art. 70 of the Companies (Table A) Regulations 1985, which apparently affirmed the case law.

It provides that:

“Subject to the provision of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the company.”²⁵⁷

²⁵⁵ [1935] 2 KB 113 C.A.

²⁵⁶ *Ibid* at p134

²⁵⁷ Table A, art.70.

The provision above reflects that the power to manage the company is vested in the board of directors. However, it allowed the articles of a company to limit or restrict the powers of directors and thereby to place those powers to the shareholder general meeting. These powers are normally connected with shareholder statutory rights, such as the right to alter the memorandum and articles;²⁵⁸ right to increase or reduce the share capital;²⁵⁹ right to appoint or remove the directors and auditor and their remunerations;²⁶⁰ right to declare the final dividend;²⁶¹ right to grant directors to allot shares.²⁶² In addition, the common law also empowered the shareholder general meeting to ratify an irregular act of the directors.²⁶³ In certain circumstances, both common law and the statutes require shareholders to approve substantial property transactions involving directors.²⁶⁴ Moreover, under the *Directors' Remuneration Report Regulations 2002*, shareholders have been empowered to have an advisory vote on the directors' remuneration report.²⁶⁵

It is noteworthy that the CA 1985 contains four relevant provisions that require the annual reports and accounts to be laid before the company in a general meeting, but does not require the meeting to consider any resolution in relation to them.²⁶⁶

²⁵⁸ See s.4 and s.9, CA 1985

²⁵⁹ See s.121, 135, CA 1985

²⁶⁰ See arts. 73-80, Table A, s.303 and s385 (1) & (2), s386, s390A and 241(A), CA 1985 (setting auditor remuneration in practice is often delegated to the board). Also see Brenda Hannigan, *op cit.* fn.221, p478.

²⁶¹ See Table A art.102.

²⁶² See s.80 and s.95 CA 1985

²⁶³ See *Bamford v. Bamford* [1970] Ch. D. 135 C.A., *Re Horsely v. Weight Ltd.* [1982] 3 All ER 1045.

²⁶⁴ See s.320 CA 1985 and *British Racing Drivers' Club Ltd. v. Hextall Erskine & Co.* [1997] 1 BCLC 182

²⁶⁵ The Directors' Remuneration Report Regulations 2002 came into force on 1st August 2002 and apply to financial periods ending on or after 31 December 2002. The Regulation has been inserted as a new schedule 7A of the CA 1985.

²⁶⁶ See s.238(1), s241, s.239, and s242, CA 1985. Notably, however, earlier Table A of the CA 1948, art. 52 stipulated that the ordinary business of the annual general meeting was the declaration of a dividend, the consideration of the accounts, balance sheets and the reports of the directors and auditors, the election of directors in place of those retiring, and the appointment of and the fixing of the remuneration of the auditors.

However, the general meeting gives the shareholders an opportunity to question the board generally on the accounts and reports, and to express their views on matters with which they are concerned.²⁶⁷ Nevertheless, in 1997, the Hampel Report suggested that the AGM should contain a resolution on the annual report and accounts.²⁶⁸ In addition, many of these issues relating to what may be conducted at the general meeting of a company have also been addressed by the Company Law Review²⁶⁹ and the subsequent Company Law Reform Bill 2006 (the Bill),²⁷⁰ which stipulates that the directors of a public company must lay the company's annual accounts and reports before general meeting of the company with on later than 6 months of that financial year.²⁷¹ If directors fail to meet this requirement, they may commit an offence.²⁷²

In China, the shareholder general meeting is the supreme organ of the authority of companies and the shareholders have extensive powers to exercise considerable control over companies' affairs. The powers of the shareholder general meeting under China's company law (the CCL 1994) are as follows²⁷³

- (i) To make decisions regarding company strategies and investment plans.

²⁶⁷ See P. L. Davies, *op cit.* fn.241, p343

²⁶⁸ See Guideline 5.20 Hampel Report 1997

²⁶⁹ See Company Law Review, *Modern Company Law for a Competitive Economy, Final Report* (the CLR Final Report, hereafter), Vol. (I), (2001) paras 7.5 – 7.61; Company Law Review, *Modern Company Law for a Competitive Economy: Completing the Structure* (hereafter, *Completing the Structure*), London: DTL, (2000), paras 5.18 -5.40 and *Company General Meetings and Shareholder Communication*, October, (1999).

²⁷⁰ On 1 November 2005 the Company Law Reform Bill was finally introduced to the House of Lords. The Bill sets out wide ranging reforms in a number of areas which will repeal about two-third of the Companies Act 1985 and amend other parts. The Bill contains 885 clauses and has 15 schedules, and yet it will not contain the full body of UK company law. It is not a consolidating measure, but it has to be read alongside the Companies Act 1985.

Read the text of the Company Law Reform Bill [HL] available from:

<http://www.publications.parliament.uk/pa/ld200506/ldbills/034/2006034.pdf>, [Accessed 25 March 2006].

²⁷¹ See cl.415 and cl.420(1b) of the Bill.

²⁷² See cl.416 of the Bill.

- (ii) To elect and dismiss the members of the board of directors and the supervisory board, and determine their remunerations.
- (iii) To examine and approve the reports of the board of directors and the board of supervisors.
- (iv) To examine and approve the annual financial budget plans and final accounting plans of the company.
- (v) To examine and approve the profit distribution plans, dividend policy and plans of recovery losses.
- (vi) To approve resolutions regarding increase or reduction of registered capital by the company.
- (vii) To approve resolutions on the issuance of bonds.
- (viii) To make decision regarding merger, division, change of corporate form, dissolution, clearance of debt and liquidation of the company.
- (ix) To amend the articles of association of the company.

In addition, the CCL 1994 provides that shareholders also have the right to examine the minutes of the shareholder general meeting and the financial and accounting statements, and to make suggestions and inquiries about the business operation of the

²⁷³ Art.103 of the CCL 1994.

company.²⁷⁴ The CCL 2006 made no change on the status of the shareholder meeting as the supreme organ of the company and replicated the provisions of the functions and powers of the shareholder meeting and shareholder right to check and copy the company's account books and minutes of shareholder meetings.²⁷⁵

Examining this list of powers, however, it is clear that the Chinese company law has granted shareholders in a general meeting with absolute sovereignty to control all the powers of the company. It is evident that the powers of the shareholder general meeting resemble those powers under the UK company law, but also provide shareholders with more inalienable powers of engagement and determination than in the UK. For example, in China, it is notable that shareholders in the general meeting have the power to decide a company's operation strategies and investment plans, and profit distributions, as well as dividend policy. In contrast, these powers under UK company law are clearly vested in the scope of the directors' authority. The rationale behind the institutional arrangement which gives the board of directors more powers to run the company is that efficiency is thought to be a primary goal of company law.²⁷⁶ In economic theory, in a company with a substantial number of shareholders, eliciting a response and obtaining the approval of all members is likely to be costly

²⁷⁴ See Art.110 of the CCL 1994.

²⁷⁵ This provision was not revised by the CCL 2006, see Arts.98, 99 and 100 of the CCL 2006.

²⁷⁶ Maughan and Copp argue that "the firm was in effect a governance structure that allowed one party (the directors/manager) to make decisions on the way in which the internalised contracts were to be interpreted. The insight that derives for this rationale is that if efficiency is thought to be a primary goal of company law, then, according to Coase's theory, one of the primary purposes of company law should be to facilitate the formation and operation of firms and to facilitate their governance by directors". See Maughan, C. W. and S. F. Copp, 1999. The Law Commission and Economic Methodology: Values, Efficiency and Directors' Duties, *Company Lawyer*. 20(4): 109-116, at115.

and time-consuming process.²⁷⁷ Therefore, the merits of shareholder meeting sovereignty in China, which give shareholders more opportunities to exercise their rights effectively and influence the corporate governance of companies, need further monitoring.

To take a particular example, the power enjoyed by the shareholder meeting reveals that the frequency of shareholder meetings is very high in China. Table 5.1 reports the frequency distribution of shareholder meetings in the sample of 267 companies in the 2002/2003 financial year. The companies hold shareholder meetings with a range between 1 to 9 times during the sample period, Only 65 firms (24% of the sample) held just one AGM, 117 firms (44% of the sample) held an AGM and an EGM; the remaining 85 cases (32% of the sample) held 3 or more shareholder meetings in the year. More interestingly, Table 5.1 shows that there was one company which convened 9 shareholder meetings in the year.

Table 5.1 Frequency Distribution of Shareholder Meetings in China

Number of shareholder meetings in 2002/2003	Frequency	Percent	Cumulative Percent
1.00	65	24.3	24.3
2.00	117	43.8	68.2
3.00	53	19.9	88.0
4.00	22	8.2	96.3
5.00	7	2.6	98.9
6.00	2	.7	99.6
9.00	1	.4	100.0
Total	267	100.0	100.0

Source: survey of the AGM/EGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets

²⁷⁷ Cheffins, B. R. 1997. *Company Law: Theory, Structure and Operation*, p17, Clarendon Press, Oxford.

It is doubtful whether or not the board of directors has the power to make decisions and run the company on behalf of shareholders in China. Shareholder involvement might mitigate agency problems, but these extensive powers granted to the shareholder meeting definitely raise transaction costs because a high frequency of shareholder meetings will generate potential costs for a company and its shareholders. In addition, individual shareholders might not be interested in attending the shareholder meetings because they are time-consuming, stressful and incur travelling expenses. Consequently, the shareholder meeting might become a controlling shareholder meeting because only the controlling shareholders are likely to take an active interest in the meetings. But evidence indicates that the interests of the controlling shareholders do not always fully overlap with those of minority investors, and the controlling shareholders might try to take advantage of the situation by supporting or withholding their votes in order to extract some extra benefit for themselves.²⁷⁸ In fact, it should be emphasised that, in China, most companies' shareholder meetings are manipulated by the controlling shareholders because no resolution can be passed without their consent.

Further, the potential difference between the role of shareholders in general meetings in China and the UK is that decision-making power exercised by the shareholders in China may have a different meaning when the majority shareholder is the government's agents or the SOEs. As for specific business decisions, the

²⁷⁸ See section 4.6 of Chapter 4 of the thesis.

government's agent or the SOE acting as a controlling shareholder is different from residual claimants in the private sector. In China, where there is not any personal interest directly connected with the economic performance of the companies, the controlling shareholders may decide to pursue an objective other than the maximisation of profits.²⁷⁹ For example, the government might have a strong control over the shareholder meeting and sacrifice a corporation's profits to achieve another state objective, such as higher employment in the region.²⁸⁰ In this aspect, on the one hand, the powers granted to the shareholder meeting in China will be meaningless to minority shareholders because the majority votes are controlled by the government or its agents and the tiny proportion of voting shares held by individual shareholders is too small to influence the outcomes. On the other hand, without adequate constraint and incentives, the managers appointed by the government or its agents are able to divert the controlling power to attenuate the state's ownership in the company, and use some of the company's resources to increase their personal satisfaction at the expense of the government objectives. Thus, on this view, although actual control power is allocated to the shareholder general meeting in China, in current arrangements, shareholders seeking to exercise their statutory power to minimise agency cost face substantial impediments.

²⁷⁹ IFF Equity Advisory Group reports "at the end of 2003 there are 1287 listed companies on the Shanghai and Shenzhen stock exchange markets, 940 of which were restructured by SOEs...Continued state control of these companies reflects various public policy objectives such as the maintenance of urban employment and direct control of sensitive industries." See IIF Equity Advisory Group, *Corporate Governance in China: An Investor Perspective*. Task Force Report, April 2004. Available from: http://www.iif.com/data/public/china_task_force_final.pdf. [Accessed 12 February 2006].

²⁸⁰ See Osgathorpe, J. D. 1996. A Critical Survey the People's Republic of China's New Company Law, 6 *Indiana International and Comparative Law Review*, 493, at 510.

5.3 Legal Procedural Rules of Shareholder Meetings

According to incomplete contract theory, shareholder meetings provide all members of a company with an opportunity for an exchange of information and opinion on the company's affairs. Therefore, it may be said that the effectiveness of the shareholder meetings is a controversial question, which depends upon certain legal requirements of convening the meeting, notification of the date and resolutions of the meeting, as well as voting policies. Without extensive procedural rules governing shareholder meetings, the substantive rights can never be fulfilled in terms of their respective influence, determination, control and implementation of corporate power. Therefore, to allow a shareholder meeting to function legally and efficiently, several important technicalities on holding a shareholders' general meeting (e.g. convening of general meeting, notice of the general meeting, method of service and quorum), the rules of voting and shareholders' resolution process are of crucial importance.

5.3.1 Types of Meetings and Legal Requirements on Convening a Meeting

Both the UK and China have a common classification of shareholder general meetings, which are the annual general meeting and all general meetings other than the annual general meetings, called extraordinary general meetings.²⁸¹ They also have

²⁸¹ See Arts. 43 and 104, the CCL 1994 and s.366 and Table A, art.36. The EGM is also called an interim meeting in China. However, in the UK, there is another classification, so called class meeting which is normally called to consider variations in class rights. See *Carruth v. Imperial Chemical Industries Ltd.* [1937] AC 707, IIL, and s372 (proxies), s374 (voting on a poll), s375 (representation of corporations), and s381 (resolution passed at an adjourned meeting) are also expressed to cover class meetings. The CCL 1994 is silent on such a classification.

the same requirement that every listed company must hold at least one annual general meeting each year.²⁸²

In the UK, an annual general meeting is normally convened by the board of directors. If a company defaulted on its statutory obligation to hold an annual general meeting it may be directed to do so by the Secretary of State for Trade and Industry acting on the application of any member.²⁸³ A publicly listed company must call a shareholder general meeting in circumstances where its net assets have fallen to one-half or less of its call-up capital.²⁸⁴ In other respects, a shareholder general meeting may be convened when directors think necessary.²⁸⁵ Alternatively, shareholders of a company holding one tenth of the paid up capital carrying the right to vote at a general meeting can require the directors of the company to convene a general meeting.²⁸⁶ However, the requisition must state the objective of the meeting and sign the written demand for the meeting, leaving it at the registered office of the company.²⁸⁷

The Bill replicates the individuals' power to call a shareholder general meeting.²⁸⁸ Apart from the threshold requirement that the shareholders calling the meeting must together hold at least 10 per cent of paid-up capital of the company and hold voting rights at the general meetings of the company,²⁸⁹ the Bill specifies that directors must

²⁸² Under the Bill, every public company in the UK must hold a general meeting as its annual general meeting in each period of 6 months beginning with the day following its accounting reference date. See cl.311 of the Bill.

²⁸³ See s.367(1), CA 1985.

²⁸⁴ See s.142(1), CA 1985

²⁸⁵ See Table A, art.37.

²⁸⁶ See s.368(1) and (2), CA 1985.

²⁸⁷ See s.368(3), CA 1985

²⁸⁸ See cl.279 of the Bill

²⁸⁹ See cl.279 (2) of the Bill

call a shareholder general meeting requisitioned by the shareholders within 21 days from the date on which they become subject to the requirement and the shareholder general meeting must be held on a date not more than 28 days after the date of the notice convening the meeting.²⁹⁰ The Bill also stipulates that the request must state the general nature of the business to be dealt with at the meeting, and may include the text of a resolution that may be moved and is intended to be moved at the meeting.²⁹¹

Under the CA 1985, the meeting can also be 'called, held and conducted in any manner the court think fit' and 'the court may give such ancillary or consequential directions as it thinks expedient and these may include a direction that one member of the company present in person or by proxy be deemed to constitute a meeting'.²⁹² The Bill has the same provision on a meeting convened by the court, but specifies that this only applies if for any reason it is impractical to call a meeting of a company in any manner in which meetings of that company may be called, or to conduct the meetings in the manner prescribed by the company's article or the law.²⁹³

In China, a shareholder general meeting is convened by the board of directors. However, an extraordinary general meeting must be held within two months if any one the following events occurs: (i) the number of members of the board of directors falls below the number set forth in the CCL 1994, or less than two-thirds of the

²⁹⁰ See cl.280 (1) of the Bill

²⁹¹ See cl.279 (3) of the Bill.

²⁹² See s.371, CA 1985. This provision is very useful where a quorum is required. The detailed discussion sees P. L. Davis, *op cit.* fn.251, p349.

²⁹³ See cl.282 of the Bill.

number of the articles of association of the company; (ii) the company's net accumulated losses reach one-third of its total paid-up capital; (iii) a meeting is required by shareholders who hold 10% or more of the company's issued shares; (vi) the board of directors or the supervisory board considers a meeting necessary.²⁹⁴

However, the CCL 1994 is silent on the procedural rule concerning when and how a shareholder or the supervisory board may request the board to convene a shareholder general meeting.

Until May 2000, 'the Opinions on the Standardisation of Shareholder General Meeting' (the Opinions 2000) was promulgated by the CRSC²⁹⁵ which adopted various provisions to regulate the shareholder general meeting of listed companies. The Opinions provide that the supervisory board or the requisition shareholders should make a written request with the detailed resolution to the board of directors to convene a shareholder general meeting, and report to the CRSC or its local securities agencies.²⁹⁶ The board of directors should make a decision within 15 days to decide whether or not to call a meeting, and inform the requisition parties and the CRSC or its local securities agencies. The requisition shareholders or the supervisory board may convene a meeting by themselves if the directors do not agree to call a meeting or fail to inform shareholders.²⁹⁷ Reasonable costs can also be recoverable from the company.²⁹⁸ But an important question is if the shareholders convene a general

²⁹⁴ Art.104, the CCL 1994

²⁹⁵ See *Zhenjiangongsi* [2000] No.53, 18 May 2000

²⁹⁶ Art. 19 the Opinion 2000

²⁹⁷ Art.20, 21 and 23 the Opinion 2000

²⁹⁸ Art.25 the Opinion 2000

meeting while the board of directors refuse their requisition, will a resolution passed at the general meeting be legally effective? If the board considers that the resolutions passed at such a shareholder meeting are not effective or refuses to implement them, what will the shareholders do? There is no clear answer to this question. However, as we have seen, section 371 of the UK Companies Act provides that “the court may, either of its own motion or on the application...of any member of the company...order a meeting to be called, held and conducted in any manner the court thinks fit”²⁹⁹. This indicates that in the UK, if there is conflict upon convening the general meeting, the court can intervene and give the resolution legal effect as it thinks fit. Unfortunately, there is no statutory provision which deals with whether the meeting can be convened by the court or other state authorities under China’s company law.

Comparing the legal requirements on convening shareholder meetings between China and the UK, it can be seen that both countries’ company laws have empowered the board of directors and the members of the company who hold 10 per cent of the company’s paid-up capital to call shareholder general meetings whenever they think proper. However, the thresholds at which one or more shareholders can exercise a requisition right to convene a shareholder general meeting could be criticised in China. Although the purpose of this provision is to allow the minorities to have an opportunity to convene a shareholder general meeting, the statutory requirement for a

²⁹⁹ see 371 of the CA 1985.

minimum threshold shareholding of one-tenth of paid-up share capital, indicates that only the controlling shareholders will be able to requisition a general meeting in China. This is because, for historical reasons, most companies come from state-owned companies and still have highly concentrated ownerships. Most members of the board come from controlling shareholders and they are normally under the control of the majority.³⁰⁰ For the minorities, they will never have a chance to exercise the right of requisition of a shareholder general meeting unless they can form a collective action.³⁰¹ In consequence, it is unavoidable that the majority will take advantage of their position to make decisions in their own interests.³⁰² Unfortunately, the CCL 2006 did not reduce the threshold requirement in this regard,³⁰³ and so the difficulties for minorities to call a general meeting remain in Chinese publicly listed companies.

³⁰⁰ Xiangcai Security Research Group, 2000. *Corporate Governance Research*. Chinese Security Association, Research on Advanced issues of Chinese Securities Market Development, China Finance Publishing Company, pp59-60

³⁰¹ We have observed that in China, the largest shareholder in each company owns on average 45.39%; the second largest owns on average 7.81%; the third largest owns on average 3.08%, the fourth largest owns on average 1.64%, and the fifth owns on average 1.12% of the total shares of the listed company. See Chapter 4 of the thesis.

³⁰² There were several cases in China since the Opinion 2000 came to effect, for example Hebei Xingfu Shiye Industry Co. (HXICL) (600743) whose 60 million shares accounted for 19.2 per cent of total stock was auctioned by the Shenzhen Intermediate People's Court in 2000. Mingliu Investment Co. won the bid and became a shareholder of the HXICL. Then Mingliu sent out a notice to the board of directors of HXICL requiring them to convene an EGM and proposing a resolution in order to send its representative to the boardroom. After its proposal was denied by the board of directors, it convened an EGM according to the Opinion 2000. The second largest shareholder of International Building Co. (000600), Kaiyuan Group holding 18.77% of total shares of International Building Co. required more than ten EGMs within 3 years since 2000. In 2002, three largest shareholders of Tiange Keji Co. (000509) were fighting each other for convening an EGM and settled by litigation in the end. See Zhou, D., 2000. Shareholders May also Convene Shareholder Meeting, *Zhongguo Zhenquanbao (China Securities Daily)* September 28, at 7. Liu, J., 2003. EGM Disputes Need Judicial Intervention, *Zhongguo Zhenquanbao (China Securities Daily)* March 18, Available from http://www.fsi.com.cn/policy200/explain203/203_0303/203_03031801.htm (in Chinese). [Accessed 12 February 2006].

³⁰³ see Art.101 (3) of the CCL 2006

5.3.2 *Notice of Shareholder Meeting*

As an important part of the shareholder meeting system, the notice of shareholder meeting should give shareholders sufficient information about the meeting at the appropriate time. Davies notes that:

“The main protection for the shareholder in such a case lies in the information made available to them in advance of the meeting and the length of notice required. On the basis of this information and during this period, they should be able to form a view whether the matter is sufficiently important for them to vote at the meeting or to attend it, and perhaps even to form an alliance with other shareholders to oppose the board...”³⁰⁴

With listed companies, in the ordinary course of events, shareholder meetings are normally convened by the board of directors. Thus, how much notice of the meeting should be delivered to the shareholders before the meeting, what kind of information should be contained in the meeting notice, what methods might be employed to serve the meeting notice, and the different meeting notice given regarding different types of resolution are vital to improve the functioning of shareholder meetings.

In the UK, as regards notice of the meeting, the CA 1985 lays down that certain minimum periods of notice must be given and any provision in the articles providing

³⁰⁴ See P. L. Davies, *op cit.* fn. 251, pp354-355.

for shorter periods than those specified in the statute is void.³⁰⁵ Under the CA 1985, the case of an AGM or any EGM called to consider a special resolution must give at least 21 days' notice, and in other cases 14 days' notice is required in writing or by electronic communication methods.³⁰⁶ There are three types of resolution referred to in the CA 1985 requiring a special notice.³⁰⁷ They are:

- (i) to remove a director from office, or to appoint another director in his/her place;³⁰⁸
- (ii) to appoint a director over the age limit (70 years old);³⁰⁹
- (iii) to remove an auditor from his/her position, or to appoint any other auditor in certain circumstances;³¹⁰

In practice, however, listed companies are governed by the Combined Code, which requires 20 working days' notice for the AGM (not other meetings).³¹¹ In the Bill, the minimum notice period for a general meeting of a public company has been amended to (a) in the case of an annual general meeting at least 21 days, and (b) in any other case, at least 14 days.³¹² A short notice for the AGM in a public company is not applicable, but for other general meetings is allowed if 95 per cent of members agree to it.³¹³ In addition, the Bill states that "where by any provision of the Companies Act

³⁰⁵ See s.369(1) CA 1985

³⁰⁶ See s.378(2), 369(2), (3), 369(4B) and 4(C), CA 1985, but Table A, art.38 provides that the resolution concerning the appointment of a directors requires 21 days' notice. Under s.15 of the Electronic Communication Act 2000, 'electronic communication' is given a very wide definition, which embraces telephone, telex, fax and email communication.

³⁰⁷ See s.379, CA 1985

³⁰⁸ See s.303, CA 1985

³⁰⁹ See s.293, CA 1985

³¹⁰ See s.388(3) and 391(A) 1985 includes to fill a casual vacancy or reappointment of a retired auditor.

³¹¹ Para. C.2.4. the Combined Code.

³¹² See cl.283(2) of the Bill.

³¹³ See cl.283(4) of the Bill.

special notice is required of resolution, the resolution is not effective unless notice of the intention to move it has been given to the company at least 28 days before the meeting at which it is moved”.³¹⁴ The Bill also extends the method of the service as in hard copy form or in electronic form, or by means of website access.³¹⁵ However, notice of a general meeting must be sent to every member of the company and every director.³¹⁶

In China, the minimum period of notice of the general meeting seems to have been regarded as an important matter under the CCL 1994. Art.105 of the CCL 1994 specifies that, when convening a shareholder general meeting, notice should be given to all shareholders thirty days before the meeting, stating the matters to be considered at the meeting. Notice of a meeting to the holders of bearer shares is required 45 days before the meeting by a public announcement.³¹⁷ However, the holders of bearer shares need to deposit their share certificates with the company for a period of five days before the meeting until the end of the meeting if they are attending.³¹⁸

Although the CCL 1994 sets out longer periods of notice of meetings compared with the UK, these requirements for increasing the effectiveness of meetings are not so definitive. The CCL 1994 makes no difference, relating to the content and time period of notice, between ordinary and special resolutions of the shareholder meetings. So

³¹⁴ See cl.288(1) of the Bill.

³¹⁵ See cl.285 of the Bill.

³¹⁶ See cl.286 of the Bill.

³¹⁷ See Art.105 paras (1) and (2) of the CCL 1994.

³¹⁸ See Art.105 para (3) of the CCL 1994.

the effect is that the content of the notices and related detailed matters are largely left to the articles of association of a company. The State Council Securities Commission (the SCSC)³¹⁹ considered that it was necessary to proscribe mandatory provisions in the articles of association of Chinese listed companies. In December 1997, the Directive was promulgated which prescribes detailed mandatory provisions to the articles of association of the listed companies in China.³²⁰ In particular, Article 48 of the Directive prescribes that the notice shall specify the time and place of the meeting, the proposed resolution, and shall clearly indicate that all shareholders and their representatives have the right to attend and vote at the general meeting.³²¹ Interestingly, the CCL 2006 did not give statutory backing to the requirements of the Directive.

In January 2002, the CSRC and the State Economic and Trade Commission jointly issued the “Code of Corporate Governance for Listed Companies in China” (Hereafter, the CCGC)³²² which provides limited consideration in this regard. Clause 8 of the CCGC only specifies that “Besides ensuring that the shareholder meetings proceed legally and effectively, a listed company shall make every effort, including fully utilising modern information technology means, to increase the number of shareholders attending the shareholder meeting”.³²³ However, whether such an

³¹⁹ The SCSC used to be the competent authority of the government responsible for regulating securities in China and the China Securities Regulatory Commission (the CSRC) used to be the executive body of the SCSC. However, in 1998, the CSRC took over all functions of the SCSC, and the SCSC no longer exists afterwards.

³²⁰ See the Directive 1997, *op cit.* fn.227.

³²¹ *ibid.* art.48 of the Directive.

³²² See “Code of Corporate Governance for Listed Companies in China” (Zhenghianfa No.1 2002). Available from: http://www.csrc.gov.cn/en/jsp/detail.jsp?inford=1061968722100&type=CMS_STD [Accessed 12 February 2006]

³²³ See cl.8 of the CCGC 2002. *op cit.* fn.28.

abstract requirement will be able to secure all shareholders of a company who are scattered around the whole country to be fully informed is questionable. In practice, most companies do not notify shareholders of AGMs and EGMs individually. Instead, notices are published in local securities newspapers and placed on the company's or other relevant websites. The information contained is no more than the date of the meeting, venue, and duration; a simple structured meeting agenda; proxy rights, delivery date and location; shareholder registration date and place; attendance deadline; and meeting contact person details. Detailed information regarding the resolutions of the meetings and voting procedures are seldom disclosed to shareholders before the meeting.

In theory, any notice of the meeting should contain sufficient information concerning the purpose of any proposed resolution for shareholders to be able to make reasonable judgement about whether or not to attend the meeting.³²⁴ In practice, since detailed resolution information is not delivered to the shareholders at the time before the meeting takes place in China, the shareholders have almost no time to understand the issues and raise appropriate questions to the board of directors during the meeting. Nevertheless, most resolutions of AGMs and EGMs in Chinese publicly listed companies can still be passed because the controlling shareholders who are normally the policy makers and a majority of the board of directors are their representatives, have first-hand information in most events. The practical problem of expropriation of

³²⁴ See J Farrar et. al., *op cit.* fn.245, pp313-314.

minority shareholders resulting in information asymmetry between the controlling shareholder and minority shareholders is particularly acute in China. However, the CCL 2006 did not make any amendment to the notice of the meeting and the potential problems of information asymmetry remain unsolved.

5.3.3 Quorum Requirements

A quorum is the minimum number of shareholders who have to be present for the business to be validly transacted at a meeting.³²⁵ In the UK, unless the articles provide otherwise, the quorum for all company meetings is two shareholders (or their proxies) entitled to vote personally present.³²⁶ At common law, one person cannot constitute a meeting, even though he/she holds proxies for several other persons, the meeting will still be null and void.³²⁷ However, in China, the rule on quorum did not appear in the CCL 1994, and the CCL 2006 has totally omitted this issue too. Although Clause 5 of the CCGC specifies that a listed company shall set out convening and voting procedures for a shareholder meeting in its articles of association³²⁸, whether or not a quorum system should be incorporated into the articles of association or an incumbent board and the controlling shareholders are willing to produce a quorum at a shareholder meeting,³²⁹ is unclear. Regardless of the case, there is no doubt that the

³²⁵ *Ibid.*, p317.

³²⁶ See s.370(4), and Table A, art.40.

³²⁷ See *Sharp v. Dawes* (1876) 2 QBD 26, *Byng v. London Life Association Ltd.* [1990] Ch.170 at 183, [1989] 1 All ER 560 at 565.

³²⁸ See cl.5 the CCGC. *op cit.* fn.28.

³²⁹ In English practice the quorum is part of a shareholder agreement designed to prevent the majority from thwarting the wishes of the minority. Therefore the majority shareholder may be unwilling to produce a quorum in order to avoid problems created by such a device. However, the court has the power to overrule a quorum under certain circumstances. See *Re British Union for Abolition of Vivisection* [1995] 2 B.C.L.C. 1, *Re El Sombrero Ltd.* [1958] Ch. 900. some detailed interpretation see P. L. Davis, *op cit.* fn.251, pp349-350

shareholder general meeting coupled with the absence of a quorum requirement may result in very low attendance rates. However, in reality, the effect is that a single-shareholder general meeting has existed in listed companies in China.³³⁰ Without a quorum system, whether such a single-shareholder general meeting would pass resolutions in the best of interests of others is always questionable.

From an economic perspective, it is true that the law should provide shareholders with a set of voting rules that enable them to exercise their voting rights at low cost, but the quorum requirements may impose transaction costs both on the firms and shareholders. However, an optimal quorum requirement might be necessary to ensure that any material corporate actions (e.g. amendment of the articles of association, the removal of a director who was elected by cumulative voting, transfer pricing advantages to the controlling shareholder, or providing loan guarantees etc.) approved at the shareholder meeting are for the benefit of all shareholders.³³¹ Underpinning this point is the view that an optimal quorum requirement could be a useful supplement to restrict the expropriation of minority shareholders by the controlling shareholders in China.

³³⁰ The survey shows that there are 2 companies out of 267 companies that held their shareholder general meeting with a single shareholder in the year 2002/2003. More details discussed in section 5.4 of this chapter.

³³¹ For example, under the Japanese Commercial Code, passage of a special resolution requires the attendance at the general meeting by shareholders possessing one-third of outstanding shares with voting rights – “the quorum”, and a vote in favour of such resolution by shareholders representing more than two-third of those voting rights. See Ryoko Ueda, *Corporate Governance and Reform of Japan's Commercial Code*. J-IRIS Research Newsletter, Issues No.2, October 2002.

5.3.4 *The Rules of Voting and Proxy*

In the UK, voting procedures are highly regulated by the CA 1985. The general principle under Table A, regs. 46 and 54 specify that voting shall be by show of hands (every shareholder present at the shareholders' general meeting has one vote irrespective of how many shares are held) unless a poll is demanded.³³² The normal practice for exercising voting rights in the shareholder meetings is by show of hands in the first instance, and then if a valid demand is made, for a poll to be held.³³³ Section 373 of the CA 1985 also sets out the rights of shareholders to demand a poll on any question, but demanding a poll shall not be effective (except in the election of a chairman or the adjournment of the meeting) unless it is made by at least 5 shareholders entitled to vote at that meeting or by any number of shareholders holding at least 10% of voting shares.³³⁴

However, voting by a show of hands has been criticised as an inappropriate method for listed companies because of the rule of proxies under the current UK voting system.³³⁵ PIRC's research director Stuart Bell claims that:

“...voting rights have a value and are an important part of the corporate governance process. But the current system is ramshackle. There is a clear need for radical reform of the dual voting system. It is ludicrous that a director

³³² See Table A arts.46 and 54.

³³³ See Farrar et al, *op cit.*fn.245, p322.

³³⁴ See s.373(1), CA 1985. Table A, art.46 extend this by allowing any two members (instead five shareholders) or the chairman to call for a poll.

³³⁵ See Table A, art.54 and 59, a proxy is not entitled to vote on a show of hands. The criticism has been made by CLR, Final Report. *op cit.*, fn.269, p20.

can still be elected even though a majority of votes opposed him.³³⁶ Voting by show of hands is an unrepresentative anachronism which should be abolished at the earliest opportunity.”³³⁷

In contrast, UKSA’s report argues that “abandoning show of hand voting would destroy the meetings as a forum for private shareholders to express their concerns collectively, and would lead to a collapse in attendance”.³³⁸

Voting by a show of hands has the merit of enabling uncontroversial resolutions to be disposed of quickly, and the right of the chairman on the one hand and a relatively small number of shareholders on the other to demand a poll is a safeguard against a decision being taken against the wishes of the majority shareholders, whereas a poll can provide a more accurate reflection of the voting strength among the members. By recognition that there is a potential conflict of voting results on a show of hands and a poll, the Company Law Review recommended that a quoted company will be required to disclose on its website the results of polls at its general meetings, and members of a quoted company will have a right to require an independent scrutiny of any poll, and that the scrutiny report will have to be published in the company’s report.³³⁹ The Bill takes this recommendation into consideration, provides that quoted companies will

³³⁶ PIRC’s survey found that at computer distributor Northamber plc, 55% of proxy votes were cast against one director, but he was elected on a show of hands at the meeting without the proxies being used. See PIRC, 1999. *New Survey Reveals Increase in Proxy Voting but System “Ramshackle”*, PIRC Press Release, 7 November.

³³⁷ *Ibid.*

³³⁸ See UKSA’s Response to Modern Company Law for a Competitive Economy: Company General Meeting & Shareholder Communications, at p4, 9 January 2000.

³³⁹ See the CLR, Final Report, *op cit. fn.*269, para.6.19 to 6.40, and the White Paper, Company Law Reform, para.3.1 (Cm 6456, 2005).

have to disclose the results of any poll on their website.³⁴⁰ In addition, the Bill specifies that shareholders of a quoted company who hold at least 5 per cent of the voting rights, or who number at least 100 (with an average of at least £100 of share capital each) will be able to require the directors to obtain an independent report on any polled vote.³⁴¹ The requirement for website publication of poll results is in line with current best practice.

In China, the CCL 1994 adopted the 'one share one vote' principle which means a shareholder meeting has to be conducted by a poll rather than a show of hands.³⁴² However, to ensure board representation for larger minority shareholders, the cumulative voting system³⁴³ was adopted by the Code. The Code requires that listed companies with a controlling shareholder (holding more than 30% shares of the company) should adopt a cumulative voting system to elect the members of the board of directors and supervisory board and stipulate the implementing rules in the articles of association of the company.³⁴⁴ Nevertheless, the evidence shows that most companies have not fully complied with the Code's requirement to establish a cumulative voting system. Table 5.2 shows that only 61 companies out of the 185 sample companies with a controlling shareholder employed a cumulative voting method to elect the members of the board of directors and supervisors.³⁴⁵

³⁴⁰ See cl.315 of the Bill.

³⁴¹ See cl.316 of the Bill.

³⁴² See Art. 106, the CCL 1994.

³⁴³ Cumulative voting means that it allows minority shareholders to accumulate all of their votes and allocate them among a few or even one candidate. This increases the chance of board representation for minority shareholders. It normally applies to shareholders' elections of directors, not to shareholder voting on other matters. See Palmiter, Alan R. 2003. *Corporations: Examples & Explanations*, 4ed. p119, CITIC Publishing House.

³⁴⁴ See cl.31, the CCGC, *op cit.* fn.28.

³⁴⁵ In total, 267 companies were randomly selected from the Shanghai and Shenzhen Stock Markets in this study.

Table 5.2 Frequency of Companies Exercising Cumulative Voting Method to Elect Directors or Supervisors at Shareholder Meetings in China

Cumulative Voting Method Exercised at AGM/EGM (2002/2003)	Frequency	Percent	Cumulative Percent
NO	124	67.0	67.0
YES	61	33.0	100.0
Total	185	100.0	

Source: survey of the AGM/EGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets. By observation of the ownership data, only 83 companies were identified to have no shareholder whose shareholding is more than 30 per cent of company issued shares. According to the code, the rest 185 companies should establish a cumulative voting system to elect their directors and supervisors.

The aim of the cumulative voting system is to provide the minorities with a chance to nominate directors and supervisors. The CCL 2006 ratified the cumulative voting system. The Art.106 of the CCL 2006 stipulates that

“A cumulative voting system may be implemented in accordance with the provisions of the articles of association of the company or a resolution passed at a shareholder general meeting to elect the member of board of directors or supervisory board. The “cumulative voting system” as referred to in this Law means that, when any directors or supervisors are elected at a shareholder general meeting, each share shall have the same number of votes as that of the directors or supervisors to be elected and the shareholders may pool their votes when such votes are cast”³⁴⁶.

Clearly, the CCL 2006 gives the cumulative voting system statutory effect and enables minority shareholders to have a ‘voice’ at the shareholder meeting for the

By observation of the ownership data, only 83 companies were identified to have no shareholder whose shareholding was more than 30 per cent of company issued shares. According to the CCGC, the remaining 185 companies should establish a cumulative voting system to elect their directors and supervisors.

³⁴⁶ See art.106 of the CCL 2006.

appointment of directors and supervisors. Under the cumulative system, the number of votes available to a shareholder is equal to the number of shares held times the number of positions up for election and all votes may be cast for the same director. However, whether the implementation of a cumulative voting system will enable China to improve the protection of minority shareholders remains to be seen.

The voting rule of proxy is another vital way to promote shareholder democracy for shareholders unwilling or unable to attend and vote at a shareholders' general meeting. A proxy is a person authorised by a shareholder to attend and vote at a meeting on his/her behalf. The proxy system is very important because, shareholders in publicly traded companies are often geographically dispersed or have some principal business other than investing, so that inertia and lack of interest from shareholders in attending and voting at general meetings is understandable. Proxies enhance the shareholders' abilities to exercise their rights even when they are not present at the meeting in person.³⁴⁷

In the UK, voting by proxies is mandatory. Section 372 (1) and (2) of the CA 1985 specify that any member of a company who is entitled to attend and vote at a meeting of the company may appoint another person, whether a member or not, as his/her proxy to attend and vote on his/her behalf.³⁴⁸ A company may notify its shareholders of an address to which proxy appointments may be sent using electronic

³⁴⁷ See John Farrar et al, *op cit.* fn.245, p308

³⁴⁸ See s.372 (1)and (2), CA 1985

communications and may receive appointments electronically.³⁴⁹ Articles.60 and 61 of Table A set out forms for appointing proxies and specify that an instrument appointing a proxy must be deposited at the company's registered office, or received electronically at the notified address not less than 48 hours before the meeting.³⁵⁰ In addition, the Listing Rules also require that a notice convening a meeting must accompany a form for the appointment of a proxy every time and enable the appointer to specify how the proxy is to vote on each resolution other than procedural motions.³⁵¹

Regulation 63 of Table A of the CA 1985 specifies the procedures for revoking the appointment of a proxy. Nevertheless, common law also provides certain rules on revocation of proxies. For example, a proxy who acts knowing that his/her authority has been revoked will be in breach of duty to his/her appointer.³⁵² The appointment of a proxy does not prevent the shareholder from attending and voting in person. If a shareholder, who has appointed a proxy for a meeting actually attends the meetings, the company must then accept his/her vote instead of the proxy.³⁵³

By implication, a proxy at a meeting of a publicly listed company can attend and vote, but cannot speak at the meeting under the current system. Against that background,

³⁴⁹ See s.372 (2A) CA 1985.

³⁵⁰ See Table A, arts. 60 and 61.

³⁵¹ See para.13.28(a) (b), the Listing Rules. This requirement has also been specified by Table A art. 61, as two-way proxies which are distinct from appointing a person to exercise the vote, under which a member can indicate whether he wishes to vote for or against a particular resolution.

³⁵² See *Cousins v. International Brick Co. Ltd.* [1931] 2 Ch. 90 at p104

³⁵³ *Ibid*

the Company Law Review proposed that proxies should be permitted to speak at meetings of public companies.³⁵⁴ The Bill adopts the recommendations to enhance statutory rights so that proxy appointments can authorise the proxy to attend, speak and vote at the meeting.³⁵⁵ In addition, in line with a general trend towards more active shareholder engagement, the Bill proposed to allow indirect investors (those who hold shares through intermediaries such as nominee brokers) to exercise the governance rights through proxy.³⁵⁶

In China, Article 108 of the CCL 1994 provides that a shareholder may attend a shareholders' general meeting by proxy. The proxy holder shall present the proxy statement issued by the shareholder to the company, and exercise his voting rights within the scope of the authorisation.³⁵⁷ Although the company law does not stipulate the detailed procedure rules on proxies, the Directive 1997 specifies that a proxy has to be deposited at the company's registered office, or received at the notified address not less than 24 hours before the meeting commences.³⁵⁸ The proxy must be a notarised document if it was signed by a person other than the shareholder.³⁵⁹ Clause 10 of the Code also states that the board of directors, independent directors and qualified shareholders of a listed company³⁶⁰ may solicit for the shareholders' right to vote in a shareholder meeting at the company's expense, and that adequate information should

³⁵⁴ See the CLR Final Report, *op cit.* fn.269, para.7.13 at p156.

³⁵⁵ See cl.299 of the Bill.

³⁵⁶ See cl.136 & 137 of the Bill

³⁵⁷ See Art.108, the CCL 1994

³⁵⁸ See *op cit.*, fn. 227, art.52 of the Directive 1997.

³⁵⁹ *ibid.*

³⁶⁰ The difficulties with this provision are that it provides no guidance on the definition of 'the qualified shareholder' and how the proxies should be initiated.

be provided to persons whose voting rights are being solicited.³⁶¹ However, the mechanisms of proxy voting provided by the Directive 1997 and the Code were not added into the CCL 2006 and the effectiveness of the proxy remains largely uncertain.

Compared with the UK, although the proxy voting system has been adopted by China,³⁶² it seems that it does not function in the same way. In China, as we observed, the largest shareholder in listed companies owns on average 44.9%,³⁶³ whereas each individual investor normally holds less than 0.5% of company issues shares.³⁶⁴ There are no powerful intermediaries like banks, insurance companies or other institutional investors who are able to solicit proxies. It can be seen that adopting proxy voting does not help minority shareholders. The controlling shareholder has absolute control in determining the effectiveness of the proxies, and hence makes the directors loyal to him/her, but not to minority shareholders or the company as a whole. In addition, because there is no legal instruction on how to vote by proxy, with little knowledge of proxy voting and insufficient information about the company's affairs, the small individual shareholders have neither the incentive nor the capability to scrutinise managerial performance.³⁶⁵ Not surprisingly, considering the substantive defects of the ownership structure and shareholders' perception on proxy voting, it is apparent that the proxy will be incapable of meaningful application in China.

³⁶¹ See cl.10, the CCGC, *op cit.* fn.28.

³⁶² See Art.108, the CCL1994 and Art.52, the Directive 1997, *op cit.* fn.227.

³⁶³ See Shi, S. and D. Weisert, 2002. Corporate Governance with Chinese Characteristics, *China Business Review*, Volume 28, No.5. In our survey in Chapter 4, the largest shareholder on average owned 45.39% of the company issued shares.

³⁶⁴ See Xu and Wang, *op cit.* fn.214, p84.

³⁶⁵ *Ibid* at p85.

5.4.5 Resolutions and Voting Restrictions

In practice, there are three types of resolutions which may be encountered at the shareholder general meetings in the UK. An ordinary resolution is one which is passed by a simple majority of shareholders entitled to attend and vote at a meeting either in person or by proxy. It is used for all matters not requiring another type of resolution under the CA 1985 and the articles of association of a company.³⁶⁶ A special or an extraordinary resolution is one which is passed by a majority of not less than three-quarters of such shareholders entitled to attend and vote at a meeting either in person or by proxy.³⁶⁷ A special resolution is required in respect of fundamental changes to the company and an extraordinary resolution is required only for certain matters connected with winding up, or when a class meeting is asked to agree to a modification of class rights.³⁶⁸ However, the Bill abolished extraordinary resolutions as a separate category.

Shareholders have the power to vote for or against any resolution proposed at the shareholder general meeting. In the UK, common law proposes that a shareholder who is not a fiduciary of the company, is not subject to any rule against conflict of interest and duty when he/she exercises his/her voting. In *Peter's American Delicacy Co. Ltd v. Health*,³⁶⁹ the Court states that

³⁶⁶ For example, the removal of a director (s.303, CA 1985); the removal an auditor (s.391, CA 1985); and the alteration of capital (s.121, CA 1985)

³⁶⁷ The main difference between a special resolution and an extraordinary resolution is the notice period which is discussed in section 5.3.2.

³⁶⁸ See, s.378 (1), (2) and (3), CA 1985, and s.81 (1) (c), Insolvency Act, 1986.

³⁶⁹ [1939] 61 CLR 457

“The shareholders are not trustees for one another, and, unlike directors, they occupy no fiduciary position and are under no fiduciary duties. The vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owners’ personal advantage.”³⁷⁰

This statement clearly provides that a shareholder’s vote is a property right, and prima facie may be exercised by a shareholder as he/she thinks fit in his/her own interest.³⁷¹ Nevertheless, English Courts hold that a resolution of the members of a company would be invalid if members voting for it did not vote *bona fide* in the interests of the company³⁷² or if the resolution was adopted for an improper purpose.³⁷³ These issues were also considered by the Company Law Review which essentially concluded that the powers of the majority and of a blocking minority should be unconstrained by the Act³⁷⁴ However, the majority when deciding on an alteration to the constitution or class rights must take the decision *bona fide* in the best interests of the members, or the members of the class, as a whole.³⁷⁵ The votes of a member who has an actual or threatened wrong on the company may be invalidated by the court when used to vote on the issue, whether as a member of a majority or a blocking minority.³⁷⁶ There is no doubt that these recommendations are aimed at adopting a particularly strict approach

³⁷⁰ *Ibid*, p.504

³⁷¹ See *Carruth v. Imperial Chemical Industries Ltd.* [1937] AC 707 at p.765

³⁷² See *Allen v. Gold Reefs of West Africa Ltd.*[1900] 1 Ch 656

³⁷³ See *Re Western Mines Ltd.* [1975] 65 DLR (3d) 307 at 313

³⁷⁴ See *op cit.* fn. 269, Completing the Structure para.5.110

³⁷⁵ *Ibid*

³⁷⁶ *Ibid*

to the exercise of majority voting powers so as to prevent misuse of the power to the detriment of minority shareholders.

In China, resolutions of shareholder general meetings are categorised into two types: ordinary resolutions and special resolutions. An ordinary resolution of the shareholder general meeting shall be passed with a simple majority vote, apart from resolutions on the merger, division, liquidation, or amendment to the articles of association which require a two-thirds majority vote.³⁷⁷ In addition, the Directive 1997 provides that the shareholders' general meeting may decide through an ordinary resolution that certain important matters should be decided by a special resolution.³⁷⁸ The Directive 1997 further specifies that a shareholder who has related transaction interests in a resolution, except in special circumstances and subject to the approval of the competent authorities,³⁷⁹ is not permitted to vote on this resolution and his/her vote is not counted in a poll.³⁸⁰ The Directive 1997 clearly attempts to extend corporate fiduciary duties to those who have sufficient voting shares to determine the outcome of a shareholder vote – i.e. the controlling shareholders. By adopting the approach of the Directive 1997, the CCL 2006 specified that any shareholders whose liabilities are to be secured by the guarantee or assets of the company, or any shareholder which is controlled by the *de facto* controller, whose liabilities are to be guaranteed by or

³⁷⁷ See Art.106, 107, the CCL 1994.

³⁷⁸ See art.65, the Directive 1997, *op cit.* fn.227.

³⁷⁹ There is no consensus official interpretation on the vague term “competent authorities”. See Gang, Yu and Allen Wong, A new Listed Company Law: CSRC Guideline on Article of Association for Listed Companies in China. July 1998. Available from: <http://www.omm.com/webcode/navigate.asp?nodeId=817> [Accessed 12 March 2006]

³⁸⁰ See art.72, the Directive 1997, *op cit.* fn.227.

secured with the assets of the company, is prohibited from voting on such a resolution at the shareholder general meeting. To some extent, the exclusion rule will prevent a controlling shareholder from misusing voting powers for his/her own purposes to the disadvantage of the minority shareholders.³⁸¹ However, no provision has been added to regulate a shareholder who has related transaction interests in a resolution.

5.3.6 Shareholders' Resolutions

In the UK, the law provides that shareholders with five per cent or more voting rights of a company, or 100 or more shareholders with shares upon which an average of not less than £100 has been paid up can require a company to put a resolution to a shareholder general meeting.³⁸² However, for a shareholders' resolution to be considered at a meeting, it must meet certain requirements stated in s.376 of the CA 1985. These requirements are that a copy of the requisition must be signed by all the requisitionists and deposited at the registered office of the company at least six weeks before the meeting, and in the case of a statement, not less than one week before the meeting.³⁸³ A statement of the proposed resolution must keep to within 1,000 words and the requisitionists should tender a sum reasonably sufficient to meet the company's expenses in giving effect to the requisition.³⁸⁴ Subject to these requirements, the directors must circulate a resolution or statement unless "on the application either of the company or of any other persons who claim to be aggrieved,

³⁸¹ See Art.16 of the CCL 2006.

³⁸² See s.376 (2), CA 1985

³⁸³ See s.377 CA 1985

³⁸⁴ See s.376 CA 1985

the court is satisfied that the rights conferred by that section are being abused to secure needless publicity for defamatory matter”³⁸⁵. Nevertheless, as the cost of printing and postage can be up to £100,000 for the largest companies,³⁸⁶ such a requirement has been described as a significant barrier to shareholders to exercise the powers under s.376.³⁸⁷

However, the right for shareholders to requisition resolutions to be put forward at an AGM has been amended by the Bill. Clause 313 of the Bill provides that shareholders holding at least 5 per cent of the shares or more than 100 in number have the right to requisition a resolution at the AGM at the company’s expense if the requisition is delivered before the end of the financial year.³⁸⁸ Nevertheless, the Bill also makes clear that a resolution may not be proposed by requisitionists if it would be ineffective (for example, because it is inconsistent with the company’s constitution or a provision of statute), or is defamatory, frivolous or vexatious.³⁸⁹ In addition, shareholders in quoted companies who hold at least 5% of the voting rights, or who number at least 100 (with an average of at least £100 of share capital each) will have the right to publish on the company's website free of charge a statement of any concerns about the

³⁸⁵ See s.377(3) CA 1985

³⁸⁶ See Knowles, G, 1996. Shareholder Communication: Proposed Changes to the Companies Act, *Company Lawyer*, 17(6), 188-189.

³⁸⁷ See P. L. Davis, *op cit.* fn.251. p351.

³⁸⁸ See cl.313 of the Bill.

³⁸⁹ See cl.269 of the Bill. This clause enables members to require a written resolution to be circulated. They may also require circulation of a statement about its subject matter. Like the members' right to require a resolution to be moved at an AGM, the percentage needed is 5% of the total voting rights (or lower if specified in the company's articles). Subsection (2) specifies some limits on the kind of resolution that may be circulated in this way, designed to stop the power being abused. See Section 525, Explanatory Notes to the Bill, prepared by the Department of Trade and Industry, are published separately the Bill 34-EN, (hereafter the Notes). Available from: <http://www.publications.parliament.uk/pa/ld200506/ldbills/034/2006034.htm> [Accessed 12 March 2006]

audit, or the circumstances in which the auditors have resigned, that they intend to raise at the AGM.³⁹⁰

In China, the CCL 1994 was silent on the right of shareholders' resolutions. However, the Directive 1997 provides a single section to ensure that shareholders are entitled to present the resolution at a meeting. Article 57 of the Directive 1997 provides that a shareholder or shareholders holding an aggregate of five per cent or more of the voting rights of a company may propose a resolution for a shareholder meeting.³⁹¹ A proposed resolution must be submitted to the board of directors in writing and must contain specific subjects for discussion and matters to be resolved. The content of the resolution must be consistent with laws, regulations or the articles of association of the company, and should not exceed the business scope of the company and the shareholder authority.³⁹² The board of directors has discretion to decide whether the resolution should be submitted to the shareholders' general meeting in the light of the best interests of the company and its shareholders.³⁹³ If the board refuses to submit the resolution to the shareholder general meeting, the reasons must be given at the meeting and announced together with the resolution.³⁹⁴ If the requisitionists do not agree with the rejection decision made by the board, they may request to convene an extraordinary general meeting to vote on the resolution they proposed.³⁹⁵ However, there is no further requirement on the time for submission of shareholders' resolutions

³⁹⁰ See cl.512 of the Bill.

³⁹¹ See art.57 the Directive 1997, *op cit*, fn.227.

³⁹² *ibid*, art.58

³⁹³ *ibid*, art.59

³⁹⁴ *ibid*, art. 60.

³⁹⁵ *ibid*, art.61.

and the circulation cost. In practice, the time for submission of shareholders' resolutions and the circulation costs are crucial to minority shareholders because, without such a requirement, the board of directors acts as a gatekeeper without the discipline of accountability and is free to determine whether or not to submit the resolution to the shareholders' general meeting and who bear the circulation costs.

However, the CCL 2006 envisages the issue of shareholders' resolutions. The Art.103 of the CCL 2006 provides that

“the shareholders that individually or collectively hold more than three per cent of the company issued shares may propose provisional resolutions and submit them in writing to the board of directors ten days before the shareholder general meeting commenced; the board of directors shall notify the other shareholders of such provisional resolution within two days of receipt thereof and present them to the shareholder general meeting for consideration. The contents of a provisional resolution shall fall within the scope of the functions and powers of the shareholder general meeting and it shall contain definite topics for consideration and specific matters to be decided on.”³⁹⁶

From this provision we can see that any shareholder(s) who satisfy the three per cent shareholding and 10 days time requirements will be entitled to propose a resolution to

³⁹⁶ see art.103 of the CCL 2006.

the shareholder meeting. No powers or advantages have been given to the board of directors to exercise their discretion to prevent the shareholder resolution being placed on the agenda. However, the shareholder proposal rule adopted by the CCL 2006 may be criticised as being too lax and inapplicable in practice. Firstly, as ownership structure is concentrated in the hands of the large shareholders, this will lead large shareholders to use their initiation power to gain financial or other benefit from management. Secondly, the circulation time is limited for the board of directors to notify all other shareholders, especially the dispersed individual shareholders. The information asymmetry would enable some shareholders to obtain the benefits for themselves at the expense of their fellow investors. Thirdly, even though the minority shareholders have a chance to put their proposals on the agenda of the shareholder general meeting, without the controlling shareholder's consent such a resolution will never be adopted by the company. Therefore, the impact of this provision will be nominal to solve corporate governance problems because China's companies continue to be dominated by controlling shareholders.

5.4 Voting Practices: Some Empirical Evidence

Attendance and voting levels are important for measuring the effectiveness of shareholder resolutions as a mechanism of corporate governance. A lower attendance or voting level is an indication of the ineffectiveness of the shareholder general meeting in fulfilling its role in the corporate governance of publicly listed companies.

As far as attendance is concerned, Kackenzie reports that in the UK, attendance in

person at the annual general meeting of listed companies is less than 1% and most voting is cast by proxy.³⁹⁷ A Consultation Document from the Company Law Review Steering Group – “The Modern Company for a Competitive Economy: Developing the Framework” reports that the average proportion of votes cast on resolutions at AGMs remains at less 50 per cent.³⁹⁸ PIRC’s annual proxy voting survey (2003) highlights shareholders’ continued failure to vote at the UK listed companies.³⁹⁹ PIRC reports that despite the introduction of the CREST electronic platform and the weight of regulatory pressure towards encouraging shareholder activism, there is no substantial increase in average voting levels compared with their previous survey. The average voting level for FTSE 350 companies was 49% in 2001 and 57% in 2002, but in 2003 it was only about 55%. The average voting level for FTSE All Shares companies was 51% in 2001 and 56% in 2002, but in 2003 was 53%.⁴⁰⁰ However, PIRC’s reports indicates that the average voting level at FTSE 100 companies was about 53%, whereas FTSE MidCap (the next largest 250 companies) average voting level was recorded over 61%. The most likely contributory evidence given for this difference is due to the cross border voting problems.⁴⁰¹ Pettet argues that the poor attendance of the AGM stems from the fact that shareholders always leave their proxies to one of the incumbent directors. Because of the soliciting of proxy votes by

³⁹⁷ See Kackenzie, C. 1993. *The Shareholder Action Handbook: Using Shares to Make Companies More Accountable*, pp119, 166, Newcastle: New Consumer Ltd.

³⁹⁸ See *The Modern Company for a Competitive Economy: Developing the Framework*, A Consultation Document from the Company Review Steering Group, p86, para.4.11. March 2002.

³⁹⁹ PIRC, 2003. *Upward Voting Trend Halted Says PIRC: PIRC’s Annual Voting Survey Highlights “Shareholders Continued Failure to Vote at UK Listed Companies”*. Available from:

<http://www.thecorporatelibrary.com/special/PR/PIRCvoting2003.pdf> [Accessed 12 March 2006].

⁴⁰⁰ *Ibid*

⁴⁰¹ *ibid*, PIRC reports that 32.1% of UK equity is held by non-UK ownership and 91.5% of this overseas is held in the FTSE 100 companies.

the board at the company's expense, it is unusual for the board's proposals to be defeated by any opposition.⁴⁰² Indeed, according to PIRC's report only 9.1% of companies had resolutions receiving an oppose vote of 20% or more and only 16.4% of the sample companies showed abstain votes in excess of 20% in the 2004 proxy voting annual review.⁴⁰³

In the UK, it seems apparent that an important reason for existing voting patterns is the passive approach taken by institutional shareholders. In the UK, institutional shareholders are the dominant investors with approximately 80 per cent of shares in publicly listed companies and they have been required to take a more active role in monitoring company management.⁴⁰⁴ However, most companies find that their AGMs are rarely attended by institutional investors or their representatives. Instead those present are predominately private investors with small shareholdings.⁴⁰⁵ By observation of the role of institutional investors in corporate governance, Solomon and Solomon describe three forms of shareholder activism which are usually employed by institutional investors to monitor company management and resolve agency problems: (1) vote at investee companies' AGMs; (2) engage in one-to-one meetings between institutional investor representatives and investee company management; (3) compile shareholder resolutions.⁴⁰⁶ However, there are signs that

⁴⁰² See Ben Pettet, *op cit.* fn.39, p171

⁴⁰³ See PIRC Proxy Voting Annual Review 2004, *Growing Opposition*, p14.

⁴⁰⁴ See the CLR, Final Report, *op cit.* fn.269, at 141.

⁴⁰⁵ Gaved, Mathew, 1998. *The Role of Disclosure in Strengthening Corporate Governance and Accountability: Corporate Governance in the United Kingdom*. OECD, February. Available from: <http://www.oecd.org/dataoecd/63/14/1932499.pdf> [Accessed 12 March 2006]

⁴⁰⁶ J. Solomon and A. Solomon, 2004, *op cit.* fn.33. p97.

institutional shareholders are increasingly recognising the importance of voting as part of their role in responsible corporate governance, but many of them still view general meetings as a waste of time and money and prefer to rely on methods other than casting votes at general meetings to exercise their influence. Instead of personally attending shareholder meetings, casting their votes by proxy reflects their attitude.

Davies argues that there are three main reasons for institutional shareholders failing to attend the AGMs: conflicts of interest, a desire for a quiet life, and technical difficulties of voting.⁴⁰⁷ Hannigan explains that institutional investors' intervention more likely occurs behind the scenes and not through the public forum of putting resolutions to the AGM and/or voting against the reappointment of incumbent management.⁴⁰⁸ Solomon et al's survey finds that institutional investors "clearly preferred not to 'waste time' attending annual general meeting (AGM) and considered that they could perform their active function perfectly well without such attendance".⁴⁰⁹ However, the Myners' Report focuses on various aspects of institutional investment in the UK and argues that institutional investors merely meeting with management of portfolio companies and expressing polite reservations about strategy is not effective shareholder activism.⁴¹⁰ The report points out that the fund managers are reluctant to intervene in companies where they own a substantial

⁴⁰⁷ See Paul L. Davies, *op cit.* fn.251, pp340-342.

⁴⁰⁸ See Hannigan, B. *op cit.* fn.221, p171.

⁴⁰⁹ See Solomon, J. F., A. Solomon, N. Joseph, and S. Norton (2000), Institutional Investors' View on Corporate Governance Reform: Policy Recommendations for the 21st Century, *Corporate Governance: An International Review*, Vol.8 215-226, at 220.

⁴¹⁰ See Institutional Investment in the United Kingdom: A Review, Myners' Report (London 2001) at para 5.79, at p90

shareholding.⁴¹¹ The Company Law Review Steering Group gave detailed consideration to the issues mentioned above and provided some radical solutions to allow institutional shareholders to actively and effectively exercise their powers in the AGMs, such as the technical rules concerning the transparency and efficiency of the voting process and the rules concerning the conflicts of interest.⁴¹² The White Paper, Modernising Company Law adopted the rule of transparency of voting.⁴¹³ Although the White Paper did not make a mandatory rule to regulate the conflict of interest issues, it envisaged that “in principle it would be in the public interest for institutional investors to be required to disclose publicly how they voted in respect of their shareholding in British quoted companies”.⁴¹⁴

Indeed, institutional investors either own or manage assets on behalf of and for the benefits of clients or members and have an obligation to manage those assets in their interests. Voting is central to the exercise of ownership control and an important element in adding value to a company. However, the ability of clients or members to monitor the way in which institutional investors exercise voting rights is limited in practice.⁴¹⁵ In addition, voting transparency could be expected to enhance the efficiency of institutional investment. First, it will reduce the risk of conflicts of interest – which institutional investors may face when voting shares – from distorting voting decisions. Secondly, it will increase the accountability of institutional investors

⁴¹¹ *ibid*, para 5.83 - 5.88, at 91-92

⁴¹² See the CLR Final Report, *op cit.*269, para 6.19-6.40.

⁴¹³ CLR, the Modernising Company Law White Paper, (Cmnd 5553-I), pp24-25, para 2.42-2.48.

⁴¹⁴ *ibid*, p25, para.2.47.

⁴¹⁵ See DTI, Transparency of Voting by Institutional Investors, Available from: <http://www.dti.gov.uk/cld/votingrightsexpl.doc> . [Accessed 25 September 2005]

to retail investors, both for voting shares and for the signals being sent to company management by voting.⁴¹⁶ The Bill confers on the Secretary of State for Trade and Industry and on the Treasury power to make regulations requiring voting disclosure by specified categories of institutional investor.⁴¹⁷ These include unit trust schemes, open-end investment, investment trust, pension schemes, insurance companies and collective investment schemes.⁴¹⁸ Under the Bill these institutional investors will be obliged to disclose how they exercise their voting rights on any resolutions at the shareholder meetings.

The poor and incomplete voting process in Chinese listed companies reflects the fact that the shareholder participation in the meeting to exercise their rights is typically far less fulsome than its counterparts in the UK. Table 5.3 shows descriptive statistics on attendance of the AGM in China. It can be seen that the average attendance of the AGM is about 15 people, which means only about six in ten thousand shareholders attend the AGM. Observation on the frequency distribution of attendance of the AGM (Table 5.4) shows that there are 83.5% of the companies in the sample having less than 20 shareholders to attending the AGM. Further, Table 5.4 shows that there are 2 companies which have held their AGM with only one shareholder present.⁴¹⁹ Interestingly enough, one of them even amended the articles of association of the company by a special resolution.⁴²⁰ One likely explanation for such an occurrence is

⁴¹⁶ *Ibid.*

⁴¹⁷ See cl.866(1) of the Bill.

⁴¹⁸ See cl.866(2) of the Bill.

⁴¹⁹ In China, company law does not provide the rule of quorum for holding a shareholder meeting. See section 5.3.3 of this chapter.

⁴²⁰ In China, there are two types of resolution referred to in the company law: ordinary resolution and special

that, although the shareholders keep corporate control power in China, this does not mean that the shareholder meeting has become an effective mechanism for quasi democratic control of the company's affairs. Indeed, the shareholder meeting in China has been criticised for being just like a rubber stamp for the wishes of the controlling shareholders. There is little or no opportunity for minority shareholders to exercise their voice and oppression of minority shareholders is a serious issue in practice.⁴²¹

The voting level at the shareholder general meetings in China is similar to UK listed companies. Table 5.5 shows that the average voting level in the 2002/2003 financial year was around 56.79% in Chinese listed companies. It was expected that the voting level would be much higher because of the high concentration of share ownership in China. Additionally, the data show that over 21.3% of the 267 companies in the sample recorded an oppose vote on proposals put forward by the board of directors (see table 5.6). However, Table 5.7 shows that the average voting level against the resolutions at the AGM does not exceed 2.5% except in 7 cases in 5 companies accounting for about 2% of the total sample, where the board of director's or supervisory board's proposals are defeated by opposed votes at the AGM.⁴²²

resolution. Amendment of article of association of the company is classified as a special resolution which is passed by two-thirds of majority votes cast in person or by proxy at a general meeting. See section 5.4 of this Chapter.

⁴²¹ See Schipani, C. A., and J. Liu, *Corporate Governance in China: Then and Now*, Colum. Bus. L. Rev. 1, p36.

⁴²² In Chengdu Yinhechuangxin (000519), the board proposal for changing company's accounting firm attracted the largest shareholder and the second largest shareholder's opposed votes, which resulted in only 6.98% votes in favour, 93.02% votes against, defeated at the AGM 2002. In Fujian Shenlongfazhan (600659), two board proposals were defeated at the AGM (2002). One was the appointment a new director which attracted 57.64% opposing votes, 15.53% abstentions and only 26.83% of votes were cast in favour. In Guangxi Guitang (000833) at the AGM (2002) one board of directors' proposal concerning the remuneration of the board of directors and supervisory board was defeated by 81.36% votes against, 18.47% votes in favour and 0.17% abstentions, and one supervisory board's proposal for increasing the number of directors was also defeated by 57.24% opposing votes, 17.17% votes in favour and 25.02% abstentions. In Shanghai Hainiao Co. (600634), board proposed resolution for dividend policies and allocation of shares to existing shareholders (8 sub items) failed to pass at the AGM (2002) by 99.71% opposing votes. In Hainan Diyitouzi plc. (600515) board's proposal for dividend policy and a new share scheme failed to pass at the AGM (20002) by 96.61% opposing votes, zero votes in favour and 3.39% abstentions.

Table 5.3 Descriptive Statistics of Attendance at the AGM in China

	N	Minimum	Maximum	Mean	Std. Deviation
Attendance of shareholder meetings	267	1.00	222.00	15.51	24.61
Total numbers of shareholders	267	2115.00	522550.00	52482.68	57498.54
Turnout ratio (per thousand)	267	.01	13.24	.57	1.26

Source: survey the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets

Table 5.4 Frequency Distribution of Attendance at the AGM in China

Turnouts	Frequency	Percent	Cumulative Percent
0-1	2	.7	.7
2-5	85	31.8	32.6
6-10	83	31.1	63.7
11-20	53	19.9	83.5
21-50	27	10.1	93.6
51-100	12	4.5	98.1
101-200	4	1.5	99.6
201-500	1	.4	100.0
Total	267	100.0	

Source: survey the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets.

Table 5.5 Descriptive Statistics of Voting Level at the AGM in China

	N	Minimum	Maximum	Mean	Std. Deviation
Voting level at of the AGM	267	1.30	89.95	56.79	14.88

Source: survey of the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets.

Table 5.6 Frequency of Companies whose Shareholders Exercise Voting Right Opposing Resolutions at the AGM in China

	Frequency	Percent	Cumulative Percent
No	210	78.7	78.7
Yes	57	21.3	100.0
Total	267	100.0	

Source: survey of the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets.

Table 5.7 Descriptive Statistics of Voting Against Resolutions at the AGM in China

	N.	Minimum	Maximum	Mean	Std. Deviation
Voting level against resolution at the AGM	49	.00	25.53	2.35	6.20

Source: survey of the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets.

In theory, the rule of shareholders' resolutions (or shareholders' proposals) is another control mechanism which provides an opportunity for shareholders to communicate with both corporate management and the other shareholders. However, Stapledon argued that although shareholders of UK quoted companies were entitled to vote upon a wide range of matters, almost all resolutions proposed at AGMs and EGMs were board- or management-initiated, rather than shareholder-initiated.⁴²³ PIRC claimed that the current rules governing shareholders' resolutions in the UK were "confused and a hindrance to action". PIRC's research showed that the shareholder resolution was little used. There were only three filed at FTSE 350 companies in 1998, and just 13 companies had been the recipient of such resolutions since 1995.⁴²⁴ Further research on shareholder resolutions conducted by PIRC in 2002 showed that the situation has not improved very much. By observation of 523 company shareholder general meetings from January to September 2002, PIRC found that there were only a handful of shareholder resolutions out of over 6000 resolutions discussed.⁴²⁵ The TUC Fund Manager Voting Survey 2003 reported that shareholder resolutions attracted the biggest negative reaction from investors. The report discussed two companies which had shareholder resolutions put forward at their 2002 AGM. At BP Plc's AGM, a shareholder resolution for "the company to prepare a risk analysis report for any operations in environmentally or culturally sensitive areas" was proposed, but the voting result shows only one vote in favour, one vote abstention and 14 votes

⁴²³ See Stapledon, G. P., 1995, Exercise of Voting Rights by Institutional Shareholders in the UK, *Corporate Governance: An International Review*, Vol.3, pp144-155.

⁴²⁴ See PIRC, 1999. Making Votes Count: PIRC Proposes Proxy Reform, PIRC Intelligence, February.

⁴²⁵ See PIRC, 2002. Modernising Company Law: PIRC's Response the White Paper, December.

against.⁴²⁶ At British Land Co. Plc's AGM, three shareholder resolutions for urging directors to formulate proposals for (i) placing substantial property assets; (ii) an ongoing share buyback programme; (iii) a one-off share buyback were put forward for voting, the first two were opposed by every single respondent. Only the final resolution attracted two abstentions.⁴²⁷ Although the TUC survey focused only on how various fund managers exercise voting rights in relation to controversial issues at company AGMs, it indicates that shareholder resolutions carried by institutional shareholders without an emphasis on collective action do not function effectively in the voting process.

In China, shareholder resolutions are normally filed by the controlling shareholders. Table 5.8 shows the frequency of shareholder resolutions proposed at the AGMs in the 2002/2003 financial year. There were 18 out of the 267 randomly selected companies in which shareholders submitted resolutions at the AGMs.

Table 5.8 Frequency Distribution of Shareholder Resolutions Proposed at the AGM in China

<i>Shareholder Resolution Proposed at the AGM (2002/2003)</i>	<i>Frequency</i>	<i>Percent</i>	<i>Cumulative Percent</i>
No	249	93.26	93.26
Yes	18	6.74	100.0
Total	267	100.0	

Sources: survey of the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets.

⁴²⁶ See TUC Fund Manager Voting System 2003 available from: <http://www.tuc.org.uk/pensions/tuc-6839-10.cfm> [Accessed 12 March 2006].

⁴²⁷ *Ibid.*

Table 5.9 shows that the issues covered by shareholder resolutions mainly focused on five main areas with a total of 23 items. They are (A) company's strategies and investment plan (6 items); (B) amendment of articles of association (5 items); (C) appointment and dismissal of members of board of directors and supervisory board (9 items); (D) remuneration policies (2 items); and (E) dividend policies (1 item).

However, Table 5.10 reports that the average attendance at the shareholder general meeting is just about 12 people. The limited number in attendance indicates that many shareholders are likely act as free riders, rather than collectively become involved in the corporate decision making process in China. By observation of the voting level, an important caveat is that most proposing shareholders control more than two-thirds of votes at the shareholder general meeting, which substantially allows them to pass their resolutions without any difficulties.

Table 5.9 Shareholder Resolutions at the AGM in China

Companies	Proposed Resolutions	Proposing shareholders	Proposing shareholder voting level	Total voting level at the AGM	Number of attendances	Votes for	Votes against	Abstention votes
600858	A (2 items) and B	The largest shareholder ⁽⁴⁾ The 3 rd largest shareholder ⁽³⁾	22.4% (1 st : 14.50% and 3 rd : 8.04%)	31.13%	27	(A1) 99.43%; (A2) 99.84% B 99.43%	(A1) 0.57%; (A2) 0.16% B 0.15%	B 0.42%
600729	A	The largest shareholders ⁽¹⁾ The 2 nd largest shareholder ⁽³⁾	35.17% (1 st : 18% and 2 nd : 17.17%)	48.04%	27	97.31%	0.87%	1.82%
000990	C	The 3 rd largest shareholder ⁽¹⁾	4.65%	59.84%	9	100%	0	0
000800	C	The largest shareholders ⁽¹⁾	63.63%	67.99%	26	100%	0	0
600103	A, B and D	The 2 nd largest shareholder ⁽³⁾	9.91%	36.24%	6	100%	0	0
000632	D	The largest shareholder ⁽¹⁾	25.84%	41.78%	15	100%	0	0
000527	C	The largest shareholder ⁽²⁾	22.19%	31.26%	6	100%	0	0
600068	C	The largest shareholder ⁽³⁾	2.2%	47.32%	6	0	0	0
600202	A	The largest shareholder ⁽¹⁾	58.99%	59.16%	10	100%	0	0
600531	B	The largest shareholder ⁽¹⁾	56.93%	64.52%	5	100%	0	0
600291	C	The 1 st , 2 nd and 3 rd largest shareholders	44.37% (the 1 st : 16.02%; 2 nd : 14.27%; 3 rd : 14.08%)	62.5%	6	100%	0	0
000060	C	The largest shareholders ⁽¹⁾	46.67%	49.7%	11	100%	0	0
600535	C	The largest shareholder ⁽²⁾	51.58%	70.52%	7	100%	0	0
600328	E	The largest shareholder ⁽¹⁾	59.22%	65.25%	3	100%	0	0
600549	B and C	The 2 nd largest shareholder ⁽³⁾	22.76%	74.42%	4	100%	0	0
000813	C	The largest shareholder ⁽¹⁾	33.87%	69.75%	7	100%	0	0
600378	B	The largest shareholder ⁽¹⁾	29.05%	61.13%	8	100%	0	0
600705	A	The 2 nd largest shareholder ⁽³⁾	5.59%	34.3%	24	97.73%	2.27%	0

Source: survey the AGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets. (1) =State Owned Enterprise; (2)=Financial Investment Enterprises; (3)=Non-financial Investment Company; (4) = State Asset Management Bureau. A=company's strategy and business plan; B= amendment of article of association; C= appointment or dismissal member of board directors or supervisory board; D=remuneration policies; and E=dividend policies.

Table 5.10 Description of Voting Level on Shareholder Resolutions and Attendance at the AGM in China

	Minimum	Maximum	Mean	Std. Deviation
Total voting level	31.13	74.42	54.23	15.20
Proposing shareholder voting level	5.59	63.63	36.76	18.26
Attendance at the AGM	3.00	27.00	12.00	8.84

Sources: survey of the AGM/EGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets.

Compared with UK institutional activism, Table 5.10 shows that shareholder participation at shareholder general meetings is higher in terms of both proposing shareholder resolutions and the voting level of proposed shareholder resolutions at the AGM in China. However, Table 5.11 shows that most proposing shareholders, who are either the SOEs or non-financial companies, are the controlling or majority shareholders in a company. Table 5.12 reports that the majority shareholder resolutions (in 10 companies) were proposed by the largest shareholder individually. There were three cases where there was no controlling shareholder (holding over 30% shares) in the companies, the largest shareholder got involved in proposing resolutions jointly with the second or the third largest shareholders or both. Two of them showed that the voting process on the proposed resolutions was cast with oppose votes and abstentions. The fact that the opposing voting levels and abstention voting levels were much lower compared with the voting level in favour of shareholder resolutions implies that shareholders are more active in a company where the ownership of a company is relatively dispersed.

Table 5.11 Distribution of Shareholder Resolutions by the Identities of Shareholders in China

Identities of shareholders	SOE	FC	NFC	SAMB	TOTAL
Number of Resolutions	11	2	8	2	23
Percentage	47.82%	8.70%	34.78%	8.70%	100%

Sources: survey the AGM/EGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets. SOE=State Owned Enterprise; FC=Financial Company; NFC = Non-financial Company; SAMB = State Asset Management Bureau.

Table 5.12 Frequency Distribution of Proposing Shareholders at the AGM in China

	Frequency	Percent
The largest shareholder	10	55.6
The second largest shareholder	3	16.7
The third largest shareholder	2	11.1
The 1st and the 3rd combined	1	5.6
The 1st and 2nd and 3rd combined	1	5.6
The 1st and the 2nd combined	1	5.6
Total	18	100.0

Sources: survey of the AGM/EGM (2002/2003 financial year) for 267 companies listed in China's SH and SZ Stock Exchange markets. Two companies are excluded from the table because the threshold of proposing a shareholder resolution is 5% of company issued shares in China, and need to be discussed separately.

However, it is notable that in two cases the resolution proposals were put forward by the third largest shareholder (holding less than 5% of company issued shares⁴²⁸) in relation to the appointment of members of the board of directors and supervisory board. In the case of the appointment of members of the supervisory board, the resolution was passed with 100% votes in favour, whereas the other one with a nomination of an independent director failed to pass by cumulative voting at the AGM.⁴²⁹ Such factors can be discussed with a review of the role of the board of directors and supervisory board. In China, under the CCL 1994, the role of a supervisory board is completely different from the German system, in which a supervisory board is not only a supervisory organ, but also a decision-making body of the company with authority over the board of directors.⁴³⁰ In fact, the supervisory board in a Chinese listed company, as only a supervisory body, has nothing to do with the decision making process, since the decision making and business operations are carried out by the board of directors independently. In practice, most members of boards of directors are the representatives of the controlling shareholders or majority

⁴²⁸ See Table 5.9 for the details.

⁴²⁹ The third largest shareholder - China Gaoke group of Gezhouba (600068) plc proposed a shareholder resolution to nominate an independent director under clause 4.1 of the Guidelines (see *op cit.* fn. 28) - "shareholders holding 1% company's shares have the right to nominate independent directors of a company". Four other nominations proposed by the board of directors together were put forward at the AGM (2002/2003). Three of the board's nominations were elected to be independent directors of the company by a cumulative voting process. There was no vote for the third shareholder's nomination.

⁴³⁰ See Xu, Y. 1997. *The Principles of Company Law*, Law Publishing House, Beijing, p.238.

shareholders and minorities normally have no place in the boardroom, but may have a chance in a supervisory board. Thus, the picture that emerges is, typically, the minority shareholder has a very limited control power over management decisions.

5.5 Conclusion

This chapter explores the status and the role of shareholders in general, and the shareholder general meeting in particular, by examining the legal aspects of shareholder rights, including the function of the shareholder general meeting, legal requirements on holding a meeting, and certain procedural rules such as notice, quorum, and voting policies etc. The comparison shows that shareholders' authority in the UK and China is enshrined in law, legislation and stock exchange listing rules, which give shareholders significant powers to participate and engage in the corporate decision making process. However, there are fundamental differences between the systems for the enforcement of shareholder rights at shareholder meetings in China and the UK. The poor and incomplete voting rules undoubtedly create problems for shareholders to exercise their rights properly in China compared with the UK.

CHAPTER 6

THE STRUCTURE AND ROLE OF THE BOARD

6.1 Introduction

The primary function of a corporate governance structure is to mitigate or resolve the agency problems created by the separation of ownership and control and lacking of monitoring.⁴³¹ On a theoretical level, the agency and organisational theories discussed in Chapter 2 highlight the fact that boards of directors have a very important role to play in corporate governance, but there are some questions concerning their effectiveness in practice. By law, boards of directors are a legal requirement for publicly listed companies and, in general, are the ultimate managerial authority of the corporation to control and direct corporate affairs.⁴³² But what role should the boards play in specifying the corporate governance of a publicly listed company? What is the most appropriate structure for a board of directors? How can the board of directors be made accountable? How does the board of directors work in practice? These questions are at the heart of corporate governance and there is no simple, unique answer for each question.

In this chapter, the emphasis is therefore on the sorts of issues in relation to the structure and role of the board of directors, which form an important part of basic company law and corporate governance regulation, and the legal status and realities in

⁴³¹ Oliver Hart, 1995. *op cit.* fn.71.

⁴³² Cheffins states that “the almost universal practice is for a company’s articles of association to endow the

which corporate boards of directors operate in China compared with UK publicly listed companies. This chapter first draws on the legal status of the boards to identify the role of the boards of directors and to explore the systematic defect of the two-tier board system and recent corporate governance developments in China - in particular, the adoption of the independent director system which is influenced by Anglo-American corporate governance practice. This is followed by an empirical analysis of our samples of companies chosen from both China and the UK to demonstrate the reality of board practice.⁴³³ This section provides an overview of research evidence pertaining to a series of factors that impact on the structure, composition, leadership of the boards and board activities. The survey results illustrate to what extent the sample companies have conformed to the corporate regulations and corporate governance code. The results explore the distinctive characteristics of the boards of Chinese listed companies and pave the way for a further empirical study that expands and refines our understanding of the impact of the boards of directors on corporate performance.

6.2 The Legal Status and Best Practices of the Board

To understand the importance of the role of the directors in the governance of companies, it is helpful to take a broader view of corporate governance to examine the board system by employing a functional comparative analysis. It is not appropriate in this study to attempt to survey the scope of such rules and regulations around the

directors with the power to manage the company.” See B. R. Cheffins, *op cit.* fn.277, p603.

world. However, a number of general points concerning a properly functioning system of corporate governance characterised by the role of the boards, the role of the non-executive/independent directors, the role of the chairman, the role of the board committees, and the frequency of board meetings, can be made by comparing China and the UK.

6.2.1 The Roles of Boards of Directors

There are many ways in which the fundamental role of the board of directors has been described in the literature. For example, research on the role of boards and the extent to which boards undertake each role were classified into two categories by Tricker – “the performance roles, in which the board is functioning on strategic and policy issues for the future, setting the corporate direction and contributing to the performance of the business; and the conformance roles, in which the board is ensuring that the company is conforming to policies, procedures and plans laid down by the board and being accountable for its activities.”⁴³⁴ Perrow argues that the board’s position at the apex of the company, monitoring and counselling management and bearing a fiduciary relationship to the shareholders of the company, ensures that directors have constituencies both internal and external to the organisation and face contingencies from both domains.⁴³⁵ Stiles and Taylor note that the board’s role in large organisations is not to formulate strategy, but rather to set the context of

⁴³³ Data sources and sample sizes are described in section 3.6, Chapter 3.

⁴³⁴ Tricker, R. I., 1994. *International Corporate Governance: Text Readings and Cases*, Prentice Hall, Sydney, p98

⁴³⁵ Perrow, C, 1986. *Complex Organizations: A Critical Essay*, New York: McGraw-Hill.

strategy.⁴³⁶ Lorsch and MacIver argue that the very essence of a process of governance is that the board must have the power to make decisions and to enforce their execution.⁴³⁷ By observing the ‘recurrent corporate crisis’, Millstein and MacAvoy suggest that the board’s role should expand beyond monitoring managers to more substantive areas, including strategic planning and providing incentives for managers that are linked to corporate performance.⁴³⁸ There are many other studies on the subject, however, and almost all of them include among the essential functions of a board the determination of strategic and tactical directions, assessing the corporation’s environment, organisation, personnel and political affairs, ensuring accountability and establishing and monitoring policies and practices introduced to ensure compliance with obligations.

In the UK, the publicly listed companies employ the unitary system. However, UK legislation does not ascribe functions to company boards and is virtually silent about their structure and operations.⁴³⁹ Given consideration of the role of the boards, it is perhaps curious that the UK Companies Act puts very little restriction on the form of the board structure or the proper role of boards or their individual members. The answer was found in the Modern Company Law: Final Report which states that: “British law gives greater flexibility to the founders and controllers of companies to

⁴³⁶ Stiles, P. and B. Taylor, 2001. *Boards at Work: How Directors View Their Roles and Responsibilities*, Oxford University Press, p31.

⁴³⁷ Lorsch, J. W. and E. MacIver, *op cit.* fn.94, p13.

⁴³⁸ see MacAvoy, P. W. and I. M. Millstein, 2003. *The Recurrent Crisis in Corporate Governance*, Palgrave Macmillan, p27.

⁴³⁹ See Cheffins, B. R. *op cit.* fn.258, p604.

design and structure their business to suit their needs than any other legal system of which we are aware.”⁴⁴⁰

In the same way, the functions of directors were not strictly described in the Bill, and that is evident in the Explanatory Notes of the Bill (the Notes, hereafter) as introduced in the House of Lords on 1st November 2005. Clause 280 of the Notes stating that:

“[T]his Part (Part 10) of the Bill does not generally directly give powers to the directors, but, under the draft model articles of association for private companies limited by shares, directors’ functions are: to manage the company’s business; and to exercise all the powers of the company for any purpose connected with managing the company’s business.”⁴⁴¹

Clearly, the flexibility provided by the UK legislators suggests that it may be more efficient to allow companies to tailor board structure and functions to the needs of a particular company. However, there has been much consideration of, and comments on, such a relaxed approach over the years. It has become evident that financial scandals in various nations during the last two decades have re-ignited many business practitioners, politicians, academics and public concerns - that continue to the present - on the phenomenon and the most appropriate mechanisms for the developments of the modern corporate governance system. In the UK, a number of committees (e.g. Cadbury Report 1992, Greenbury Report 1995, Hampel Report 1998, Turnbull Report

⁴⁴⁰ See the CLR, Final Report, *op cit.* fn.269, para.1.26.

⁴⁴¹ See the Notes, *op cit.* fn 389.

1999, Higgs Report 2003, Smith Report 2003) were set up to investigate the governance structure of UK publicly listed companies. For example, in response to serious failure of financial monitoring by UK boards,⁴⁴² the Cadbury Report claims that the board's role is an important one in corporate governance, and states that:

“Boards of Directors are responsible for governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.”⁴⁴³

The statement quoted above clearly sets out the range of board functions – formulating strategy, setting the corporate direction, supervising executive management and providing accountability to the shareholder meeting. In July 1998, the Cadbury and Greenbury Reports were amalgamated by Hampel to form one corporate governance code called “Principles of Good Corporate Governance and Code of Best Practice” (the Combined Code 1998, hereafter). The Combined Code 1998 aims to promote good corporate governance by setting out checks and balances on the power of executive directors and by establishing the minimum requirements in

⁴⁴² There were a number of corporate collapses such as the Bank of Credit and Commercial International (BCCI), Polly Peck, and the Maxwell Communication Group etc. in 1990s

⁴⁴³ see Cadbury Report, *op cit.* fn.34, para.2.5

relation to the composition and committees of the board, the determination of directors' pay and internal audit mechanisms. The Combined Code 1998 was revised in the light of the Higgs Review of the Role and Effectiveness of Non-Executive Directors (the Higgs Report, hereafter) and the Smith Review of Audit Committees in 2003. A.1 of the Combined Code 2003 which provides further guidance on the role of the board, states as follows:

“[E]very company should be headed by an effective board, which is collectively responsible for the success of the company. The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met. All directors must take decisions objectively in the interests of the company...”⁴⁴⁴

As we can see, the roles of the boards have been widened and strengthened by the new definition in the Combined Code 2003. Although compliance is not mandatory, companies incorporated in the UK with primary London listings are required to state whether they have complied throughout the accounting period with the relevant parts

⁴⁴⁴ A 1. of the Combined Code (2003)

of the Combined Code.⁴⁴⁵ The Listing Rules require a company that has not complied with the Combined Code provisions, or complied with only some of the Combined Code provisions, to specify the Combined Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.⁴⁴⁶ As a result, with a view to compliance with best practice, the board of directors has a much broader role to play to maintain a sound system of internal control and to safeguard shareholders' investment and the company's assets.

In China, publicly listed companies operate a two-tier board system which is different from the unitary system applied in the UK. The two-tier board in China consists of a directorate and a supervisory board, an arrangement transplanted from the German corporate system. The composition of the supervisory board is quite similar to the German system. Art.124 of the Chinese Company Law (the CCL 1994, hereafter) stipulates that the supervisory board shall include at least three members and comprise the shareholders' representative(s) and representative(s) of the employees of the company in an appropriate ratio which is prescribed by the articles of association.⁴⁴⁷ However, the supervisory board in China functions quite differently from the German supervisory board.⁴⁴⁸ Art.126 of the CCL 1994 provides that the functions of the

⁴⁴⁵ Under Listing Rule 16.2, a listed company must ensure that its directors accept full responsibility, collectively and individually, for the Company's compliance with the listing rules.

⁴⁴⁶ This is the so-called 'comply and explain' approach which has played a crucial role in promoting effective corporate governance practice in the UK. See Listing Rule 12.43.

⁴⁴⁷ See Art 124 of the CCL1994.

⁴⁴⁸ In Germany the supervisory board (*Aufsichtsrat*) has the primary power lying in the ability to hire and, if necessary, fire the chief executive and other executives in the management board (*Vorstand*). See §§76, 111 of the German Stock Corporate Act 1965. Also Hopt K. J. 1997. The German Two-tier Board (*Aufsichtsrat*) A German View on Corporate Governance, in Hopt K J and Wymeersch E (ed.), *Comparative Corporate Governance, Essays*

supervisory board include examining the financial records; supervising directors and managers and requesting directors and managers to make correction to their behaviour if it damages the interests of the company; convening shareholder meetings; attending the meeting of the board of directors without voting power; and other functions provided by the articles of association. The CCL 1994 does not stipulate that the board of directors and management have to report regularly to the supervisory board. Thus, it can be seen that the law provides the supervisory board with neither any power in corporate decision-making nor the authority to appoint or dismiss the members of the board of directors. In practice, the monitoring role of the supervisory board is more 'decorative' than functional.⁴⁴⁹ (see Figure 6.1).

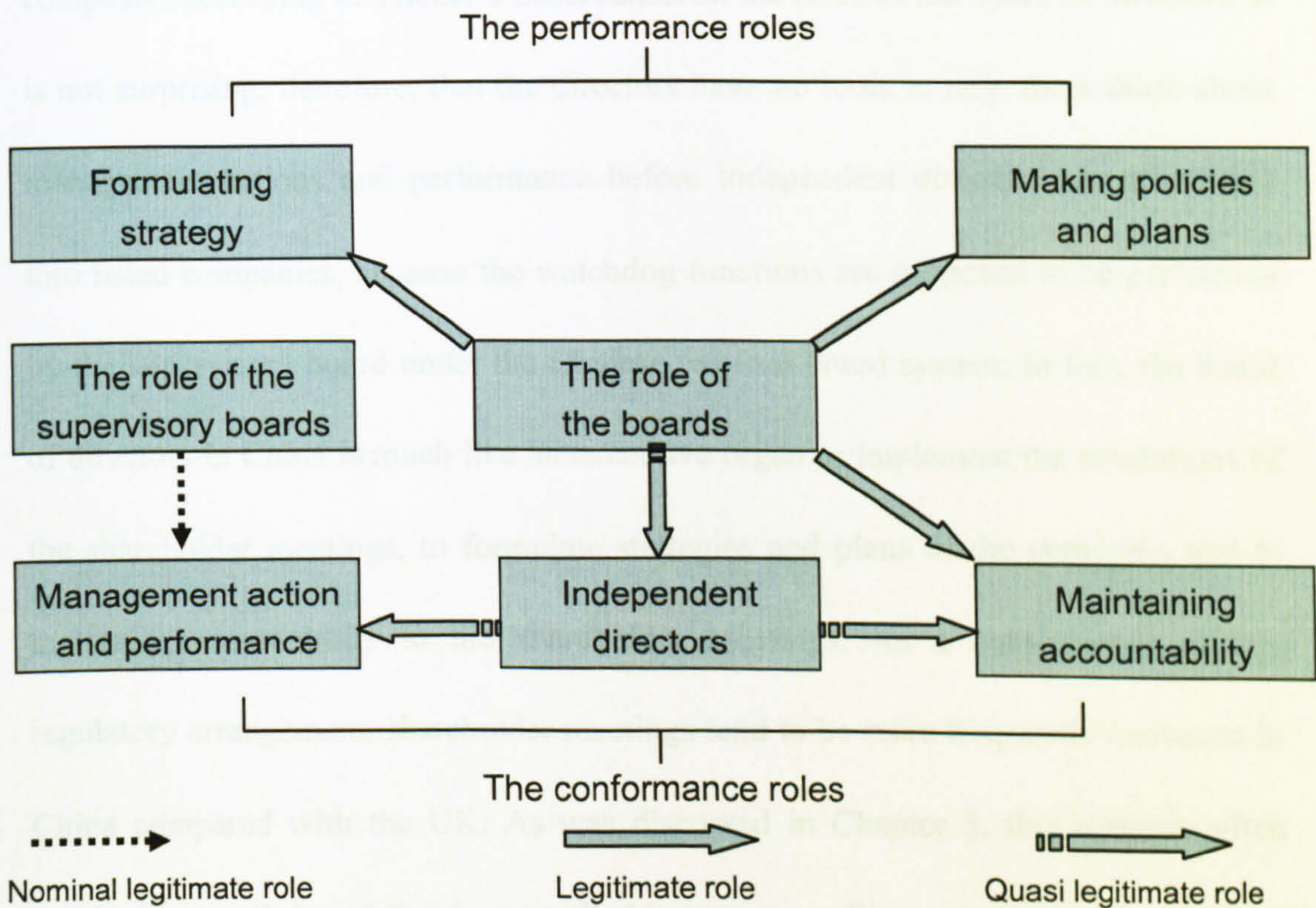
Unlike the UK, Art. 112 of the CCL 1994 expressly defines the roles of the board of directors. These roles include: (1) convening the shareholder meeting and reporting on the board's performance to the shareholder meeting; (2) implementing resolutions approved at the shareholder meeting; (3) determining the business operation and investment plans of company; (4) formulating the fiscal financial budgets and the final accounts of the corporation; (5) formulating plans for profit distributing and loss recovery; (6) formulating plans for increasing or reducing the registered capital of the company and plans for the issue of company bond; (7) formulating proposals

and Materials, Walter de Gruyter, New York.

⁴⁴⁹ World Bank and the International Finance Corporation (hereafter World Bank and IFC Report) identified that supervisory boards rarely contest decisions made by the board of directors and company executives because of the fact that supervisory board are formed of supervisors with less experienced than directors and managers means that they may be unable to supervise directors and managers effectively. See Tenev, S. and C. Zhang, *op cit.* fn.207, p100. Dahya et al find that most supervisory boards in Chinese listed companies tend to consist of an honoured guest or a friendly advisor or a censored watchdog rather than independent watchdog. See J. Dahya, Y. Karbhari, J. Xiao and M. Yang, 2003. The Usefulness of the Supervisory Board Report in China, *Corporate Governance: An International Review*, Vol.11, pp 308-321.

regarding merger, separation or liquidation of the company; (8) determining the internal management structure of the company, and (9) appointing or removing the general manager, approving nominations of vice general managers and chief financial officer by the general manager) and setting their compensations.⁴⁵⁰

Figure 6.1 The Roles of the Boards of Directors in China



Note: The diagram is designed based on the CCL 1994. Under the CCL 1994, the legal status and attributes of the board of directors characterised as “lack of supervisory functions” on management action and performance. The independent director system is established according to the Guidelines and the CCGC, which has quasi-legislative effect to listed companies in China. Therefore, the monitoring role played by the board of directors through independent directors is capped as quasi-regulatory role in this diagram. The supervisory function is played by the supervisory board under the company law, but it seems to be more nominal than real.

⁴⁵⁰ Article 112 of the CCL 1994

From the directors' perspective, obviously, the CCL 1994 empowers the board with authority to run the corporation, but problems arise as such a regulatory arrangement has produced limited and insufficient powers to enable the board of directors to supervise and monitor the executives and the management of the companies. Figure 6.1 shows the performance and conformance roles of the board of Chinese listed companies according to Tricker's observation on the roles of the board of directors. It is not surprising, therefore, that the directors have no tools to help them think about management actions and performance before independent directors are introduced into listed companies, because the watchdog functions are supposed to be performed by the supervisory board under the Chinese two-tier board system. In fact, the board of directors in China is much like an executive organ to implement the resolutions of the shareholder meetings, to formulate strategies and plans of the company, and to maintain accountability to the shareholder meetings. As a consequence of this regulatory arrangement, shareholder meetings tend to be more frequently convened in China compared with the UK. As was discussed in Chapter 5, this scenario often results in a weak board that is controlled by the controlling or majority shareholders of the company. In addition, it seems that the board of directors has no authority to supervise and monitor the performance of individual directors, the CEO, and other executives, although it has the power to decide on the establishment of the internal management structures of the company and the appointment of the managers of the company.⁴⁵¹

⁴⁵¹ *ibid.*

Following a series of high-profile corporate scandals in listed companies in China since the late 1990s,⁴⁵² the board of directors has been at the centre of the corporate governance debate. It is generally accepted that an effective corporate governance system is very much reliant on the ability of the board of directors to monitor and assess the performance of the executive team and their own performance, as well as financial accounting practices. As a result, the independent director was introduced into China's corporate governance system. In August 2001, the CSRC, authorised by the State Council, promulgated the "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies" (the Guidelines, hereafter).⁴⁵³ Four months later, the CSRC and the State Economic and Trade Commission jointly issued the "Code of Corporate Governance for Listed Companies in China" (the CCGC, hereafter).⁴⁵⁴ The primary intent of these two documents is to encourage listed companies to establish and develop a modern enterprise system, regulate the business operations of listed companies, and promote the healthy development of the securities market in China. However, it is evident that both the Guidelines and the CCGC have failed to clearly specify the role of the boards of directors, except requiring the board to maintain accountability to the shareholder meeting. Nevertheless, the two quasi-legislative documents made it clear that the independent directors should be well placed in the boardroom to monitor executive performance and control the conflicts of interest between the controlling shareholders and minority shareholders (see Figure

⁴⁵² From 1998 to 2003, as many as 14 companies were involved in fabricating transactions or accounting records or misusing corporate funds. These companies are ST Shandong Bohai, ST Tongda, ST Dongfang Dianzi, Daqing Lianyi, ST Jiaobao Shiye, ST Yinguangxia; Sanjiu Yaoye; ST Hongugang; ST Jiuzhou; Jinzhouguang; ST Shengfangke; Hubei Tianyi; PT Zhengbaiwen; Shexinkai.

⁴⁵³ See the Guideline. *op cit* fn.28.

⁴⁵⁴ See the CCGC. *op cit*. fn.28.

6.1).⁴⁵⁵ However, Chinese policymakers have no intention of using the independent director system to substitute for the supervisory board's functions. Instead, the CCGC even provides overly strong obligations to enable the supervisory board to engage in the supervisory functions.⁴⁵⁶ Of course, these obligations and related enforcing measures have strengthened the supervisory system to cope with perceived concerns over certain serious obstacles, such as information asymmetries. It is unrealistic, however, to expect the supervisory board to be able to perform a rigorous supervisory role effectively because the obligations and responsibilities addressed in the CCGC are unlikely to be enforced without granting more legislated powers to allow the supervisory boards to challenge executives in the corporate decision making process.

6.2.2 The Roles of the Non-Executive/Independent Directors

According to agency theory, the presence of independent/non-executive directors on the board will mitigate the agency costs through their mutual monitoring function. However, it needs to be borne in mind that to ensure that the role of non-executive or independent directors is effective in a company, the powers and responsibilities for

⁴⁵⁵ The details about the role of the independent directors will be discussed in the following subsection.

⁴⁵⁶ The CCGC provides five provisions in relation to the role of the supervisory board. They are: cl.59: The supervisory board of a listed company shall be accountable to all shareholders. The supervisory board shall supervise the corporate finance, the legitimacy of directors, managers and other senior management personnel's performance of duties, and shall protect the company's and the shareholders' legal rights and interests. cl. 60: Supervisors shall have the right to learn about the operating status of the listed company and shall have the corresponding obligation of confidentiality. The supervisory board may independently hire intermediary institutions to provide professional opinions. cl.61: A listed company shall adopt measures to ensure supervisors' right to learn about company's matters and shall provide necessary assistance to supervisors for their normal performance of duties. No one shall interfere with or obstruct supervisors' work. A supervisor's reasonable expenses necessary to perform their duties shall be borne by the listed company. cl.62: The record of the supervisory committee's supervision as well as the results of financial or other specific investigations shall be used as an important basis for performance assessment of directors, managers and other senior management personnel. cl.65: The supervisory board may report directly to securities regulatory authorities and other related authorities as well as reporting to the board of directors and the shareholders' meetings when the supervisory board learns of any violation of laws, regulations or the company's articles of association by directors, managers or other senior management personnel.

monitoring should be specified either by law or by self-regulations or both. Sheikh argues that the roles and responsibilities of executive and non-executive directors need to be clearly established in order that a board effectively leads and controls the business and provides direction in terms of strategy and policy.⁴⁵⁷ Generally speaking, the executive directors will have a much greater awareness of the day-to-day operations of the business, whereas the non-executive directors are not involved directly in the daily running of the corporation, but rather bring a broader perspective to the company's activities. In the UK, however, with regard to the role of non-executive directors, the Cadbury Report clearly suggests that "[N]on-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standard of conduct."⁴⁵⁸

The Hampel Report (1998) also found general acceptance that non-executive directors should have both a strategic and a monitoring function.⁴⁵⁹ Focusing on the effectiveness of the role of non-executive directors, however, the Higgs Report argues that the Combined Code 1998 offers little guidance on the role of the non-executive director and the lack of clarity about the role has affected the performance of non-executive directors in corporate governance.⁴⁶⁰ The Higgs Report suggests that the

⁴⁵⁷ Sheikh, S. 2002. Non-Executive Directors: Self-Regulation or Codification, *Company Lawyer*, 23 (10), 296-307.

⁴⁵⁸ See s.4.30 of the Cadbury Report, *op cit* fn.34.

⁴⁵⁹ See s. 3.8 of the Hampel Report

⁴⁶⁰ See Higgs, D. 2003. Review of the Effectiveness of Non-Executive Directors, London, Department of Trade and Industry. s.6.4. Available from: <http://www.ecgi.org/codes/documents/higgsreport.pdf> [Accessed 12 March 2006].

Combined Code should clarify the core elements of the role of non-executives and have made following recommendations:

“[N]on-executive directors must constantly seek to establish and maintain their own confidence in the conduct of the company, in the performance of the management team, the development of strategy, the adequacy of financial controls and risk management, the appropriateness of remuneration and the appointment and replacement of key personnel and plans for management development and succession. The role of the non-executive director is therefore both to support executives in their leadership of the business and to monitor and supervise their conduct.”⁴⁶¹

This recommendation has been embodied into the Combined Code 2003 as a supporting principle to the board of directors. Accordingly, the non-executive directors now have to not only play a monitoring or supervision role to control conflicts of interest, but also provide a broader view and bring a fresh perspective to bear on the deliberations concerning strategic and operational matters (i.e. strategy, performance and risk management, together with remuneration, appointment, and succession planning for the board itself and for senior management).⁴⁶² The imposition of these functions to non-executive directors which is consistent with the theory of managerial hegemony and resource dependency theory, can be expected to improve the effectiveness of the board of directors.

⁴⁶¹ *ibid.*

⁴⁶² See A.1 of the Combined Code 2003.

The issue of “independence” is at the heart of any debate on the role of non-executive directors, given the painful memories of past and recent corporate scandals. To ensure that non-executive directors fulfil their roles, they should be capable of providing an independent and impartial view of the board’s considerations and challenging or questioning the executive decisions. The weight of current opinion is that it is desirable to have a majority of independent non-executive directors on a listed company. The Higgs Report points out that the Combined Code 1998 requires the majority of non-executive directors to be independent of management and leave the board to determine whether a non-executive director is independent. However, there is little guidance to companies as to what the independence should entail.⁴⁶³ The Higgs Report argues that without requiring a greater degree of independence on the board, it is insufficient to give full assurance that the potential conflicts will not have an adverse effect on board decision-making.⁴⁶⁴ The Higgs Report provides a “check-list” as to the circumstances which need to be considered in determining independence⁴⁶⁵ and recommends that the Combined Code should provide that at least half of the members of the board, excluding the chairman, should be independent non-executive directors.⁴⁶⁶ Most importantly, the Higgs Report points out that the

⁴⁶³ See the Higgs Report, *op cit.* fn.460, ss.9.7 and 9.8.

⁴⁶⁴ *ibid*, ss.9.2 & 9.3.

⁴⁶⁵ A non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director’s judgement. Such relationships or circumstances would include where the director: (1) is a former employee of the company or group until five years after employment (or any other material connection) has ended; (2) has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company; (3) has received or receives additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme; (4) has close family ties with any of the company’s advisers, directors or senior employees; (5) holds cross directorships or has significant links with other directors through involvement in other companies or bodies; (6) represents a significant shareholder; or (7) has served on the board for more than ten years. See, *ibid.* p37.

⁴⁶⁶ *Ibid*, s. 9.5

independence should be defined, but not necessarily have to be in statute. However, it will be desirable if a definition lies in the Combined Code that addresses not just relationships or circumstances that would affect the director's objectively but also those that could appear to do.⁴⁶⁷ The "check-list" and the level of independence identified by the Higgs Report have been incorporated into the Combined Code 2003.⁴⁶⁸ Although it is impractical to comprehensively list all possible criteria in defining what independence really means, the "check-list" approach provides a snapshot of developing best practice and a wide range of initiatives aimed at increasing the accountability of the boards of UK listed companies.

In China, the non-executive director is virtually non-existent in corporate legislation. However, the Guidelines clearly provide a definition of independent directors. Section I (1) of the Guidelines stipulates that an independent director cannot hold any other post than the position of director, and maintain no affiliations with the listed company and its major shareholders that might prevent him or her from making objective judgements independently.⁴⁶⁹ According to the Guidelines, the independent director should express an independent opinion on the major events occurring in the listed companies and have some special power other than those stipulated in Company Law and other relevant laws and regulations. For example, they have power to approve all major related-party transactions, power to call extraordinary shareholder meetings and board meetings, and power to appoint outside auditors or consulting organizations

⁴⁶⁷ *ibid.* s.9.11.

⁴⁶⁸ See A.3.2 of the Combined Code 2003.

independently.⁴⁷⁰ In addition, the Guidelines stipulate that the independent directors shall earnestly perform their duties in accordance with laws, regulations and the company's articles of association, shall protect the overall interests of the company, and shall be especially concerned with protecting the interests of minority shareholders from being infringed.⁴⁷¹

Compared with the UK system, notably, the role played by the independent directors in China seems limited to monitoring the performance of management and controlling shareholder-related transactions, with particular emphasis on minority shareholder protection. It is unclear whether the independent directors should have any responsibility for reviewing and initiating strategic analysis, formulating strategy and setting corporate direction. Clearly, from the recent development of the UK non-executive system, the notion that independent directors only play the conformance function is no longer fashionable. The role of independent directors should include those of both monitoring the behaviour of management and more actively contributing to strategic policy-making. In addition, as the Guidelines are largely formed by using imprecise wording to describe actions and circumstances,⁴⁷² there are no clearly defined criteria for the role of the independent directors. Lu argues that due to the lack of unified requirements and related standards, the operation of independent directors in companies was like “eight immortals crossing the sea – each showing his

⁴⁶⁹ See s.I(1) of the Guidelines, *op cit.* fn.28.

⁴⁷⁰ *Ibid.* s. V & VI.

⁴⁷¹ *Ibid.* s.I(2).

⁴⁷² *Ibid.* s.II.

or her own prowess”.⁴⁷³ As a result, the independent monitoring functions reflect differences in individual interpretations of the remit of involvement, as well as different degrees of involvement.

6.2.3 *The Role of the Chairman*

The role of the chairman is another very important issue relating to the need to direct and control the board. In most countries the appointment and the role of the chairman is not mandated by statute, but is left to the company articles or rules. In some cases the chairman literally does no more than chair board meetings, in other cases the chairman may exercise considerable influence and power.⁴⁷⁴ In the UK, Table A provides for the appointment of a chairman of the board to preside over the meeting of the board, and on questions to be decided at the meeting allows the chairman to have a second or casting vote in case of an equality of votes.⁴⁷⁵ In Table A, specimen articles of association, the chairman is referred to solely in the context of the conduct of meetings of the board and shareholders. The framework under company law therefore empowers the chairman with the “public face” of the company and the ultimate arbiter (by virtue of his or her casting vote) in the case of a dispute at the meeting.⁴⁷⁶ Common law also identifies the chairman’s function in relation to the

⁴⁷³ Lu, T., 2001. *Corporate Governance in China*, Institute of World Economics and Politics, Chinese Academy of Social Science. Available from: <http://www.iwep.org.cn/cccg/pdf/Corporate%20Governance%20in%20China%20%20Prof.pdf>. [Accessed 12 March 2006]

⁴⁷⁴ See the Higgs Report, *op cit.* fn.460, p23.

⁴⁷⁵ Table A, arts. 88 and 91.

⁴⁷⁶ Graham, L., 2002, Comments on the Higgs Review of Non-Executive Directors by Victoria Younghusband. Available from: http://www.dti.gov.uk/cld/non_exec_review/pdfs/victoriayounghusband.pdf [Accessed 12 March 2006]

conduct of the meeting to see whether it is conducted properly and in accordance with the common law of meetings, the articles and the companies legislation.⁴⁷⁷

The Cadbury Report points out that the chairman's role is crucial in securing good corporate governance. In particular, the Cadbury Report states that

“[C]hairmen are primarily responsible for the working of the board, for its balance of membership subject to board and shareholders' approval, for ensuring that all directors, executive and non-executive alike, are enabled and encouraged to play their full part in its activities.”⁴⁷⁸

Further, the Cadbury Report emphasizes that it is the chairman's responsibility to “ensure that the non-executive directors receive timely, relevant information tailored to their needs, and to ensure that both non-executive directors and executive directors make an effective contribution and accept their full share of responsibilities of governance”.⁴⁷⁹ The Higgs Report also confirms that the chairman plays an important role in creating the conditions for overall board and individual non-executive director effectiveness.⁴⁸⁰ Compared with the Cadbury report, the Higgs Report points out that, as the leader of the board, the chairman also has the responsibility of leading the board in setting the values and standard of the company, of ensuring executive and non-executive directors working as a team, and of ensuring effective communication

⁴⁷⁷ see *John v. Rees* [1970] Ch 345, at p382 and *Byng v. London Life Association Limited*, [1990] Ch. 170

⁴⁷⁸ See Cadbury Report, *op cit.* fn.34, para.4.7.

⁴⁷⁹ *ibid.* para. 4.8.

⁴⁸⁰ See the Higgs Report, *op cit.*fn.460, p23.

with shareholders.⁴⁸¹ Higgs' recommendations on the role of the chairman are now supporting principles incorporated into the Combined Code 2003.⁴⁸²

In the UK, one of the basic principles on board leadership structure is the separation of the roles of chairman and chief executive, which was set out in the Cadbury Report in 1992. There are a number of arguments for separating the roles of chairman and chief executive. For example, Cadbury argues that putting the chairman and CEO positions together concentrates a great deal of power in the hands of one person which makes it more difficult for the board to carry out its supervisory function.⁴⁸³ With recognition of a high level of separation of the role of chairman and CEO,⁴⁸⁴ the Higgs Report identifies that the separation of these roles is "one of the strengths of the UK corporate governance regime, which can avoid concentration of authority and power in one individual and differentiate leadership of the board from running of the business".⁴⁸⁵ The Combined Code 2003 further points out that "the role of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board".⁴⁸⁶ Clearly, the benefits of the separation of the roles of chairman and the chief executive envisaged by the work of the Cadbury and Higgs Reports are now widely acknowledged.

⁴⁸¹ *Ibid.*

⁴⁸² see A.2 of the Combined Code 2003

⁴⁸³ Cadbury, Adrian, 2002. *Corporate Governance and Chairmanship: A Personal View*, Oxford University Press, p108.

⁴⁸⁴ According to the Higgs Report, around 90 per cent of listed companies have split these roles. See Higgs Report, *op cit.* fn.460, p23

⁴⁸⁵ *ibid.*

⁴⁸⁶ A.2 of the Combined Code 2003.

It is striking that both the appointment and the role of the chairman is mandated by statute in China. The CCL 1994 provides that “the board of directors shall have a chairman, and may have one or two vice-chairmen. The chairman and vice-chairman shall be elected by the board of directors through affirmative votes by a majority of the directors.”⁴⁸⁷ Under the CCL 1994 the chairman has been legitimately named as the legal representative of the company.⁴⁸⁸ The functions include the conduct of meetings both at board and company level, monitoring the implementation of the board’s resolutions, and signing the share certificates and bond certificates of the company.⁴⁸⁹ In practice, it is common in most companies for the entitlement of the chairman as the legal representative of the company to be misinterpreted as having the ultimate authority over the management of the company. Although the CCL 1994 has clearly set out that the chairman has no any executive function, it is perfectly legal, if the board of directors decide, for the chairman to carry out executive functions.⁴⁹⁰ In addition to the duality of the chairman and the CEO, sometimes the chairman is considered to be more influential than the general manager of the company (*zongjinli*) when the chairman is working full-time in the company.⁴⁹¹ The potential risk of this phenomenon was recognised by the CCL 2006. The provision that the chairman of the board of directors is automatically entitled to be the legal representative of the company has been abolished. Under the CCL 2006, apart from the chairman of the

⁴⁸⁷ See Article 113 of the CCL 1994.

⁴⁸⁸ *Ibid.*

⁴⁸⁹ *ibid.*, art.114.

⁴⁹⁰ Art.120 of the CCL 1994 provides that the board of directors of the company may decide that a board member is to serve concurrently as the general manager. According to art. 119 of the CCL 1994, the executive functions shall be carried out by general manager (*Zongjingli*) of the company who has similar responsibilities to the CEO in the UK or US.

⁴⁹¹ Zhong, Juyin., 2002. Chairman and General Manager (*Zongjingli*) Who is the CEO of the Chinese Companies? *Chinese Securities*, 31 January.

board of director, other persons such as the executive director or the manager can also serve as the legal representative in accordance with the provisions of the company's articles of association.⁴⁹² This reform is an important step toward improving corporate governance.

6.2.4 The Roles of Board Committees

The establishment of board committees comprising entirely or principally independent directors is very important to improve the effectiveness of the board. It is generally accepted that three board committees - the audit committee, the nomination committee and the remuneration committee - could provide an independent check and balance in an area where some board members, particularly executives, may have a conflict of interest. All committees of the boards serve two purposes, as Charkham observed: one is to "facilitate the dispatch of business"; the other is to "involve the non-executive directors by familiarising them in detail with some important aspect of the governance of the company".⁴⁹³ In the UK, the authority to establish committees of the board is entirely at the discretion of the board of directors.⁴⁹⁴ In China, the CCGC provides that the board committees may be established "in accordance with the resolutions of the shareholders' meetings".⁴⁹⁵ However, as in the UK, the CCGC clearly stipulates that all board committees are accountable to the board of directors

⁴⁹² See art.13 of the CCL 2006.

⁴⁹³ Charkham, J., 1994. *Keeping Good Company: A Study of Corporate Governance in Five Countries*, Oxford University Press, p274.

⁴⁹⁴ Smerdon, R., 2004. *A Practical Guide to Corporate Governance*, 2ed. Sweet & Maxwell Ltd. p161; Chambers, Andrew D. 2005. Audit Committee: Practice, Rules and Enforcement in the UK and China. *Corporate Governance: An International Review*, Vo.13 pp92-100, at 99.

⁴⁹⁵ Cl.52 of the CCGC provides that the board of directors of a listed company may establish a corporate strategy committee, an audit committee, a nomination committee, a remuneration and appraisal committee and other special committees in accordance with the resolutions of the shareholders' meetings. See the CCGC, *op cit.* fn.28.

and not directly to shareholder meetings.⁴⁹⁶ In addition, both the UK and China require that all board committees shall be composed solely of directors and that a majority of the members of the committees must be independent.⁴⁹⁷ The roles and duties imposed on the committees are not identical in China and the UK. Therefore, it is appropriate to refer in rather more detail to each of the three committees, given the role which they play in the corporate governance system.

- **Audit Committee**

It is commonly recognised that a close relationship between auditors and the senior executive management is one of the main factors which led to the corporate scandals and failures in recent years.⁴⁹⁸ The existence of a strong, independent audit committee can avoid any possibility of domination by top executive management of the board's links with the auditors. In the UK, the primary role of the audit committee is to ensure the integrity of financial reporting and the audit process by ensuring that the external auditor is independent and objective and does a thorough job, and by fostering a culture and an expectation of effective supervision.⁴⁹⁹ The main responsibilities of the audit committee now set out in the Combined Code 2003, include: (1) monitoring the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them; (2) reviewing the company's internal

⁴⁹⁶ *ibid*, cl.58 of the CCGC.

⁴⁹⁷ *ibid*, cl.52 of the CCGC, and A.4.1, B.2.1 and C 3.1 of the Combined Code 2003.

⁴⁹⁸ See Richard Smerdon *op cit.*494, p161.

⁴⁹⁹ See Smith Report, p22.

financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, reviewing the company's internal control and risk management systems; (3) monitoring and reviewing the effectiveness of the company's internal audit function; (4) making recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor; (5) reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements; (6) developing and implementing policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and reporting to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.⁵⁰⁰

In China, the CCGC stipulates that the main duties of the audit committee would include: recommending the engagement or replacement of the company's external auditing institutions; reviewing the internal audit system and its execution; overseeing the interaction between the company's internal and external auditing institutions; inspecting the company's financial information and its disclosure; and monitoring the

⁵⁰⁰ See C.3.2. the Combined Code 2003.

company's internal control system.⁵⁰¹ Compared with the UK, the CCGC has not given clear guidance on how audit committees should implement their duties, although the contexts of the duties are quite similar.

In China, the main functions of the supervisory board are to check the financial affairs of the company, so it seems that some of the functions performed by audit committees overlap with those of supervisory boards. In fact, as discussed in Section 6.2.1, under the current Chinese legal system, the supervisory board is made up of a combination of shareholder representatives and company employee representatives. Thus, the supervisory board in China has no independent features compared with the audit committee. In addition, the CCGC specifies that there is at least one independent director from the audit committee who shall be an accounting professional. The qualification requirement warranted the audit committee to be more competent than the supervisory board for ensuring that the company's financial statements and reports are accurate and use fair and reasonable estimates.

- **Nomination Committee**

Charkham points out that the nomination committee is designed to do three things: “give the chairman a conscience when he picks buddies”; “offer alternatives”; and “improve the selection process”. In the UK, the Combined Code (2003) provides that the nomination committee should lead the process for board appointments and making

⁵⁰¹ See cl. 54 of the CCGC, *op cit.* fn.28.

recommendations to the board.⁵⁰² The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.⁵⁰³ For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises.⁵⁰⁴

In China, according to the CCGC, the nomination committee is responsible for formulating standards and procedures for the election of directors and making recommendations, extensively seeking qualified candidates for directorships and management; and reviewing candidates for directorships and management and making recommendations.⁵⁰⁵ The World Bank and IFC Report shows that in China, large shareholders nominate new directors in 57 per cent of listed companies, the board of directors does so in 34 per cent of companies, the chair of the board in 6 per cent of companies, and the other 3 per cent is nominated by other existing directors.⁵⁰⁶

The existence of the nomination committee will bring an element of discipline into the nomination process and inevitably have a great influence on the choice of the candidates free from the control by large shareholders. However, patronage of independent directors is not enjoyed by the nomination committee alone in China.

⁵⁰² A.4.1 of the Combined Code 2003.

⁵⁰³ *Ibid.* A 4.1.

⁵⁰⁴ *ibid.* A4.3.

⁵⁰⁵ See cl.55 of the CCGC, *op cit.* fn.28.

⁵⁰⁶ See S. Tenev and C. Zhang, *op cit.* fn.207, p92

The CSRC Guidelines provide that the shareholders holding more than 1 per cent of outstanding shares (either individually or jointly) have the right to nominate independent directors.⁵⁰⁷ Interestingly, the CSRC Guidelines also require that the company should submit the relevant background materials about the nominees of the independent directors to the CSRC and the stock exchange where the company is listed. The CSRC shall examine the qualifications of the nominated independent directors within 15 working days. If a nominee is rejected by the CSRC, he/she can still be a candidate for a directorship but not for an independent one.⁵⁰⁸ Clearly, the establishment of the system of independent directors in China has been promoted by compulsory government force and it is by no means a natural result of market development.⁵⁰⁹

- **Remuneration Committee**

Directors' remuneration is an important aspect of the corporate governance debate which plays a key role in mitigating 'agency problems' between managers and shareholders. In the UK, the Companies Act 1985 imposes various limitations which can prevent a director from arranging to have his/her company pay an excessive amount for his/her service.⁵¹⁰ In 1995, the Greenbury Committee drew up a report on directors' remuneration which identifies good practice.⁵¹¹ The Greenbury Report provisions were then included in the Combined Code which provides that "the

⁵⁰⁷ See s.IV(1) of the Guidelines, *op cit.* fn.28.

⁵⁰⁸ See *ibid.*, s.IV(3)

⁵⁰⁹ See Lu, Tong, *op cit.* fn.:473.

⁵¹⁰ See ss.312-314 and 319 of the CA 1985

⁵¹¹ see Greenbury Report, 1995. Directors' Remuneration, Report of a Study Group Chaired by Sir Richard Greenbury.

(remuneration) packages should be sufficient to attract, retain and motivate executive directors of the quality required, but should avoid paying more than is necessary for this purpose.”⁵¹² In addition, the Combined Code 2003 requires that a proportion of executive remuneration should be structured so as to link rewards to corporate and individual performance.⁵¹³ Accordingly, most executive compensation packages are made up of four basic components: salary and benefits, annual bonuses, share options and long term incentive plans in the UK.⁵¹⁴

However, it was recognised that corporate governance issues relating to directors’ remuneration needed to be addressed in a more rigorous manner. The role of the remuneration committee is to prevent an executive-dominated board from ‘using their left hands to mark their own examination papers and reward themselves the prize by using their right hands’. In the UK, the new Combined Code specifies that the remuneration committee should judge where to position their company relative to other companies.⁵¹⁵ The design of performance related remuneration should strictly follow the Schedule A of the Code.⁵¹⁶ In addition, the remuneration should carefully consider what compensation commitments (including pension contributions and all other elements) their directors’ terms of appointment would entail in the event of early termination.⁵¹⁷ Furthermore, the remuneration committee should consult the

⁵¹² B.1 of the Combined Code 2003.

⁵¹³ *Ibid.*

⁵¹⁴ Martin J. Conyon, Simon I. Peck, Laura E. Read and Graham V. Sadler, 2000. The Structure of Executive Compensation Contracts: UK Evidence. *Long Range Planning* 33, pp478-503. The detailed Rules contained in B.1.1 – B.1.4 of the Combined Code 2003.

⁵¹⁵ B.1 Supporting Principle, the Combined Code 2003

⁵¹⁶ *ibid*, B1.1.

⁵¹⁷ *ibid*. B1.5.

chairman and/or chief executive about their proposals relating to the remuneration of other executives. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.⁵¹⁸ Finally, the remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management.⁵¹⁹ It is clear that the remit of the remuneration committee has been extended to cover all aspects of directors' compensation and the pay-determination process.

In China, there is a mandatory legislative requirement that either the form or amount of directors' and managers' remuneration must be approved by a resolution of the shareholder meeting.⁵²⁰ Board remuneration is not comparable to the practice in the UK because a performance-related pay system has not been established by Chinese listed companies. However, the matters relating to directors' remuneration are considered further by the CCGC which draws up the principles of good practice with respect to remuneration and incentives of directors.⁵²¹ The CCGC provides that:

⁵¹⁸ *ibid.*, B.2 Supporting Principle

⁵¹⁹ *ibid.* B2.2.

⁵²⁰ Art. 103 (2) of the CCL 1994

⁵²¹ See the CCGC. *op cit.* fn.28. Cls. 77-79.

“[T]o attract qualified personnel and to maintain the stability of management, a listed company shall establish rewarding systems that link the compensation for management personnel to the company's performance and to the individual's work performance; the performance assessment for management personnel shall become a basis for determining the compensation and other rewarding arrangements for the person reviewed; and the results of the performance assessment shall be approved by the board of directors, explained at the shareholder meeting and disclosed.”⁵²²

It is clear that the CCGC is attempting to encourage the listed companies to establish a system for rewarding managerial performance that will align the conflicts of interest between shareholders and the management of the company. However, the remit of the remuneration committee has been broadened and renamed as ‘remuneration and appraisal committee’. Accordingly, the main duties of the remuneration and appraisal committee are given by the CCGC and include studying the appraisal standard for directors and management personnel, conducting appraisal and making recommendations, and studying and reviewing the remuneration policies and schemes for directors and senior management personnel.⁵²³ Nevertheless, although a system for rewarding managerial performance has not been generally accepted by the listed companies, their underlying objective can be considered as an attempt to make executive compensation changes reflect corporate performance.

⁵²² *Ibid.*

⁵²³ *Ibid.* cl.56.

6.2.5 Board Meetings

Stiles and Taylor argue that the main area for the board to analyse and make a judgement upon the performance of the chief executive and other executives is at the board meeting.⁵²⁴ Evidence regarding the significance of board meeting frequency carries potentially important governance implications. In the UK, the Companies Act 1985 provides no legislative requirement on how often the board meeting should be held per year. Regulation 88 of Table A lays down fundamental principles which allow the directors to organise their affairs with some flexibility subject to the provisions of the articles.⁵²⁵ However, to ensure that the board conducts their control and monitoring function effectively, the new Combined Code 2003 Provision A.1.1 requires that the board should meet regularly to discharge its duties effectively.⁵²⁶ Unlike the UK, Art.116 of the CCL 1994 stipulates that the board of directors in China shall hold meetings at least twice a year.⁵²⁷ However, the minimum requirement on the board meeting is obviously insufficient to ensure that the board fulfils their duties effectively. Thus, the CCGC points out that the board of directors shall meet periodically, and shall convene interim meetings in a timely manner when necessary.⁵²⁸ Nevertheless, the word “necessary” is not defined to provide clear direction toward the fulfilment of their duties.

⁵²⁴ see Stiles, P. and B. Taylor, *op cit.* fn.436, p73

⁵²⁵ Table A, art.88

⁵²⁶ See A.1.1 of the Combined Code 2003.

⁵²⁷ Art.116 of CCL 1994.

⁵²⁸ Cl.45 of the CCGC. *op cit.* fn.28.

6.3 Boards of Directors: Some Empirical Evidence

6.3.1 Size of the Board

As a basic measure of board structure, the size of the board has been argued to have a material impact on the quality of corporate governance. Zahra and Pearce review the theoretical perspectives on the board of directors and conclude that large boards are often argued to be more capable of monitoring the actions of management, as it is more difficult for CEOs to dominate large boards or to obtain consensus for making decisions that harm shareholders' interests.⁵²⁹ Conversely, some researchers argue that large boards can be dysfunctional through poorer communication, delayed decision-making or more severe bureaucratic problems.⁵³⁰ By taking both sides of the model into consideration, all arguments discussed above seem to indicate that larger boards are beneficial from both the agency and resource dependence perspective, but dysfunctional from the strategic decision-making perspective. However, these studies provide little empirical evidence on what the optimal board size may be from an effective monitoring perspective.⁵³¹

⁵²⁹ Zahra, S. A. and J. A. Pearce II, 1989. Boards of directors and Corporate Financial Performance: A Review and Integrative Model, *Journal of Management*, vol. 15, No.2, 291-334.

⁵³⁰ Yermack, D. 1996. High Valuation of Companies with a Small Boards of Directors, *Journal of Financial Economics*, 40: 185-212; Dehaene, A., De Vuyst, V. and Ooghe, H. 2001. Corporate Performance and Board Structure in Belgian Companies, *Long Range Planning*, 34, 383-389; Eisenberg, T., Sundgren, S. AND Wells, M.T. 1998. Large Board Size and Decreasing Firm Value in Small Firms, *Journal of Financial Economics*, 48, 35-54; John, K and Senbet, L. W. 1998. Corporate Governance and Board Effectiveness, *Journal of Banking & Finance*, 22, 372-403; and Sigh, H., and F. Harianto, 1989. Management-Board Relationships, Takeover Risk, and the Adoption of Golden Parachutes. *Academy of Management Journal* 32, 7-24. Conyon, M. J. and Peck, S. I., 1998. Board Size and Corporate Performance: Evidence from European Countries, *The European Journal of Finance*, 4, 291-304.

⁵³¹ Mak, Y. T. and Roush, M. I. 2000. Factors Affecting the Characteristics of Boards of Directors: An Empirical Study of New Zealand Initial Public Offering Firms, *Journal of Business Research*, 47, 147-159.

Koontz suggests that there is an optimal size which ranges anywhere from five to thirteen members.⁵³² Koontz argues that less than five is insufficient for covering all the legal board responsibilities, but more than thirteen becomes unwieldy with not everyone getting an adequate chance to participate.⁵³³ Lipton and Lorsch note that the norms of behaviour in most boards are dysfunctional, although increased board membership may confer benefits in terms of improved monitoring of the organisation's activities.⁵³⁴ They argue that these benefits may be outweighed by costs such as slower decision making. Lipton and Lorsch recommend a maximum board size of ten and favour eight or nine, as this enables all the directors to get to know each other and to contribute effectively in board discussions with a true consensus emerging.⁵³⁵ Jensen also contends that keeping boards small can help improve their performance. He argues that "when boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control. Since the possibility for animosity and retribution from the CEO is too great, it is almost impossible for those who report directly to the CEO to participate openly and critically in effective evaluation and monitoring of the CEO."⁵³⁶ Indeed, Rebeiz's survey also shows that a small board size of about seven or eight directors is more likely to invite more active involvement from the members, and the directors tend to be more decisive and faster in their decision-making process.⁵³⁷ As the foregoing

⁵³² Koontz, H., 1967, *The Board of Directors and Effective Management*, New York, McGraw-Hill Book Company, p121.

⁵³³ *Ibid.*

⁵³⁴ Lipton, M. and J. W. Lorsch, 1992. A Modest Proposal for Improved Corporate Governance, *The Business Lawyer* 48: 59-77.

⁵³⁵ *Ibid.*

⁵³⁶ Jensen, M. C. 1993. The Modern Industrial Revolution, Exit, and the Failure of Internal Control Mechanisms, *Journal of Finance*, XL VIII, 831-880, at 865.

⁵³⁷ Rebeiz, K. S. 2002. Strategies for Corporate Governance in Engineering Corporations, *IEEE Transactions on*

analysis and recommendations suggest, the choice of the size of the board has a clear implication for the function of the boards.

In the UK, s.282 of the CA 1985 stipulates that “the number of directors of a public company shall not be subject to any maximum but shall not be less than two.”⁵³⁸

Table A also provides that “unless otherwise determined by ordinary resolution, the number of directors...shall not be subject to any maximum but shall not be less than two.”⁵³⁹ Based on our survey of 196 UK listed companies in this study, it is found that the board sizes of the UK sample companies ranged from 4 to 15, with an average of 7.5 directors in the 2002-2003 financial year. In comparison, in China, according to the company law, a board should consist of 5 to 19 directors. In our sample of 267 Chinese listed companies, the study finds that this requirement has been strictly applied by all sample companies. Table 6.1a shows that the board size of Chinese companies ranged from 5 to 19, with an average of 10 directors in the 2002-2003 financial year. Further comparative analysis of board size in the two countries is given in Table 6.1b, which shows that about 81% of Chinese companies have boards of 9 or more directors, whereas about 69% of the UK companies have fewer than 9 directors on the boards. Figure 6.2 shows bar charts of board size and highlights some significant differences in board size between the two countries.

Engineering Management, Vol.49, No.4, pp398-408.

⁵³⁸ See s.282 of the CA 1985.

⁵³⁹ Table A, art.64.

Table 6.1(a) Descriptive Statistics of the Size of Board

Country	N	Minimum	Maximum	Mean	Std. Deviation
China	267	5.00	19.00	10.04	2.38
UK	196	4.00	15.00	7.53	2.16

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

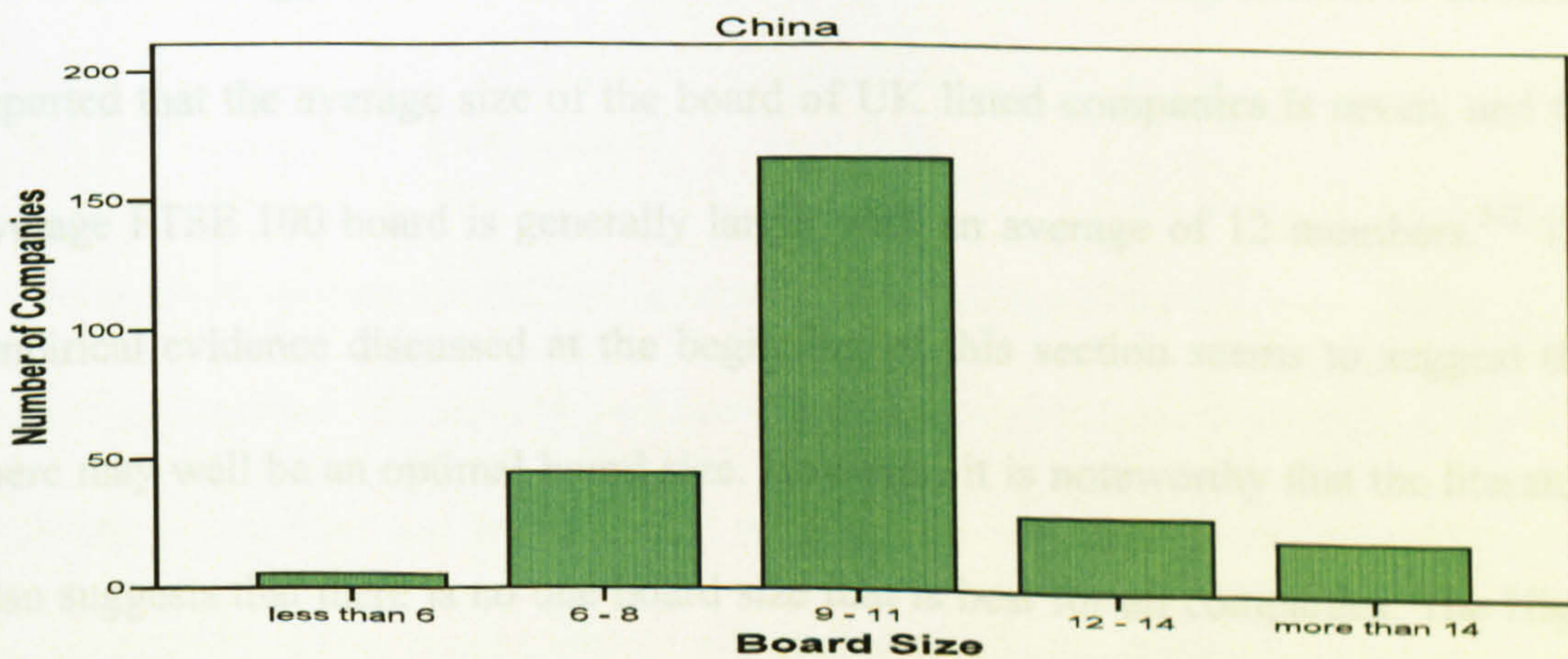
Table 6.1(b) Frequency Distribution of the Size of Board

Size of boards	China		UK	
	Frequency	Percent	Frequency	Percent
Less than 6	5	1.9	73	37.2
6-8 directors	45	16.9	62	31.6
9-11 directors	167	62.5	51	26.0
12-14 directors	29	10.9	9	4.6
More than 14 directors	21	7.9	1	.5
Total	267	100.0	196	100.0

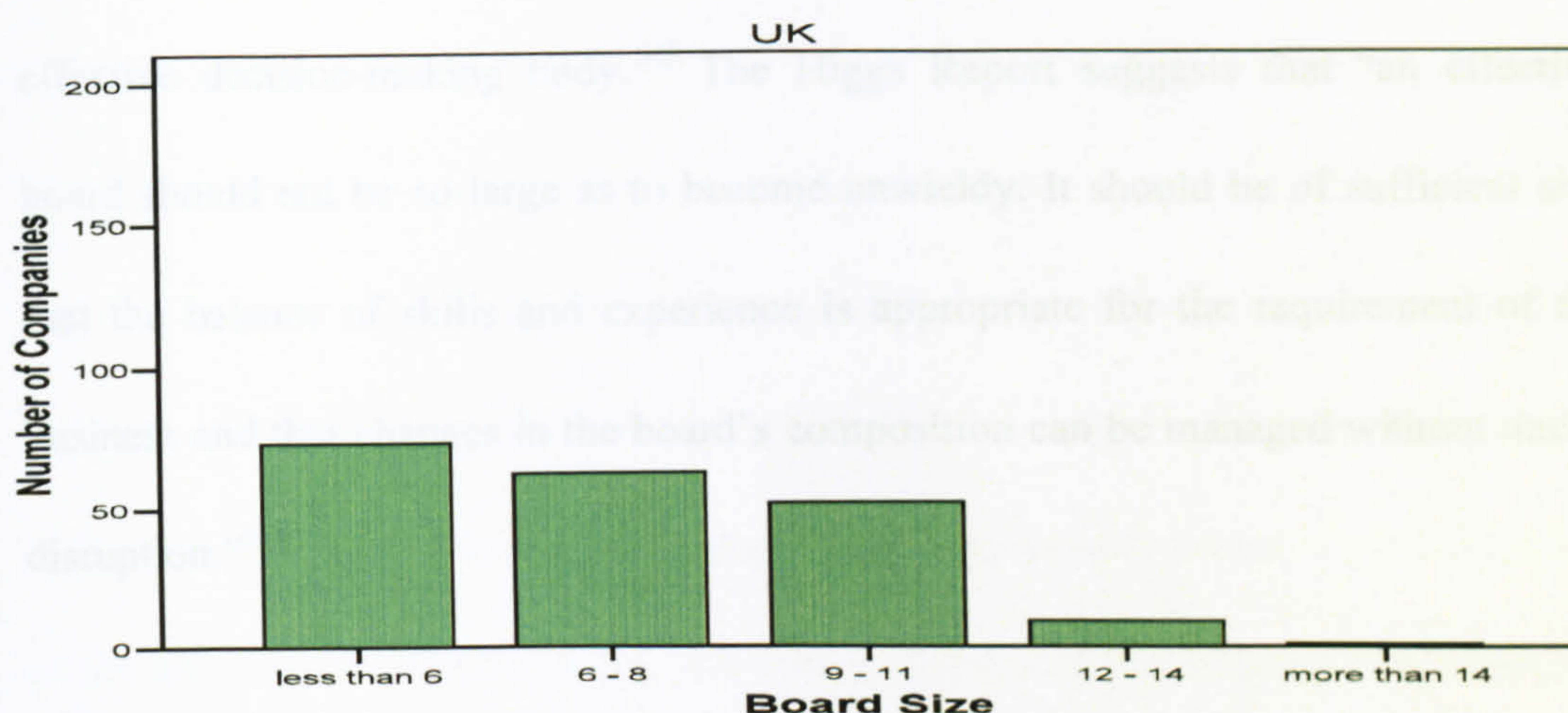
Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Figure 6.2

Frequency Distribution of Board Size



Frequency Distribution of Board Size



Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Board size has been examined by a number of researchers in the past decade in the UK. It is clear that the trend is toward small, but more qualified boards.⁵⁴⁰ For example, Short and Keasey examined a sample of the listed companies in the UK between 1988 and 1992 and reported that the average board size was 7.36.⁵⁴¹ More recently, the Higgs Report on the role and effectiveness of non-executive directors reported that the average size of the board of UK listed companies is seven, and the average FTSE 100 board is generally larger with an average of 12 members.⁵⁴² The empirical evidence discussed at the beginning of this section seems to suggest that there may well be an optimal board size. However, it is noteworthy that the literature also suggests that there is no one board size that is best for all companies. The Higgs

⁵⁴⁰ Cook, L. and K. Leissle, 2002. UK Company Corporate Governance: Comparing the FT-1000 and TechMark-100 Indices, available from: http://www.boardroomanalysis.com/gov/UK%20Company%20Research_FY99-00_March%202002.pdf [Accessed 25 September 2004]

⁵⁴¹ Short, H. and K., Keasey, 1997, Institutional Shareholders and Corporate Governance in the United Kingdom, in: K. Keasy, S. Thompson and M. Wright, eds., *Corporate Governance: Economic and Financial Issues*, Oxford University Press, Oxford, pp18-53.

⁵⁴² See Higgs Report, *op cit.* fn.460, p22.

Report identifies that the size of the board is an important factor to make the board an effective decision-making body.⁵⁴³ The Higgs Report suggests that “an effective board should not be so large as to become unwieldy. It should be of sufficient size that the balance of skills and experience is appropriate for the requirement of the business and that changes in the board’s composition can be managed without undue disruption.”⁵⁴⁴

In China, although the listed companies have been required to introduce independent directors into their boardroom, the size of the board appears to have increased only slightly compared with the figure of 9.9 identified by the World Bank and IFC published report, which was based on a survey 257 companies listed on the Shanghai Stock Exchanges.⁵⁴⁵ However, given that more than 81% of sample companies have 9 or more directors, it is presumed that the majority of companies might have dysfunctional boards in China.

6.3.2 Composition of the Board

Many academic researchers have reviewed board composition by investigating the ratio and number of executive and non-executive/independent directors on a board. From a logistical perspective, the supervision of management is a primary responsibility of the boards. Rebeiz argues that the board should act independently from management in exercising its fundamental duty of loyalty and care. He stresses

⁵⁴³ See Higgs Report, *op cit.* fn.460, s.4.09.

⁵⁴⁴ See s.4.10 of Higgs Report *op cit* fn460.

⁵⁴⁵ See S. Tenev and C. Zhang, *op cit.* fn.207.

that the standard of care should apply to the protection and creation of the firm's economic value, whereas the standard of loyalty should be directed first and foremost to the shareholders because of the board's fiduciary responsibility to the shareholders, and it is essential for the board to have an effective process for optimum corporate governance performance.⁵⁴⁶ Based on agency theory, Fama and Jensen argue that in order to ensure that the board acts independently from management, a preponderance of outside directors must be in place to ensure that management actions are consistent with shareholder value maximisation.⁵⁴⁷ According to the resource dependence theory, Rebeiz points out that outside directors do enjoy some advantages, such as being a critical link to the external environment by providing access to valued resources and information in their own respective companies for which they work full time or by providing advice and insight into the workings of government.⁵⁴⁸

A variety of empirical studies explore the relationship between board composition and the board's monitoring function. For example, Fama and Jensen argue that independent directors are likely to be better monitors because their interests are less likely to be aligned with those of management and they have the incentive to 'develop a reputation as experts in decision control'.⁵⁴⁹ Weisbach finds that firms with outsider-dominated boards are more likely to remove a CEO when a firm is performing poorly than firms with insider-dominated boards.⁵⁵⁰ Mehran argues that

⁵⁴⁶ *Ibid.*

⁵⁴⁷ Fama, E. F. and Jensen, M. C. 1983, Agency Problem and Residual Claims, *Journal of Law and Economics*, vol. XXVI, pp327-349.

⁵⁴⁸ See Rebeiz, K.S. *op cit* fn.537.

⁵⁴⁹ See Fama and Jensen, *op cit.* fn 547. p315.

⁵⁵⁰ Weisbach found that a board composed of at least 60% of outside directors was more likely than a board

non-executive directors are effective monitors when dealing with executive compensation by attempting to reduce agency costs and tie compensation more closely to firm performance. However, there are a number of recent studies which argue that independent directors will not monitor management without a significant stake in the firm.⁵⁵¹ They insist that managerial shareholding is the key determinant of board's monitoring behaviour.⁵⁵² In addition, there are impediments to effective monitoring by non-executive directors. Baysinger and Hoskisson find that non-executive directors are external and part-time, and do not possess all the information that executive directors have, and the information asymmetry problem is likely to cause some difficulties for effective monitoring.⁵⁵³ Nevertheless, much of the literature has established a clear picture of how the board should be structured and what the contribution of non-executive/independent directors should be. As a result, the importance of board composition is prominently recognised in many countries' corporate governance development agendas. Therefore, how the independent board system is implemented in different jurisdictions merits further research.

The Higgs Report states that by July 2002, there were 5,172 executive, 4,610 non-executive and 1,689 chairman posts held by directors in UK listed companies. On average, non-executive directors comprise around half of FTSE 100 boards. In smaller companies the non-executive directors comprise on average just over a third

comprising less than 60% of outside directors to dismiss an underperforming CEO. See Weisbach, M. S. 1988 Outside Directors and CEO Turnover, 20 *Journal of Financial Economics*, 431, 433.

⁵⁵¹ See, Shleifer, Vishny, 1997, *op cit.* fn.38.

⁵⁵² *ibid.*

⁵⁵³ Baysinger, B. D. and R.E. Hoskisson, 1990. The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy, *Academy of Management Review*. 15, 72-87.

of the boards.⁵⁵⁴ Among the 196 UK companies in this study the findings show that the overwhelming majority of boards of UK companies exceed the Combined Code requirement for one third of the board to be non-executives. The average percentage of non-executive directors is more than half (54%) and about 97% of boards have non-executive directors that comprise more than one-third of the board. About 14% of boards have non-executive directors that comprise more than two-thirds of the board (see Table 6.2a and 6.2b).

In China, the Guidelines required that by June 30th, 2002, at least two members of the board of directors should be independent directors; and by June 30th, 2003, at least one-third of the board should be independent directors.⁵⁵⁵ According to the CSRC report, a total of 1,244 companies out of 1,250 listed companies on the Shanghai and Shenzhen Stock Exchanges had established independent directors by the end of June 2003, and most of the 1,244 companies had satisfied the requirement in respect of at least one of its independent directors being an accounting professional.⁵⁵⁶ In this study, Table 6.2a reports that among all 267 Chinese companies, the proportion of directors who are independent averages just over one quarter. This figure indicates that the independent board system has not been well established in China by the date of this study. Table 6.2b indicates that approximately 2% of boards of Chinese listed companies have no independent directors at all, but more than 90% of companies

⁵⁵⁴ see Higgs Report, *op cit.* fn.460, p18.

⁵⁵⁵ See Section I (3) of the Guidelines, *op cit.* fn28

⁵⁵⁶ See Four Measures to Improve China's Independent Director System, Shanghai Securities News, 6 February 2004, citing in Lu et al. Corporate Governance Correspondence, vol.1, 2004, available at http://www.iwep.org.cn/cccg/pdf/tongxun_2003-5.pdf [Accessed 28 September 2005].

have satisfied the requirement in respect of boards comprised of at least one-third independent directors.

Table 6.2(a) Proportion of Non-executive/Independent Directors

Country	N	Minimum	Maximum	Mean	Std. Deviation
China (INDs)	267	.00	66.00	25.16	8.729
UK (NEDs)	196	16.67	100.00	53.92	16.48

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

Table 6.2(b) Frequency Distribution of Non-executive/Independent Directors

Proportion of NED/IND	China		UK	
	Frequency	Percent	Frequency	Percent
None	5	1.9	0	0
Less than 1/3	242	90.6	6	3.1
Between 1/3 to 2/3	20	7.5	163	83.2
Greater than 2/3	0	0	27	13.8
	267	100.0	196	100.0

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

6.3.3 Board Leadership Structure

It has been argued that the separation of the roles of chairman and CEO ensures an adequate system of checks and balances against potential abuses of power by management. Indeed, from an agency perspective, the separation of the roles of CEO and chairman of the board can dilute the power of the CEO and reduce the potential for a management-dominated board.⁵⁵⁷ In addition, consistent with the managerial hegemony theory, Dalton and Kesner state that "the real threat to the exercise of independent judgement by the board of directors is the dual role of the CEO as board

⁵⁵⁷ L. A. A. Van den Berghe and A. Levrau, 2004. Evaluating Boards of Directors: What Constitutes a Good Corporate Board?, *Corporate Governance*, Vol.12, 461-478.

chairman.”⁵⁵⁸ Goyal and Park also argue that the dual leadership structure creates too much power in the hands of the CEO and makes it harder for a board to replace a poor performing CEO, which potentially results in reducing the flexibility of the board to address large declines in performance.⁵⁵⁹ However, some literature in favour of the CEO and chairman’s duality argue that the duality leads to increased effectiveness, which result in a situation where there is a clear leader of the organisation so that there is no room for doubt as to who has authority or responsibility over a particular matter.⁵⁶⁰ The literature discussed above suggests that the question of the separation of the CEO and chairman positions has been controversial in studies of corporate governance.

In the UK, in accordance with the Cadbury recommendations, the vast majority of companies have separated the role of chairman (who runs the board) from that of the CEO (who runs the company) since the 1990s. For example, Dahya et al find that 15.4% of the UK listed companies in their sample combined the CEO and chairman roles during 1993-1996 periods.⁵⁶¹ Similarly, Conyon and Murphy report that only 18% of UK companies combined the CEO and chairman in 1997.⁵⁶² In this study, the incidence of duality of the CEO and chairman in our sample of 196 UK listed

⁵⁵⁸ Dan R. Dalton and Idalene F. Kesner, 1987. Composition and Duality of Boards of Directors: An International Perspective, *Journal of International Business Studies*, pp33-42, at p35.

⁵⁵⁹ Goyal, V. and C. Park, 2002. Board Leadership Structure and CEO Turnover, *Journal of Corporate Finance*, 8:49-66.

⁵⁶⁰ Donaldson L. and Davis J., 1991. Stewardship Theory or Agency Theory: COE Governance and Shareholder Returns, 16(1) *Australian Journal of Management* 49.

⁵⁶¹ Conyon, M. J. and K. J. Murphy, (2000), The Prince and the Pauper? CEO Pay in the United States and the United Kingdom, *Economic Journal*, Vol.110, No. 467, pp209-226.

⁵⁶² Dahya, J., McConnell, J.J. and G.N. Travlos, (2002), The Cadbury Committee, Corporate Performance and Top Management Turnover, *Journal of Finance*, Vol.57, pp461-483.

companies is found to be slightly higher than the Higgs Report, with about 16% of them combined in one person. In China, by contrast, neither company law nor the CCGC provides rules that the roles of chairman and CEO should be separated. However, the study finds that the chairman and CEO duality is not very high. Only 12% of the sample companies in China have a combined board leadership structure in 2002/2003 financial year (see Table 6.3).

Table 6.3 Chairman and CEO Duality

Country	N	Mean
China	267	11.61
UK	196	16.41

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

MacAvoy and Millstein state that "...ideally, the board's chairman should be an independent director, thus separating the role in form as well as substance."⁵⁶³ A board needs leadership separate from the CEO to serve as a check on management and to respond to expanded demands for accountability and transparency. Although the board leadership structure data in this study indicates that the majority of companies have separated the roles of chairman and CEO in China, it does not mean the chairman is an independent outside member of the board. Ho argues that in most

⁵⁶³ They argue that "the first important initiative is for the board to develop an identified independent leadership, by separating the roles of chairman of the board and CEO and appointing an independent director as chairman. Independent leadership is critical to positioning the board as an objective body distinct from management and, in particular to the board's abilities to: (i) identify the issues it should focus on including, in particular, the strategic issues of importance; (ii) obtain the information it needs to assess management's performance against its chosen strategy, including the overall conduct of the business; and (iii) prevent any management efforts to obfuscate important issues or information needed thereby hindering the board's ability to fulfill its responsibilities." see Paul W. MacAvoy and Ira M. Millstein, 2003. *The Recurrent Crisis in Corporate Governance*, Palgrave Macmillan, p4 and p95.

cases either the chairman of the board or the CEO or both in China is nominated, appointed and dismissed predominantly by the controlling or majority shareholders.⁵⁶⁴ Obviously, this form of leadership structure could make the listed companies more like a wholly-owned subsidiary company of the controlling or majority shareholders so that board decisions are normally in the interest of the controlling or majority shareholders rather than the interests of the company as a whole. In addition, it is argued that the title of chairman and CEO can be very misleading in China because many chairmen of the board work full-time for the companies and are executives in all but name.⁵⁶⁵ This scenario suggests that the separation of the role of chairman and CEO seems to put the CEO in the 'hot seat', that the CEO may be overawed by such a chairman and feel constrained in the day-to-day running of the company without frequent reference to the chairman. It also appears to be more difficult for such a chairman to be able to stand sufficiently back from the day-to-day running of the business.

6.3.4 Committees of the Board

Board subcommittees play a key role within the functioning of corporate boards, and committee structure and composition can be important indicators of board independence. Theoretical perspectives examining the antecedent and effects of board committees usually draw from agency theory and resource dependence theory. Based on agency theory, Dalton et al note that the impact of board committees has been

⁵⁶⁴ Simon S. M. Ho, 2003. *Corporate Governance in China: Key Problems and Prospects*, Centre for Accounting Disclosure and Corporate Governance, School of Accountancy, The Chinese University of Hong Kong.

⁵⁶⁵ See Zhong, Juyin, *op cit.* fn.491.

given special attention by both academics and practitioners since “many of the critical processes and decisions of boards of directors do not derive from the board-at-large, but rather in subcommittees.”⁵⁶⁶ Referring to the resource dependence perspective, Stiles and Taylor argue that a non-executive director with a financial background sitting on an audit committee (which reflects a good use of expertise) can improve the quality of financial reporting and reduce potential fraudulent practice.⁵⁶⁷ Klein notes that independent directors can only perform the monitoring function if they are embedded in an appropriate committee structure.⁵⁶⁸ Managerial hegemony theory is also used to explain the function of the nomination committee. Shivdadani and Yermack construct a measure of CEO involvement in the director nomination process based on whether the board has such a committee and whether the CEO is serving on it. They find that the CEO involvement in the selection process decreases the board’s independence.⁵⁶⁹ In a survey of directors, Lorsch and MacIver find that when the CEO nominates a candidate, 11% of the directors indicated that that person was always accepted, while 57% said the CEO’s choice was accepted “most of time”, and 42% of the directors reported that the CEO nominated candidates were rarely rejected by the nomination committee.⁵⁷⁰ Similarly, the compensation committee is an institutional device to resolve the potential conflicts of interest between insider executives and the firm’s owners. Newman and Wright’s study, involving 161 of the

⁵⁶⁶ Dalton, D. R., C.M. Daily, A. E. Ellstrand and J. L. Johnson, 1998, Meta-analytic Reviews of Board Composition, Leadership Structure, and Financial Performance, *Strategic Management Journal*, 19, 3: 269-290. at 284.

⁵⁶⁷ Stiles, P. and B. Taylor, *op cit.* fn.436, pp69-70.

⁵⁶⁸ Klein, A: *op cit.* fn.112.

⁵⁶⁹ Shivdasani, A. and D. Yermack, 1999, CEO Involvement in the Selection of New Board Members: An Empirical Analysis, *Journal of Finance* 54: 1829-54.

⁵⁷⁰ Lorsch, J. W. and E. MacIver, *op cit.* fn.94

250 largest US listed companies, find that CEO compensation is greater in firms having remuneration committees that include at least one executive director or affiliated non-executive director than in firms having remuneration committees consisting solely of independent non-executive directors.⁵⁷¹ Indeed, as Williamson observed, the absence of an independent compensation committee is akin to the CEO, “writing his pay check with one hand and signing it with the other”.⁵⁷² Despite many wide-ranging claims about the importance of the board subcommittee, more empirical research is required to understand the board subcommittees as they have emerged in different countries.

Of the 196 sample companies from the UK, Table 6.4 shows that almost all companies in the study have standing audit committees (98.5%) and compensation committees (98.5%), and about three-quarters of the sample companies have a nomination committee, but the relative independence of these committees varies. The independence levels of the audit and compensation committees tend to be higher than that of nomination committees. 191 companies (99%) have a majority of independent members on their audit committees, with 95.3% being fully independent; 189 companies (97.9%) have a majority of independent members on their independent compensation committees, with 92.7% being fully independent; and 129 companies (90%) have a majority of independent members on their nomination committees, but with only 45.1% being fully independent.

⁵⁷¹ Newman, H. A. and Wright, D. W. 1995. *Compensation Committee Compensation and its Influence on CEO Compensation Practices*, Working Paper, School of Business, University of Michigan.

⁵⁷² Williamson O. E. 1995. *The Economic Institutions of Capitalisms*, the Free Press: New York.

Table 6.4 Board Committees

Board Committee		China		UK	
		Frequency	Per cent	Frequency	Per cent
Audit committee	No committee	183	68.5	3	1.5
	Majority independent *	74	88.1	191	96.4
	100 per cent independent	0	0	184	95.3
Nomination committee	No committee	190	71.2	52	26.5
	Majority independent *	67	87.0	129	65.8
	100 per cent independent	0	0	65	45.1
Remuneration committee	No committee	178	66.7	3	1.5
	Majority independent *	75	88.2	189	97.4
	100 per cent independent	0	0	179	92.7

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 196 companies listed in London Stock Exchange market.

*Majority independent includes those that are 100 per cent independent. Independent figures calculated based only on those companies that have established a committee.

Among the 267 sample companies from China, Table 6.4 above indicates that the proportions of companies with audit, nomination and remuneration committees only stand at 31.5%, 28.8% and 33.3% respectively. Among those companies with established committees, about 88% of audit and remuneration committees contain a majority of independent directors, and 87% of nomination committees contain a majority of independent directors. Nevertheless, none of these committees are formed entirely of independent directors.

6.3.5 The Frequency of Board Meetings

Brown's study on the effectiveness of UK independent directors reports that in 1997, among a sample of 480 UK listed companies, 9% of boards held less than 5 meetings per year; 23% held 5-8 meetings; 65% held 9-12 meetings; but 3% of boards held more than 12 meetings.⁵⁷³ Cook and Leissle comparing the FTSE 100 and TechMark

⁵⁷³ Peter Brown, 1997. The Effectiveness of UK Independent Directors, *Corporate Governance*, Vol.5, pp232-235.

100 find that 66 of the 87 sample FTSE 100 companies reported that the average number of board meetings held in the 1999-2000 financial year was 9, whereas 45 of the 73 sample TechMark 100 companies reported that their average number of board meetings was 10 in the same period.⁵⁷⁴ In this study, 175 of the 196 sample UK listed companies disclosed the board activities in their annual reports, which show on average that the boards held 9 meetings with a range between 4 and 21 in the 2002-2003 financial year (see Table 6.6).

Table 6.5 Frequency of Board meetings

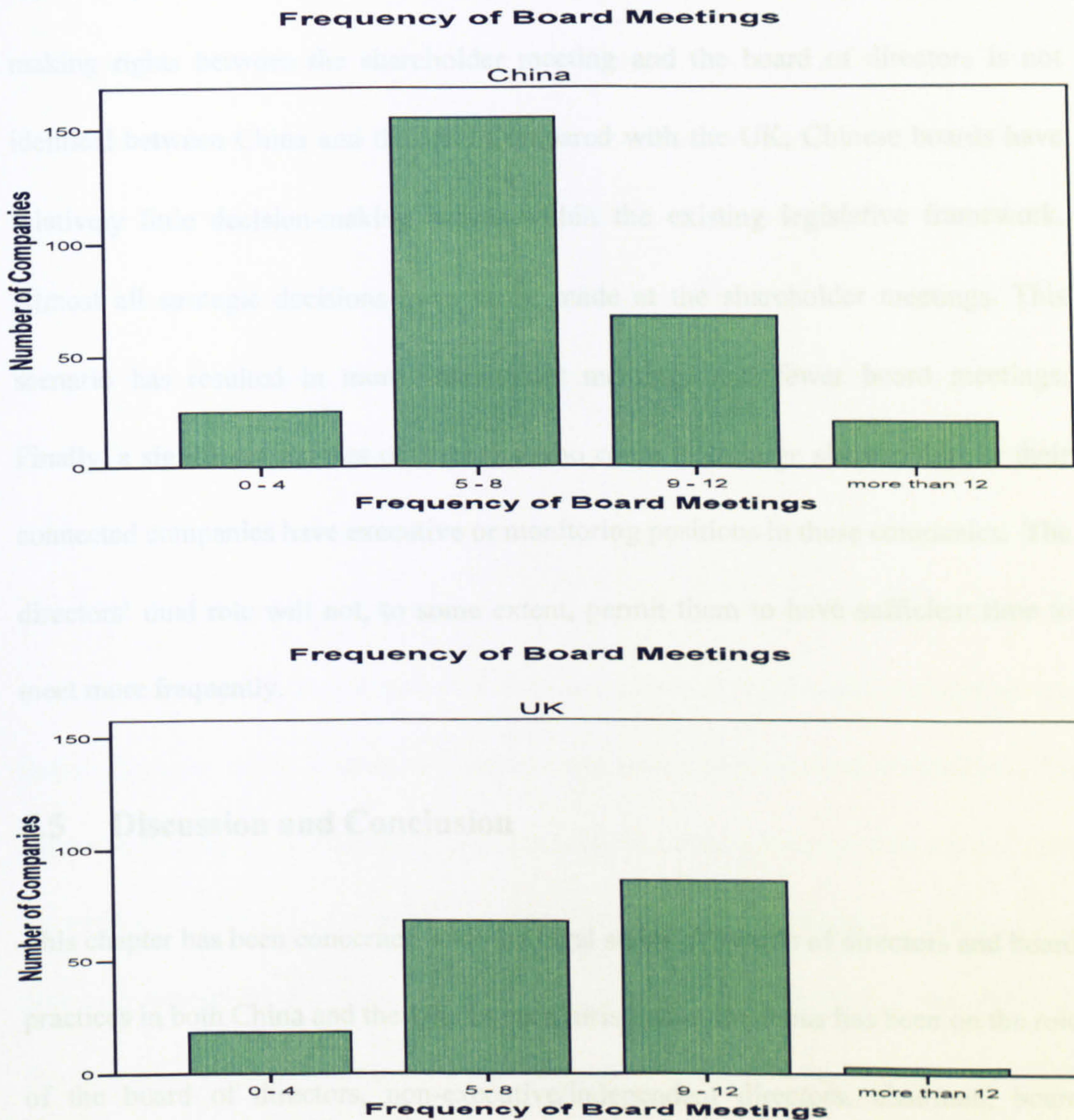
	N	Minimum	Maximum	Mean	Std. D	Frequency			
						(0-4)	(5-8)	(9-12)	(More than 12)
China	267	3	27	7.75	3.18	25 (9.4%)	155 (58.1%)	67 (25.1%)	20 (7.5%)
UK	175	4	21	8.81	3.18	18 (10.3%)	68 (38.9%)	86 (49.1%)	3 (1.7%)

Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 175 companies listed in London Stock Exchange market.

This study find that the boards of Chinese listed companies held an average of 8 meetings in the 2002-2003 financial year with a range between 3 and 27. In comparison, in 1999, the World Bank and IFC Report found that Chinese listed companies averaged 4.2 board meetings per year,⁵⁷⁵ so the data suggest that many Chinese boards now tend to have more meetings. Table 6.6 shows that only one quarter of the sample companies in China had board meetings 9-12 times per year, whereas almost a half of the boards in the UK met 9 to 12 times. Figure 6.3 also provides a clear picture of the differences of the board meeting frequency between China and the UK.

⁵⁷⁴ Cook, L. and K. Leissle, *op cit.* fn.540.

Figure 6.3



Source: the survey of 267 companies listed in China's SH and SZ Stock Exchange markets and 175 companies listed in London Stock Exchange market.

There are at least three possible reasons for this difference. First, the board meetings of the UK listed companies serve both executive and monitoring functions, whereas in China the monitoring function, at least in law, is delegated to the supervisory board. Therefore, monitoring-related decisions are conducted by the meetings of the

⁵⁷⁵ see S. Tenev and C. Zhang, *op cit.* fn.207.

supervisory board. Secondly, as was seen in chapter 5, the distribution of decision-making rights between the shareholder meeting and the board of directors is not identical between China and the UK. Compared with the UK, Chinese boards have relatively little decision-making power within the existing legislative framework. Almost all strategic decisions have to be made at the shareholder meetings. This scenario has resulted in more shareholder meetings and fewer board meetings. Finally, a significant number of directors who come from large shareholders or their connected companies have executive or monitoring positions in these companies. The directors' dual role will not, to some extent, permit them to have sufficient time to meet more frequently.

6.5 Discussion and Conclusion

This chapter has been concerned with the legal status of boards of directors and board practices in both China and the UK. In each jurisdiction the focus has been on the role of the board of directors, non-executive/independent directors, chairman, board committees, as well as board activities with particular emphasis on the frequency of board meetings through both functional comparative analysis and empirical analysis. The functional comparative analysis provides a partial answer to the questions which are asked at the beginning of the chapter and shows that the Chinese board system is unique in many aspects. For example, the Chinese two-tier structure does not seem to provide adequate control and supervision functions over corporate affairs. In practice, the Chinese supervisory board works in a way that is quite different from the legally

defined model. Lin observes that the supervisory board which is usually formed by labour unions, party members, and major shareholder representations, has a loosely defined monitoring role over the board of directors and managers.⁵⁷⁶ Cheng argues that supervisory boards in China have great difficulty in performing their supervisory duties.⁵⁷⁷ Guo states that the great weakness of supervisory boards in China is lack of independence.⁵⁷⁸ The members of a supervisory board are not “external” in nature. In fact, as employee representatives, most of them are senior or junior managers of the company, whereas the shareholder representatives are normally closely related with executive directors because they are all nominated by the controlling shareholders.⁵⁷⁹ In such a scenario, it is doubtful that such a supervisory board could challenge the decisions made by the boards of directors and senior management. In addition, the supervisory board as a monitoring organ, which functions merely as a figurehead, has no more than formal power to contest decisions made by the board of directors and company executives. For example, according to Art.126 of the CCL 1994, although the supervisory board has the power to check the company’s financial accounts and monitor the performance of directors and senior managers, it may have difficulties in obtaining sufficient information or lack expertise to fulfil its functions.⁵⁸⁰ If directors or managers have done something that is not in their corporations’ best interests, the

⁵⁷⁶ See Lin, T. W. 2004. *Corporate Governance in China: Recent Developments, Key Problems and Solutions*, USC Marshall Research, University of Southern California, Marshall Business School.

⁵⁷⁷ See Cheng, Y., 2000. *Enterprises Demand Supervision*, *China Economic Daily*, January 10.

⁵⁷⁸ See Guo, R., 2002. Disinterested or Uninterested? Some Thoughts on the CSRC's Independent Directors Guiding. *Perspectives*, Vol.3. No 5. available at

http://www.oycf.org/Perspectives/17_063002/Disinterested_Uninterestedd.htm [Accessed 25 September 2004]

⁵⁷⁹ Minkang Gu, 2003. Will an Independent Director Institution Perform Better than a Supervisor? Comments on the Newly Created Independent Director System in the People’s Republic of China, 6 *Journal of Chinese and Comparative Law*. 59. Shen S. and J. Jia, 2004. Will the Independent Directors Institution Work in China? *Loyola of Los Angeles International & Comparative Law Review*. Vol.27:223-48.

⁵⁸⁰ See art.126(1) & (2) of the CCL 1994

supervisory board can only demand directors and managers to make amends.⁵⁸¹ In addition, if such a demand fails, the supervisory board may propose to hold an extraordinary general meeting.⁵⁸² However, it can be easily rejected by the board of directors as the power to convene a shareholder meeting is only vested in the board of directors.⁵⁸³

The weak monitoring function of the supervisory board in China's publicly listed companies can be attributed to various loopholes of the CCL 1994. Although the CCGC reinforced the role of the supervisory board, in many cases, the supervisory board has no real "teeth" to fight with the board of directors. As mentioned earlier, the supervisory board, unlike the supervisory board in Germany, is neither involved in the selection of directors and managers, nor has the power to dismiss them or bring an action against them. However, the problems associated with the role of the supervisory board have been envisaged by the CCL 2006. Article 54 of the CCL 2006 allows the supervisory board to propose the dismissal of any directors or senior managers who are in violation of laws, administrative regulations, the articles of associations of the company, or resolutions of the shareholder meeting.⁵⁸⁴ In addition, under the CCL 2006, the supervisory board will have the power not only to propose the convening of an extraordinary general meeting, but also be able to convene and preside over the meeting itself if the board of directors fails to perform its function of

⁵⁸¹ *ibid* art.126 (3)

⁵⁸² *ibid.* art.126(4)

⁵⁸³ *ibid.* art.104(4) & (5)

⁵⁸⁴ See art.54 (2) of the CCL 2006.

convening and presiding such a meeting as provided by law.⁵⁸⁵ Furthermore, the supervisory board has been given the power to initiate legal proceedings against any directors or senior managers in breach of their duties.⁵⁸⁶ However, it is noteworthy that law in itself has not resolved all previously mentioned problems, in particular, the lack of independence of the supervisory board. Empirical evidence has shown that this system is still controlled by the controlling shareholders or board of directors of the company. The effectiveness of the two-tier board system is not guaranteed as it is still unclear whose interests the supervisory board represents.

Nevertheless, as has been seen, China is also seeking to enhance the board monitoring functions through the use of independent directors. Yet, it is noteworthy that the effectiveness of the independent director system can be affected by the way in which corporate governance principles are put into practice. Tam argued that the independent director system transplanted from the Anglo-American system by China is based on competitive external markets, and with a strong role played by the court system.⁵⁸⁷ In the UK, the market based corporate governance system relies on arm's-length transactions and shareholder sovereignty that protect the small and diverse individual shareholders. In contrast, it is clear that China does not have the accompanying ownership structure conditions (structure driven path) which allows the external market to come to its own conclusions. Therefore, whether the

⁵⁸⁵ *ibid.* art.54(4).

⁵⁸⁶ *ibid.* arts.54(6) & 152.

⁵⁸⁷ On Kit Tam, 2000. Models of Corporate Governance for Chinese Companies, *Corporate Governance: An International Review*, Vol.8 pp52-64.

development of corporate governance arrangements in the external market-based Anglo-American model and the role that corporate governance has played could be achieved in China is still questionable.

Within the current independent director system, empirical analysis in this study shows that the independent director system has now been adopted and applied by most Chinese listed companies. Certainly, the legal environment is the most important condition which will influence the effectiveness of corporate governance. In fact, the CSRC identified three major problems which have prevented companies from exploiting the advantages of independent directors in China: (1) some independent directors are not sufficiently independent; (2) some independent directors lack corporate management knowledge; and (3) it is difficult to ensure that the right independent directors obtain sufficient information about the companies they serve.⁵⁸⁸ In addition, achieving good corporate governance requires increased enforcement capability for regulatory bodies and a corresponding legal environment. Practice shows that the CRSC has met many practical difficulties in the implementation of the CCGC, such as collecting evidence, lack of power and ability to enforce the law, and the cooperation of other judicial departments.⁵⁸⁹ Although the CCL 2006 now affirms that a listed company shall have independent directors in the boardroom,⁵⁹⁰ the lack of tradition and institutions for law enforcement in China casts doubt on both the implementation and the effectiveness of the new corporate

⁵⁸⁸ See Shanghai stock exchange, *op cit* fn.233.

⁵⁸⁹ See Lu, T. *op cit*. fn.473.

governance system. Given the above, it seems clear that merely adopting such 'modern' corporate governance measures and structures does not mean that an effective governance system has been developed. To support this proposition, Chapter 9 attempts to conduct a regression analysis of the relationship between the current Chinese board structure and firm performance to test the effectiveness of the internal mechanisms within the Chinese corporate governance system.

⁵⁹⁰ see art.123 of the CCL 2006

CHAPTER 7

DIRECTORS' DUTIES: THE LEGAL AND REGULATORY REQUIREMENTS

7.1 Introduction

Sheikh and Chatterjee define corporate governance from a legal perspective as “a system whereby directors are entrusted with responsibilities and duties in relation to the direction of a company’s affairs”.⁵⁹¹ The Company Law Review Steering Group (the CLR) recognises that the rules on directors’ duties lie at the heart of corporate governance.⁵⁹² Indeed, it is generally agreed that an effective corporate governance system should provide mechanisms for regulating directors’ duties in order to prevent them from slacking, shirking or abusing their power and to ensure that they act in the best interests of a company and its shareholders. From a legal perspective, therefore, the concern in this chapter is with how well the duties of directors have been established in order to ensure that directors devote adequate attention to the company’s affairs and carry out their functions competently in China compared with the UK.

In this chapter, the comparative analysis is approached from the UK point of view to identify how a company’s directors are generally expected to satisfy two common law

⁵⁹¹ See Saleem Sheikh and SK Chatterjee, *Perspective on Corporate Governance*, in Saleem Sheikh and William Rees, ed. *Corporate Governance & Corporate Control*, Ch1. at p5, London : Cavendish, 1995. For other definitions see section 2.2.1 of this thesis.

⁵⁹² See the CLR, Final Report, *op cit*, fn.269, para.3.2.

duties – fiduciary duties and duties of care, skill and diligence, and to highlight certain recent developments both in case law and the growing impact of the company law reform in respect of codification of directors’ duties. This is followed by a similar approach to examine the general legal requirements imposed on directors and how they have evolved in order to enhance the accountability of directors in China and to critically assess the perceived problems compared with the UK in relation to the uncertainty and ambiguity surrounding directors’ duties. The criticisms articulated in this chapter highlight certain aspects of law on the basic standards of directors’ accountability which need to be amended by reference to the UK rules.

7.2 The Duties of Directors in the UK

7.2.1 The Fiduciary Duties

In the UK, fiduciary duties imposed on directors are similar in broad terms to those of trustees to ensure that they act with good faith and loyalty in managing the company.⁵⁹³ The governing principle is that the company has placed trust in the director who is expected to reciprocate by acting with the utmost good faith towards the company when dealing with it or acting on its behalf.⁵⁹⁴ The substance of the fiduciary duties owed by a director to the company has developed over time through decisions of the courts in numerous different cases, but falls into four main areas. The

⁵⁹³ See, *Percival v Wright* [1902] 2 Ch 421; *Allen v Hyatt* (1914) 30 TLR 444; *Re Smith & Fawcett* (1942) Ch. 304; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443.

⁵⁹⁴ See *Bristol and West Building Society v Mothew* [1998] Ch 1, p.18 per Millett states: ‘A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence’.

first is the primary duty to act *bona fide* in the interests of the company.⁵⁹⁵ In *Dorchester Finance v. Stebbing*⁵⁹⁶ Foster J stated that ‘A director must exercise any power vested in him as such, honestly, in good faith and in the interests of the company....’⁵⁹⁷ In examining a *bona fide* exercise of a power by a director of a company, Pennycuik J in *Charterbridge Corporation Ltd v. Lloyds Bank Ltd*⁵⁹⁸ said that “the proper test, I think, of whether a director of a company has acted *bona fide* in the interest of the company ... must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.”⁵⁹⁹

The second point is that directors must exercise their powers for a proper purpose and must not act for any collateral purpose.⁶⁰⁰ In *Re Smith & Fawcett Ltd*⁶⁰¹ Lord Greene MR said that directors were bound to exercise the powers conferred upon them “*bona fide* in what they consider – not what the court may consider – is in the interest of the company, and not for any collateral purpose”⁶⁰². In *Howard Smith v. Ampol Petroleum Ltd*⁶⁰³, Lord Wilberforce emphasized that in a case which the court has

⁵⁹⁵ See *Dorchester Finance v. Stebbing* [1989] BCLC 498; *Charterbridge Corporation Ltd v. Lloyds Bank Ltd* [1970] Ch 62; *Regentcrest plc v. Cohen* [2001] 2 BCLC 80, *Runciman v. Walter Runciman plc* [1992] BCLC 1084, and *Extrasure Travel Insurance Ltd. v. Scottergood* [2002] All ER (D) 307.

⁵⁹⁶ See *Dorchester Finance v. Stebbing* [1989] BCLC 498.

⁵⁹⁷ See *Dorchester Finance v. Stebbing* [1989] BCLC 498, pp501-02.

⁵⁹⁸ [1970] Ch 62.

⁵⁹⁹ [1970] Ch 62, p74.

⁶⁰⁰ See *Re Smith & Fawcett Ltd.* [1942] Ch 304, *Punt v. Symons & Co Ltd.* [1903] 2 Ch 506, *Piervy v. S Mill & CO Ltd.* [1920] 1 Ch 77, *Caiman v. National Association for Mental Health* [1971] Ch 317. *Howard Smith Ltd. v. Ampol Petroleum Ltd.* [1974] AC 821, *Criterion Properties PLC V. Stratford UK Properties LLC* [2003] BCC 50, CA, *Bishopsgate Investment Ltd. v. Maxwell (No.2)* [1993] BCLC 1282, *Extrasure Travel Insurance Ltd. v. Scattergood* [2002] All ER (D) 307.

⁶⁰¹ [1942] Ch 304.

⁶⁰² [1942] Ch 304, p306.

⁶⁰³ [1974] AC 821.

found that directors have believed they were acting *bona fide* in the interests of the company, the court must find whether the purpose for which the director acted was objectively proper or improper.⁶⁰⁴ On the facts in *Howard Smith v. Ampol Petroleum Ltd* the court held that the directors' use of their fiduciary powers over the shares in the company for the purpose of destroying an existing majority or creating a new majority was unconstitutional. The directors' primary objective was to alter the majority shareholding and the allotment was invalid.⁶⁰⁵ In *Extrasure Travel Insurance Ltd v. Scattergood*⁶⁰⁶, it was suggested that the test of improper purpose was an objective one. In any case where the exercise of a power by directors is challenged, it is for the court to take a four-step test: (i) identify the power whose exercise is in question; (ii) identify the proper purpose for which that power was delegated to the directors; (iii) identify the substantial purpose for which the power was in fact exercised; and (iv) decide whether that purpose was proper.⁶⁰⁷ In *Extrasure Travel Insurance Ltd v. Scattergood*, the claimant alleged that the decision to transfer £200,000 out of Extrasure's bank account to another company in the group in order to meet the demands of a pressing creditor of that other company by two of its formal directors was not in its best interests and was made for an improper purpose.⁶⁰⁸

⁶⁰⁴ [1974] AC 821, [1974] All ER 1126. The case involved a takeover battle for a company where the directors favoured a particular bidder and made an allotment of shares to that bidder with a view to diluting the holdings of the potential rival bidders for the company. As the directors' primary objective was to alter the majority shareholding, although the directors had acted honestly, it was unconstitutional for directors to use their fiduciary powers over the shares in the company for the purpose of destroying an existing majority. It was held that the directors had improperly exercised their power. In practice, improper allotments of shares are now constrained by statute. Ss.80 and 89 of the CA 1985 requires the general meeting to give the directors authority to allot and require that allotments be on a rights basis unless the shareholders agree otherwise.

⁶⁰⁵ *Ibid.*

⁶⁰⁶ [2002] All ER 307.

⁶⁰⁷ See *Extrasure Travel Insurance Ltd v. Scattergood* [2002] All ER 307, Ch D. para.92. The four stages were developed from *Howard Smith v. Ampol Petroleum Ltd* [1974] AC 821.

⁶⁰⁸ By applying the four-steps test, the court concluded that: (i) the power in question was the directors' ability to deal with the assets of Extrasure in the course of trading; (ii) the purpose for which that power was conferred on the directors was broadly to protect Extrasure's survival and to promote its commercial interests in accordance

The third point is that directors must not place themselves in a position of a conflict of interest (no-conflict rule).⁶⁰⁹ The principle against conflict of interest can be traced to *Aberdeen Railways Co. v. Blaikie Brothers*⁶¹⁰, where Lord Cranworth LC states that no fiduciary director “shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect”.⁶¹¹ The no-conflict rule established in this case allowed a company to avoid any contract which the directors entered into on its behalf in which one or more of the directors had an interest, unless that interest had been disclosed to the company and approved by the general meeting. The disclosure of directors’ interests in corporate transactions is important for the application of the no-conflict principle. As can be seen from the Court of Appeal case *JJ Harrison (Property) Ltd v. Harrison*, a director who failed to make sufficient disclosure of his interest on the purchase of a property from the company some 11 years before proceedings were commenced, was held liable to account for the profits made from the transaction.⁶¹²

with the objects set out in its Memorandum; (iii) the Defendants’ substantial purpose in making the transfer was to enable the recipient company (Citygate) to meet its liabilities, not to preserve the survival of Extrasure; and (iv) the purpose for which the transfer was made was plainly an improper one. See *Extrasure Travel Insurance Ltd v. Scattergood* [2002] All ER 307, Ch D. para.140.

⁶⁰⁹ *Aberdeen Railways Co & Blaikie Bros* (1845) 1 Macq 461; *Hely-Hutchinson v. Brayhead Ltd.* [1968] 1 QB 549. *Guinness plc v. Saunders* [1990] 2 AC 663, *Runciman v. Walter Runciman plc* [1992] BCLC 1084

⁶¹⁰ (1845) 1 Macq. HL 461.

⁶¹¹ In this case the conflict is obvious as the chairman of the claimant’s board of directors was also the managing partner of the defendant. The director is obliged to act in the interests of the company to purchase goods on behalf the claimant’s company at the lowest price, while as a managing partner of the defendant, he wishes to sell the goods at the highest price. Where such a conflict exists, the court allowed the claimant to set aside a contract for the purchase of equipment entered into between it and the defendant. See *Aberdeen Railways Co. v. Blaikie Brothers* (1854) 1 Macq. HL 461, at 471

⁶¹² [2002] 1 BCLC 162, CA.

Finally, directors owe a duty not to make secret profit (no-profit rule).⁶¹³ The no-profit rule is derived from the leading trust case of *Keech v. Sandford*⁶¹⁴, but the leading authority for the application of the no-profit rule was *Regal (Hastings) Ltd v. Gulliver*.⁶¹⁵ In this case, the House of Lords held that the directors had made their profits “by reason of the fact that they were directors of Regal and in the course of the execution of that office.”⁶¹⁶

The common law fiduciary duties are supplemented by a number of provisions in Part X of the CA 1985.⁶¹⁷ For example, s.317 of the CA provides that a director of a company who is in any way, whether directly or indirectly, interested in a contract, or proposed contract, with the company must declare the nature of the interests at a

⁶¹³ *Keech v. Sandford* (1726) Sel Cas Ch 61; *Cook v. Deeks* [1916] AC 554; *Regal (Hastings) Ltd v. Gulliver* [1942] 1 All ER 378, HL; *Guinness plc v. Saunders* [1990] 2 AC 663; *Don King Productions Inc v. Warren* [2000] 1 BCLC 607; *Industrial Development Consultants Ltd. v. Cooley* [1972] 2 All ER 162.

⁶¹⁴ (1726) Sel Cas Ch 61.

⁶¹⁵ [1967] 2 AC 134n, [1942] 1 All ER 378, HL. The plaintiff company (Regal), the owner of a cinema, was contemplating the purchase of the leases of two other cinemas which were to be transferred to a subsidiary company formed by Regal called Amalgamated. Concurrently, Regal was contemplating the sale of all three cinemas to a third party. The intention of the directors was that Regal should subscribe for shares in Amalgamated and then Regal would sell those shares to the third party. There was some trouble over providing a guarantee; the transaction was changed so that the directors of Regal subscribed for shares in Amalgamated instead of Regal itself and then those directors sold those shares to the third party, thereby making an immediate and handsome profit. The purchasers of Regal brought an action against the former directors claiming that they had made a profit in breach of fiduciary duty.

⁶¹⁶ The governing principle laid down in *Regal (Hastings) Ltd v. Gulliver* was applied in *Phipps v. Boardman*. In that case, Lord Upjohn stated four stages to test whether a fiduciary is misusing his position for his personal advantage as follows: “(i) The facts and circumstances must be carefully examined to see whether in fact a purported agent and even a confidential agent is in a fiduciary relationship to his principal. It does not necessarily follow that he is in such a position; (ii) Once it is established that there is such a relationship, that relationship must be examined to see what duties are thereby imposed upon the agent, to see what is the scope and ambit of the duties charged upon him; (iii) Having defined the scope of those duties one must see whether he has committed some breach thereof and by placing himself within the scope and ambit of those duties in a position where his duty and interest may possibly conflict. It is only at this stage that any question of accountability arises; and (iv) Finally, having established accountability it only goes so far as to render the agent accountable for profits made within the scope and ambit of his duty.” See *Phipps v. Boardman* [1967] 2 AC 46 at 127. In *Industrial Developments v. Cooley*, Roskill J referred the four propositions above and found that the defendant had deliberately placed himself in a position where his duty to the company and his personal interests were conflicted. Roskill J. held that the defendant was accountable to the company for all the profits he received under the contract because “information which came to him while he was managing director and which was of concern to the plaintiff and relevant for the plaintiffs to know, was information which it was his duty to pass on to the plaintiffs.” See *Industrial Developments v. Cooley* [1972] 1 WLR 443.

⁶¹⁷ Part X are intended to reinforce the common law rules by regulating a wide range of certain transactions or arrangements by directors with their companies which give rise to possible conflict interest. See Part X of the CA 1985.

meeting of directors of the company.⁶¹⁸ S.324 imposes a duty on directors and shadow directors to notify the company of interests in shares in or debentures of the company or associated companies.⁶¹⁹ In addition, as a particular conflict of interest which may give rise to problems when directors purchase assets from, or sell assets to, their companies or companies in which they have an interest, s.320 of the CA provides that a director of a company or of its holding company may not enter into any arrangement to acquire from or transfer to the company a “non-cash asset” without first obtaining approval for the transaction from the members by ordinary resolution passed in general meeting.⁶²⁰ These statutory duties of disclosure under Part X are necessary to prevent any self-preserving director from contracting with his or her own or associated companies.

7.2.2 The Duty of Care and Skill

In addition to directors’ fiduciary duties, in the UK, directors have a duty of care and skill in relation to the management of company business.⁶²¹ The common law standards of reasonable care and skill were summarised by Romer J in *Re City Equitable Fire Assurance Co*,⁶²² as comprising three main propositions: (i) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected of a person of his knowledge and experience;⁶²³ (ii) A director

⁶¹⁸ S.317 of the CA 1985.

⁶¹⁹ S.324 of the CA 1985.

⁶²⁰ See s.320 (1) of the CA 1985 which regulates ‘substantial property transactions’.

⁶²¹ See *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498.

⁶²² [1925] Ch 407.

⁶²³ [1925] Ch 407 at 428.

is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.⁶²⁴ (iii) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.⁶²⁵ Under the principles established by the case of *Re City Equitable*, few directors have ever been found liable in negligence for the corporate losses which resulted from what appeared to be clear mismanagement of the company's business.

Although *Re City Equitable* still remains good law, it is notable that the scope and extent of those obligations is somewhat vague, since there are no generally recognised standards of the degree of skill and care,⁶²⁶ and the elements of the test are out of date and not robust enough for the protection of the interests of a company in modern times.⁶²⁷ Nevertheless, these propositions have been substantially modified by the later case laws and statutes. In *Dorchester and Finance Co Ltd v. Stebbing*, Foster J. applied the proposition laid down in *Re City Equitable*, but held that non-executive

⁶²⁴ *Ibid* at 429.

⁶²⁵ *Ibid*.

⁶²⁶ Sheikh and Chatterjee criticise that the duty of care, skill and diligence imposed on directors is too lax so that a director is only obliged under common law to have the minimum qualifications and show only minimal care and attention to company affairs. See Saleem Sheikh and SK Chatterjee, *op cit.* fn.591; Riley argues that the duty of care, skill and diligence with its lax characteristic standards have offered too little protection for companies and their shareholders. See C.A. Riley, 1999. The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard, *Modern Law Review*, Vol.62, pp697-724, at 698.

⁶²⁷ See Guy Nesbitt, 2006. Directors' Duties under Common Law and Statute, *The Tax Journal*, 825, pp13-14.

directors who were qualified accountants or who had considerable accountancy and business experience had been negligent in signing blank cheques which allowed the managing director to misappropriate the company's money. This implied that the professional directors would use reasonable skill in performance of the duties of the office based on what might reasonably be expected from a person in their position.

But more significantly, the general standard of care has been changed since the judicial initiative was seized by Hoffmann L J in the case of *Re D' Jan of London Limited*⁶²⁸ by the application of both subjective and objective tests under section 214 of the Insolvency Act 1986 (the IA 1986).⁶²⁹ In *Re D' Jan of London Limited*, Hoffmann L J held that "the duty of care owed by a director at common law is accurately stated in s.214 (4) of the IA 1986".⁶³⁰ It is the conduct of "a reasonably diligent person having both: (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that director has."⁶³¹ Accordingly, a director who signed an inaccurate fire insurance proposal form to insure the company's property without checking its content was regarded as negligent.⁶³²

⁶²⁸ *Re D' Jan of London Limited* [1993] BCLC 646.

⁶²⁹ S.214 (4) of the Insolvency Act 1986 provides that: "the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both – (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that director has."

⁶³⁰ *Re D' Jan of London Limited* [1993] BCC 646.

⁶³¹ *ibid.*

⁶³² *ibid.*

A modern statutory approach laid down in s.214 (4) of the IA 1986 indicates that company directors will be judged by the objective standards of the reasonably diligent person, but that standard will apply with regard to the functions which an individual undertakes in relation to the company and his/her knowledge and experience in question. In addition, with regard to the content of the duty of care, skill and diligence in terms of what can be expected of a reasonably diligent director, the particular role and responsibilities which the director has in the company, including whether he/she is an executive or non-executive director needs to be taken into account. Hoffmann LJ in *Bishopsgate Investment Management Ltd (in liq) v. Maxwell*⁶³³ suggested that “the existence of a duty to participate must depend upon how the particular business is organised and the part which the director could be reasonably expected to play”.⁶³⁴ Similarly, in *Re Barings plc (No.6)*⁶³⁵ the Court of Appeal upheld that directors must carry out their supervisory duties, but to what extent the duty is to be discharged “must depend on the facts of each particular case, including the director’s role in the management of the company”.⁶³⁶ In the more recent case *Equitable Life Assurance Society v. Bowley*⁶³⁷, Langley J observed the nature and extent of the duties of non-

⁶³³ [1993] BCLC 1282.

⁶³⁴ [1993] BCLC 1282, para.12.7

⁶³⁵ [2002] 1 BCLC 523.

⁶³⁶ *Ibid*, para.36, the Court of Appeal agreed with the following statement by Jonathan Parker J at the first instance: (i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors; (ii) Whilst directors are entitled (subject to the Articles of Association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions; (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company.

⁶³⁷ *Equitable Life Assurance Society v. Bowley* [2004] 1 BCLC 180.

executive directors, and in particular the extent to which they could be discharged from responsibility for the action of other executives, and held that:

“[I]t is well known that the role of non-executive directors in corporate governance has been the subject of some debate in recent years. For present purposes, as Mr Milligan submitted, it in any event suffices to say that the extent to which a non-executive director may reasonably rely on the executive directors and other professionals to perform their duties is one in which the law can fairly be said to be developing and is plainly ‘fact sensitive’. It is plainly arguable, I think, that a company may reasonably at least look to non-executive directors for independence of judgment and supervision of the executive management.”⁶³⁸

The above *dicta* clearly indicate that there is a changing area of the law as it clarifies the dual standards of care, skill and diligence. Clearly, by formulating the duty of care in this way, the duty owed in law by a non-executive director to a company could differ from the duty owed by an executive director because different roles have been performed by different type of directors. To be sure, as we have discussed in chapter 6, the directors have different roles in running a company’s affairs which have appeared in the provision of the new Combined Code. Therefore, the common law would have to develop to react to the changing demands of society. In fact, in the cases examined above, the court appears to have rightly taken into consideration the

⁶³⁸ *Ibid*, para.41.

differences between executives and non-executives, independent directors, chairman, members of board committees, and so on. Nevertheless, it is noteworthy that there is no difference between the test to be applied to non-executives and those applied to executives or others; the differences lie in their functions they shall fulfil and the extent of the care and diligence that they can be reasonably expected to exercise.⁶³⁹

7.2.3 *Statutory Statement of Duties*

As discussed above, it is evident that many principles regulating directors' behaviour are established by case law rather than in a provision of the CA 1985. The complexity and overlap of the many and varied rules governing directors' fiduciary duties have made it difficult for directors to understand what to do before they act.⁶⁴⁰ In 1999 the Law Commission and the Scottish Law Commission investigated the law regulating directors' duties and produced a joint report - 'Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties',⁶⁴¹ which clarified that there should be a statutory provision codifying the principal duties of company directors. In 2002, the CLR took a step further and proposed a statutory statement of duties⁶⁴² and recommended that the general duties imposed on directors should be put on a statutory footing, to provide greater clarity on what is expected of directors and make the law more accessible; and to make development of the law in this area more

⁶³⁹ See R. Slyn, 2003. Directors' Duties. In Glen James, Slaughter and May ed. *A Practitioners Guide to Directors' Duties and Responsibilities*, City & Financial Publishing, p87.

⁶⁴⁰ See Boyle, A.J. and J. Birds, 2004. *Boyle & Birds' Company Law*, 5th ed. Jordans, p535. Law Commission Report 'Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties', Law Com. No.153, (London: Stationery Office, 1999), para.14.4, at p273-274.

⁶⁴¹ *Ibid.* Law Commission Report.

⁶⁴² See the CLR, Final Report, *op cit.* fn.269.

predictable; and to correct the defects in the present duties relating to conflicts of interest.⁶⁴³

A new statutory statement of directors' general duties under the Bill set out seven general duties based on certain common law rules and equitable principles⁶⁴⁴ and are to be interpreted and applied in the same way as common law rules or equitable principles as they apply in relation to directors.⁶⁴⁵ The statutory duties specified in sections 154-170 of the Bill which are owed by a director of a company to the company include:

(1) Duty to act within powers.⁶⁴⁶ This duty codifies the current principle of equity under which a director should exercise his/her power in accordance with the terms of articles of associations of the company and use that power for a proper purpose.⁶⁴⁷ However, this stark statutory statement offers no specific guidance to the courts. The application of this duty will still need the courts to make their assessments of what should count as a breach.

(2) Duty to promote the success of the company.⁶⁴⁸ This duty enshrines in the statutes what is commonly referred to as the principle of "enlightened shareholder value".⁶⁴⁹ Under this principle a director must act in a way that he or she considers, in

⁶⁴³ See the Notes, *op cit.* fn.389, para.301.

⁶⁴⁴ See *ibid*, para.304.

⁶⁴⁵ See cl.154 (3) & (4) of the Bill.

⁶⁴⁶ See *ibid*, 155 of the Bill.

⁶⁴⁷ Common law principle of proper purpose has been discussed in section 7.2.1.

⁶⁴⁸ See cl.156 of the Bill. Some concerns have been raised as to the meaning of 'success' in this context and there will be considerable uncertainty as to how success is to be judged. However, the government has stated that 'success' will normally mean "long-term increase in value". See Lord Sainsbury of Turville, Second Reading debate, Hansard Col.245, 11 January 2006.

⁶⁴⁹ See cl.156 of the Bill.

good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In doing so, there is a non-exhaustive list of factors which a director has to consider: (a) the likely consequences of any decision in the long term; (b) the interests of employees; (c) the need to foster the company's business relationships with suppliers, customers and others; (d) the impact on the community and environment; (e) the desirability of the company maintaining a reputation for high business conduct, and (f) the need to act fairly between members.⁶⁵⁰ The scope of these obligations is somewhat vague, since there are no general recognized standards as to what "promoting the success of the company" means in practice. In addition, it is also ambiguous as to whether a director could be held in breach of his duty when he or she fails to consider the factors (a) to (f) listed above or give one factor less weight than others when making day-to-day decisions.

(3) Duty to exercise independent judgment.⁶⁵¹ This duty requires directors not to fetter their discretion to act other than in accordance with an agreement which has been duly entered into by the company or in a way authorised by the company's constitution.⁶⁵² This duty provides a departure from the common law – 'prohibit directors from fettering their future discretion' the meaning of which the courts have interpreted over many years.

(4) Duty to exercise reasonable care, skill and diligence.⁶⁵³ This duty which derives from the recent case law and s.214 of the IA 1986 (discussed in s.7.2.2 above), sets

⁶⁵⁰ *Ibid.*

⁶⁵¹ See cl.157 of the Bill.

⁶⁵² *Ibid.*

⁶⁵³ See cl.158 of the Bill.

out a combined objective and subjective test. The combined dual standard test recognises that a director owes a duty to his/her company to exercise the same standard of care, skill and diligence that would be exercised by a reasonably diligent person with: (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as the director in relation to that company – “an objective test”, and (b) the general knowledge, skill and experience that the director actually has – “a subjective test”. The codified dual test approach confirmed the fact that not every director will have an equal knowledge and understanding of a company’s business. Consequently, the duty imposed will vary according to the role of each individual played in the company. In effect, the test will ensure that those directors with more experience, including non-executive directors, will be subject to a higher standard by virtue of their particular knowledge, skill and experience.

(5) Duty to avoid conflict of interest.⁶⁵⁴ This duty covers all conflicts, actual and potential, between the interests of the directors and interests of the company. This includes conflicts relating to exploitation of the company’s property, information or opportunity for personal purposes. This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company. However, such a transaction or arrangement must be declared under clause 161 in the case of proposed transactions or clause 165 in the case of existing transactions unless an exception applies under those clauses.⁶⁵⁵ In addition, the Bill clarifies that this duty is not

⁶⁵⁴ See cl.159 of the Bill

⁶⁵⁵ See the Notes, *op cit.* fn 389, para.337.

infringed if the situation cannot reasonably be regarded as arising in relation to a conflict of interest; or the matter has been authorised by the directors (i.e. authorisation has been given by the independent directors in a public company) and the authorisation is effective (i.e. satisfied with the quorum of the meeting or voting procedural requirements).⁶⁵⁶

(6) Duty not to accept benefit from third party.⁶⁵⁷ This duty aims to prohibit the exploitation of the position of director for personal benefit. However, it will not prohibit directors from accepting a benefit from a third party as a result of their directorship if its acceptance cannot reasonably be regarded as likely to give rise to a conflict of interest.⁶⁵⁸ Nevertheless, in practice, this duty may give rise to debate and some uncertainty over what benefit may be regarded as likely to give rise to a conflict.

(7) Duty to declare interest in proposed transaction with the company.⁶⁵⁹ This duty requires a director not only to disclose any interest, direct or indirect, that he/she has in relation to a proposed transaction or arrangement with the company, but also declare the nature and extent of his/her interests to the other directors. In addition, a director must make further declaration if the earlier disclosure is no longer accurate or complete. A director will breach the duty if he/she fails to declare something he/she ought reasonably to have known, but the duty does not otherwise require a director to declare anything he/she does not know.⁶⁶⁰

⁶⁵⁶ See the Notes, *op cit.* fn 389 para 339-341.

⁶⁵⁷ See cl.160 of the Bill.

⁶⁵⁸ See the Notes, *op cit.* fn 389 para 342 – 344.

⁶⁵⁹ See cl. 161 of the Bill.

⁶⁶⁰ See the Notes, *op cit.* fn 389 para 345-352.

Inevitably, the Bill initiated the main elements of the directors' fiduciary duties established by both common law and the equitable principles which set out the basic standards of directors' accountability. The statutory statement of directors' fiduciary duties intends to provide greater clarity and useful guidance for directors to understand what the law expects them to do and make the law more accessible. The codification of directors' fiduciary duties will in turn help to improve standards of governance in UK listed companies.

7.3 Duties of Directors in China

7.3.1 The Duty of Loyalty

Unlike the UK directors' fiduciary duties which have been developed over a century with a process of judicial decisions setting precedents and applying or distinguishing them in various circumstances by the judges, China did not start developing a range of directors' duties until the early 1990s. Prior to 1990, there was little codification to regulate corporate directors and managers. With the promulgation of the CCL 1994 the legal underpinning for the concept of directors' duties was put into place. Although the words "fiduciary duties" were not clearly expressed, certain concepts akin to these duties manifested themselves in the context of the CCL 1994. For example, Article 59 of the CCL 1994 states that the directors, supervisors and managers shall abide by the company's articles of association, faithfully perform their duties and protect the interests of the company and shall not take advantage of their

position, functions and powers in the company to seek personal gains,⁶⁶¹ which is akin to a fiduciary duty of loyalty under common law. Under this provision, it seems that directors, supervisors and general managers should act in a *bona fide* and diligent way in the interests of the company. However, the words “faithful” and “the interests of the company” employed in the context of the Article 59 of the CCL 1994 have not been clearly defined so that they are not well understood by either the directors or shareholders.

In addition, Article 60 of the CCL 1994 provides that the directors and managers of a company shall not misappropriate company funds including lending company funds to others, depositing company assets in the directors’ own personal accounts or in personal accounts of other individuals, or using company assets as security for the personal debts of shareholders of the company or of other individuals.⁶⁶² This strict rule seems to function against any director and manager who might misuse his or her power in a particular situation mentioned above. However, this provision is difficult to enforce because most listed companies in China are controlled by the majority or controlling shareholders.⁶⁶³ As we have seen these shareholders are mainly SOEs, government agencies, or other corporate entities and they frequently dominate the board of directors. An outstanding problem in these companies is that the controlling shareholders divert the capital of listed companies for other uses and listed companies provide guarantees for controlling shareholders. According to data from the CSRC,

⁶⁶¹ Art.59 of the CCL 1994.

⁶⁶² Art.60 of the CCL 1994.

⁶⁶³ See Chapter 4 of the thesis.

the problem of controlling shareholders diverting the capital for other uses existed in 676 listed companies with a total value of RMB 96.669 billion (£7.4 billion) and 20% of listed companies provided guarantees for controlling shareholders and associated parties in 2002.⁶⁶⁴ This problem becomes even more serious when it is realised that some listed companies have suffered great economic losses or a considerable threat to the operation of the company by breaching this provision, but none of these companies' directors has been held in breach of fiduciary duties.⁶⁶⁵

At common law, the "no-conflict" rule is probably the most important of the directors' fiduciary duties. Article 61 of the CCL 1994 also provides a mandatory context which regulates two distinct factual situations in which conflicts of duty and interests are likely to arise. Firstly, directors and managers are prohibited from engaging in their own business or operating business for others in the same business category as the company which they are serving, or engaging in any acts which may damage the interests and benefits of the company, and any profits derived from such acts will be appropriated by the company.⁶⁶⁶ Secondly, directors and managers are prohibited from entering into contracts or conducting transactions with the company unless they are authorised by the articles of association or approved by the

⁶⁶⁴ See Q. Jiang, *op cit.* fn.235.

⁶⁶⁵ For example, on 31 December 1999, *Monkey King plc* provided funds for an amount of RMB890,000,000 and a guarantee for RMB244,000,000 to *Monkey King Group*, its majority shareholder. The aggregate amount of the two items exceed RMB1,130,000,000 and represent 121.4% of its total assets. As a result, *Monkey King plc* was operating under great difficulties. On 27 February 2001, the *Monkey King Group* was declared bankrupt in accordance with law. *Monkey King plc* was also close to bankruptcy. *Jinan Motorbicycle*, a publicly listed company, provided funds and guarantee for an amount of more than RMB2,500,000,000 to *Jinan Motorcycle Group*, its majority shareholder. This resulted in huge losses for 2001. See Gao Xianmin (Ed.), *Secrets of Listed Companies* World Publication Press, 2001, pp. 101-110; *Jinan Motorcycle: Replay of Monkey King Fiasco*, published on 17 June 2001 in *Nanfang Weekend*.

⁶⁶⁶ Para.1 of Art.61 of the CCL 1994.

shareholder meeting.⁶⁶⁷ It seems clear that the CCL 1994 seeks to ensure that the company's interests are favoured by a strict no conflict rule that whenever a director acts in these circumstances, any profits he might make will have to be disgorged to the company. Nevertheless, what is notable compared with the UK no-conflict principle is that the duty of disclosure has been entirely omitted under Art.61 of the CCL 1994. In the absence of a detailed provision on the duty of disclosure, the proper functioning of the fiduciary duties designed to control conflicts of interest should be difficult to enforce in China.

Unlike UK fiduciary duties of directors, in China a “no-profit” rule was not specified as a duty to directors under the CCL 1994. Instead, Article 62 of the CCL 1994 stipulates that directors, supervisors and managers must not disclose any company secrets unless otherwise in accordance with the law or approved by shareholder meeting.⁶⁶⁸ This provision seems to present the rule against the exploitation of corporate opportunities or information in order to resolve the problem of conflicts of interest. However, the term “company secrets” is not defined by the law. Such a provision has been criticised as being too skeletal with a lack of operating standards.⁶⁶⁹ In practice, without the support of equitable principles and precedents, it is doubtful that the Chinese courts, especially the local courts, will interpret the term “company secret” under Art.62 and implement it to penalise directors.

⁶⁶⁷ *Ibid*, para.2.

⁶⁶⁸ *ibid*, art.62.

⁶⁶⁹ Zhang, X. C., 1998. Practical Demands to Update the Company law, *Hong Kong Law Journal* 28, 248-260 at 254. Yuan, A. 2000. Foreign Direct Investments in China – Practical Problems of Coping with China's Company Law and Laws for Foreign-invested Enterprises. *Northwestern Journal of International Law and Business*, 20: 475-508, p493.

As have been discussed above, there are a number of problems with directors' duties under the CCL 1994, compared with the established case law and new statutory statement of directors' duties in the UK. First, the CCL 1994 imposes fiduciary duties on directors, but these apparently fall short of the generally accepted standards to test whether the directors act *bona fide* in the interests of the company. Moreover, without requiring the declaration of interests of directors, the no-conflict of interest rule will not be effectively implemented. Finally, the vague language of the law creates some difficulties for the courts and judges to penalise the directors.

The CSRC has clearly realised the problems and tried to pursue the quasi-regulation to improve the standards of behaviour of directors. In 1997, the CSRC published the Directive of Articles of Association of Listed Companies (the Directive 1997) which applies to all companies listed in China's Stock Exchange Markets. The Directive 1997, with twelve chapters and 194 Articles, attempt to provide a uniform model for listed companies to formulate their articles. Several articles in the Directive 1997 concern the problems of directors' duties mentioned above. For example, in addition to duties and responsibilities of directors specified by the CCL 1994, the Directive 1997 imposes additional fiduciary duties on directors. Article 80 of the Directive 1997 stipulates that directors shall comply with the law, corporate regulation and the company's articles of association, faithfully perform their duties and protect the interests of the company. Once a director is in a position in which his or her duty to the company conflicts with this personal interest, the director must act in the best

interests of the company and shareholders, and ensure that: (i) directors should remain within the scope of powers which have been conferred on them;⁶⁷⁰ (ii) directors must not take advantage of their office to obtain for themselves or others any business opportunity which ought to belong to the company, or accept commissions in connection with the company's transaction without the informed consent of the shareholders in a shareholders meeting.⁶⁷¹

In order to ensure that directors are precluded from entering into engagements in which they have, or can have, a personal interest conflicting, or which may conflict, with the interests of the company they serve, the Directive 1997 further provides that:

“[E]xcept as permitted by the articles of association or legally authorized by the board of directors, a director may not act on behalf of the company or the board of directors in his own name. If a third party reasonably believes that a director, who is acting in his own name, is acting on behalf of the company or the board of directors, such a director must clarify his position and status in advance.”⁶⁷²

In addition, if a director or an enterprise in which he/she assumes a position has an interest, directly or indirectly, in any existing or proposed transaction, contract or arrangement of the company (other than a service contract), such a director must disclose his/her interests to the board of directors at the earliest opportunity. The

⁶⁷⁰ Article 80 (1) of the Directive 1997, *op cit.* fn.227.

⁶⁷¹ *Ibid.* art. 80 (7) – (8).

⁶⁷² *Ibid.* art. 82.

interested director may not be counted in the quorum for or vote at the board meeting with respect to such matters. A related party transaction approved by the board of directors in violation of the above requirements may be avoided at the option of the company, unless the transaction is entered into between the company and a third party acting in good faith.⁶⁷³

As we have seen, all these provisions clearly reflect the trend of improving the current legal framework of company law by introducing more familiar common law rules and doctrines. Although the title of the Directive 1997 may not readily indicate its mandatory nature, the CSRC has made it clear that any change or deletion of the necessary contents of the Directive 1997 without acceptable justification will cause CSRC's refusal to process any application from the companies concerned for their listing matters.⁶⁷⁴ Nevertheless, because this Directive 1997 is neither the formal law nor a judicial explanation promulgated by the Supreme Peoples' Court (SPC), it carries very weak legal authority, which casts doubt on whether courts in China would recognize its legal effects. Indeed, experience has shown that regulations and enforcement have provided neither the companies nor shareholders with the protection they require.⁶⁷⁵

⁶⁷³ *Ibid.* art. 83.

⁶⁷⁴ See the Notice of the CSRC Concerning Promulgation of the Directive of on Article of Association for Listed Companies, (*Zhengjian*) [1997] No.16.

⁶⁷⁵ See Deng, J. 2005. Building an Investor-Friendly Shareholder Derivative Lawsuit System in China, *Harvard International Law Journal*, (46), p347.

Although the Chinese government has realised that it is very important to reinforce the directors' duty of loyalty to the company by placing a maximum constraint on a director against them to gain personal benefits from corporate opportunities, we note with considerable disappointment that the CCL 2006 did not reframe much of the duties imposed on directors by the Directive 1997. The legal effects of the non-conflict rules and the rule of disclosure imposed on directors by the Directive 1997 remain unclear. The duty of loyalty of directors provided under the CCL 1994 simply reappeared in the CCL 2006 with a refined list of eight principles that could properly guide the consideration of individual issues in relation to the duty of loyalty.⁶⁷⁶ However, there is no detailed rule to describe either the content of the relevant obligations, or the appropriate enforcement mechanism to ensure how gains made from the breach can be restored to the company.

7.3.2 Duty of Care, Skill and Diligence

In China, the absence of the duty of care, skill and diligence of company directors is the weakest portion of the CCL 1994. However, the Directive 1997 clarified that directors must exercise their powers given by the company with care,

⁶⁷⁶ Art. 149 of the CCL 2006 provides a checklist prohibiting directors and senior officers from the following acts: (1) to misappropriate any funds of the company; (2) to deposit funds of the company in bank accounts opened in their own names or in the names of others; (3) to lend funds of the company to others or put up assets of the company as security for others in violation of the articles of association of the company or without approval by the shareholder general meeting or the board of directors; (4) to enter into any contract or transaction with the company in violation of the articles of association of the company or without approval of the shareholder meeting or shareholder general meeting; (5) to take advantages of their positions to obtain for their own benefit or the benefit of others any business opportunities that belong to the company or to engage in the same type of business as that of the company for their own account or for the account of others without approval of the shareholders' meeting or the shareholders' general meeting; (6) to accept commissions on transactions between others and the company and keep such commissions as their own; (7) to disclose any secret of the company without authorisation; and (8) to commit any other act that is in violation of their duty of loyalty to the company. Gains made by a director or a senior officer in violation of any of the provisions above shall be restored to the company.

conscientiousness and diligence⁶⁷⁷ so as to ensure that: (i) the company's business activities comply with state laws, regulations and economic policies and do not exceed the business scope stipulated by its business license;⁶⁷⁸ (ii) directors treat all shareholders fairly;⁶⁷⁹ (iii) directors read all commercial or financial reports of the company carefully and timely acquaint themselves with the business operation and management of the company;⁶⁸⁰ (iii) a director personally exercises the lawful powers to manage the company free from the control of others and shall not delegate his powers to others, except as permitted by laws, regulations or approved by informed shareholders in a shareholders meeting;⁶⁸¹ and (iv) directors accept the lawful supervision and reasonable suggestions on their performance of their duties provided by the supervisory committee.⁶⁸² In addition, Article 85 of the CSRC Directive 1997 provides that a director who fails to attend two successive board meetings, whether in person or through delegating his duties to others, is deemed incapable of performing his duties and the board of directors shall propose to the shareholder meeting to remove that director.⁶⁸³

From the above provisions we can see that China has employed a different approach to define the duty of care, skill and diligence compared with the UK. As previously examined, in the UK there is a clear emphasis on both subjective and objective

⁶⁷⁷ Art.81 of the Directive 1997, *op cit.* fn.227.

⁶⁷⁸ *Ibid.* art. 81 (1).

⁶⁷⁹ *Ibid.* art. 81 (2).

⁶⁸⁰ *Ibid.* art. 81 (3)

⁶⁸¹ *Ibid.* art. 81 (4)

⁶⁸² *Ibid.* art. 81 (5)

⁶⁸³ *ibid.* art. 85

standards to justify directors' conduct in running a company's affairs. In comparison, the CSRC Directive 1997 just provides a radical restatement of duty of care with a checklist for the compliance with due diligence (the objective test), but no consideration is given to whether directors might come to the task with different backgrounds in terms of knowledge, ability and experience (the subjective test). Accordingly, directors could easily be held liable just by virtue of their failure to perform some required activities, such as failure to attend the board meetings, or failure to treat all shareholders fairly, or failure to pay attention to the company's financial reports, or failure to be involved in the management and independent business decision making, or failure to accept supervisions. For example, *Baiwen plc* allegedly exaggerated its profits by 19 million RMB before its initial public offering in 1996 and then invented another 143.9 million RMB in profits during its three years as a listed company. The company was also accused of providing misleading financial statements in its annual reports. In September 2001, Jiahao Lu, a retired English professor, was charged with failure to perform his duties as an independent director of *Baiwen* from January 1995 to 2001 by CSRC. The CSRC alleged that Lu attended a meeting in 1995 where the board discussed the firm's financial statement, but failed to object or voice any opinion on the financial statements.⁶⁸⁴

⁶⁸⁴ Jiahao Lu was fined 100,000 RMB (£7400) by CSRC. This is the first case in which an independent director has been charged as breach of duty of care, skill and diligence in China. Lu appealed against the CSRC's judgement to the Beijing No.1 Intermediate People's Courts, but failed since he failed to file his appeal within the prescribed period under the Administrative Procedural Law. See Y. Yang, Ex-Baiwen Independent Directors Case Rejected, *Shenzhen Daily*, August 15, 2002, available from: http://pdf.sznews.com/GB/content/2002-08/15/content_1225103.htm, [Accessed September 25, 2005].

However, it should be emphasised that operating an objective standard test without reference to any subjective consideration⁶⁸⁵ or a so-called 'Business Judgment Rule'⁶⁸⁶ would render directors not to take appropriate business risks and also cause some practical problems which may hinder the enforcement of directors' duties.⁶⁸⁷ Indeed, Li reports that directors have become increasingly frustrated with the CSRC's requirements on directors' duties so that more than 10 independent directors have resigned from listed companies after the *Baiwen's* independent director incident.⁶⁸⁸ To some extent, this tendency could be attributed to the CSRC's decision to fine Jiahao Lu which made it impossible for directors to be excused by their inability or inexperience. To avoid possible adverse effects, China should, therefore, consider adopting either the subjective standard test or a general business judgement defence, with a restatement of duty of care, skill and diligence, in order to control directors' accountability effectively. Unfortunately, the CCL 2006 made no provision setting the parameters as to whether the duty of care and skill should be imposed upon directors, and if so, what degree of duty of care and skill is expected of a director.

⁶⁸⁵ As discussed in section 7.2.2, the common law appears to endorse the view that if a company appoints a director who is not competent, or does not possess the requisite level of knowledge or experience, the company and its shareholders should bear the consequences of their own selections.

⁶⁸⁶ The Business Judgment Rule doctrine employed by the US courts when they are required to evaluate the potential liability of a corporate director to the corporate for damages allegedly sustained as a result of the director's lack of due care or attention. The rule was addressed in 4.01(c) of the *Principle of Corporate Governance: Analysis and Recommendations*, published by the American Law Institute in 1941. The rule requires that "a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose". See Cox, J. D., 1982. Searching for Corporation's Vote in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, *Duke Law Journal*, 959-1011, p962.

⁶⁸⁷ See C. A. Riley, *op cit.* fn.626. pp697-724. Similar point is made by the Law Commission Report 'Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties', Law Com. No.153, (London: Stationery Office, 1999) paras. 3.85-3.91

⁶⁸⁸ See Li, C., 2002. Independent Directors Quit as CSRC Gets Tough, *South China Morning Post* (Hong Kong), August 21.

7.4 Conclusion

Having determined that the key role of directors is to manage the company's business and exercise its powers, the legal system must devise some means of controlling the directors in the exercise of those powers to ensure that they act in the best interests of the company. The discussion in this chapter, which contains a detailed comparison of directors' duties between China and the UK, shows how the law has been developed in order to control directors' accountabilities. This chapter not only critically examines and analyses the duties imposed on the directors in the UK and China, but also highlights certain aspects of the law which need to be amended in China compared with the UK. Although the context of fiduciary duties and the duty of care, skill and diligence elaborated by the CSRC has shown a positive attempt to control directors' accountabilities, it is noteworthy that a regulatory regime will not be successful unless it has efficient and effective enforcement mechanisms. With this in mind, the next chapter will provide a detailed examination of the different mechanisms for the enforcement of directors' duties in China and the UK in order to determine the effectiveness of the legal control of directors' accountability in China compared with the UK.

CHAPTER 8

THE ENFORCEMENT OF DIRECTORS' DUTIES

8.1 Introduction

The previous chapter has examined the role of legal duties in obliging directors to act in the interests of the company and its shareholders. We have seen that the rules and standards relating to directors' fiduciary duties and duty of care, skill and diligence have received considerable attention in both China and the UK over the years. We have also noted that although the formulation of these duties differs between China and the UK, the substance is much the same since China has apparently recently adopted some common law rules. The essential process of the imposition of the duties on directors obviously attempts to set bounds to directors' exercise of corporate powers and to prevent their corporate managerial powers from being used arbitrarily. However, Parkinson argues that for any of these functions to be fulfilled effectively, there must be a realistic prospect of enforcement which is largely dependent on shareholder action.⁶⁸⁹ Fischel and Bradley argue that directors' duties enforced by derivative action play a fundamental role in aligning the interests of directors and shareholders.⁶⁹⁰ Boyle claims that in the context of public listed companies, shareholders, especially institutional shareholders pursuing derivative actions, should be encouraged in their special role of providing a sanction for the system of corporate

⁶⁸⁹ See J. E. Parkinson, 2000. *Corporate Power and Responsibility: Issues in the Theory of Company Law*, Oxford University Press, p237.

⁶⁹⁰ See Daniel R. Fischel and Michael Bradley, 1986. The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 *Cornell Law Review*, 261.

governance established by the Cadbury Report.⁶⁹¹ Pistor and Xu argue that simply transplanting the substantive rules, such as fiduciary duties, from one country to another might not always lead to the intended consequences. To ensure that the substantive rules are effective, procedural rules should also be designed in such a way that minority shareholders would have standing in court to seek compensation of damages.⁶⁹² Indeed, the enforcement of directors' duties and the rights and remedies of shareholders raise not merely substantive provisions in company law, but also inevitably involve procedural issues that would enable shareholders to bring and pursue a lawsuit.

It is with this issue in mind that the present chapter aims to examine the following questions: In what circumstances and upon what grounds will shareholders be able to bring an action against the wrongdoing directors in the UK and in China? How effective are the rules on shareholder action to ensure directors' accountability in China compared with the UK? If the enforcement rules in China are rather weak compared with the UK, how can the rules be improved?

⁶⁹¹ A. J. Boyle, 1997. The New Derivative Action, *Company Lawyer*. 18: 256, at 258.

⁶⁹² Katharina Pistor and Chenggang Xu, 2002. Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory. Law Working Paper No. 01/2002. European Corporate Governance Institute. Available at http://econ.lse.ac.uk/staff/cxu/pub/Pistor-Xu_FiduciaryDuty_02.pdf [Accessed on 25 April 2005].

8.2 Enforcement of Directors' Duties in the UK

8.2.1 *The Rule in Foss v. Harbottle*

In *Foss v. Harbottle*⁶⁹³, two shareholders in a company sued its directors for fraudulent misapplication of the company's funds, arguing that the directors should compensate the company. The suit was brought on behalf of all of the shareholders except the director who was also a shareholder. It was held that the shareholders could not succeed, because the proper plaintiff was the company to whom the wrong had been done. The legacy of rule in *Foss v Harbottle*, was set out by Sir James Wigram VC who stated that in respect of wrongs done to the company, "the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative"⁶⁹⁴. Thus, if an action did not have the support either of the directors of the company, in whom the power to bring proceedings on the company's behalf generally rests, or of a majority of shareholders,⁶⁹⁵ it could not proceed.

The rule in *Foss v. Harbottle* was developed in *MacDougall v. Gardiner* where Lord

Mellish said:

⁶⁹³ (1843) 2 Hare 461.

⁶⁹⁴ *Ibid* at 491.

⁶⁹⁵ Generally, the management of a company is vested in its board of directors. Thus it is usually only the board which has the right to initiate proceedings in the company's name, and a board cannot be compelled to comply with a resolution of shareholders. See *Automatic Self-Cleaning Filter Syndicate Co. Ltd v. Cuninghame* [1906] 2 Ch 34, 45; *John Shaw & Sons (Salford) Ltd v. Shaw* [1935] 2 KB 113, 134; and *Breckland Group Holdings Ltd v. London & Suffolk Properties Ltd*. [1989] BCLC 100, 104-105. However, in practice, and as noted in the above cases, a majority of shareholders will control the composition of the board, and may vote to remove directors if their wishes are not followed.

“in my opinion, if the thing complained of is a thing which in substance the majority of the company are entitled to do, or if something has been done irregularly which the majority of the company are entitled to do regularly, or if something has been done illegally which the majority of the company are entitled to do legally, there can be no use in having litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.”⁶⁹⁶

This statement reflects that if the alleged wrong is ratifiable by a majority of the company's shareholders at the general meeting, the minority cannot bring a derivative action on behalf of the company against the wrongdoing directors. In this respect, the majority rule principle has generated the greatest legal uncertainty with the existing derivative action which is dependant upon shareholder ratification. Indeed, the possibility of ratification is sufficient to deprive the ability of a shareholder to bring a derivative action.⁶⁹⁷ For example, majority shareholders may by lawful ratification preclude or terminate a derivative action regardless of whether it is in the interests of the other shareholders.⁶⁹⁸ The most important question, however, is whether the minority shareholder has been improperly prevented from bringing such an action. It is therefore arguable that an unrestrained majority rule principle could provide no justification for depriving a shareholder of *locus standi* to sue because the majority

⁶⁹⁶ See *MacDougall v. Gardiner* [1875] 1 Ch 13

⁶⁹⁷ See, Saul Fridman, 1992. Ratification of Directors' Breaches, 10 *Company and Securities Law Journal*, p252.

⁶⁹⁸ See *Pender v Lushington* (1877) 6 Ch. D. 7; *Re Ringtower Holdings plc* (1989) 5 BCC 82; and *Re Astec (BSR) plc* [1998] 2 BCLC 556.

might be ill-motivated or have a false impression of the meaning of ratification for the company's benefit.

8.2.2 *Fraud on Minority*

The above description of the rule in *Foss v. Harbottle* seems that it has rendered a minority shareholder unlikely to pursue proceedings on behalf of the company against wrongdoing directors. However, the courts have not taken this simple view, but rather a number of exceptions from the rule have been established. In *Prudential Assurance Co Ltd v. Newman Industries Ltd (No.2)*⁶⁹⁹ the Court of Appeal summarised Jenkins LJ's judgement in *Edwards v. Halliwell*⁷⁰⁰ which established that:

“...[T]here is no room for the operation of the rule if the alleged wrong is *ultra vires* the corporation, because the majority of members cannot confirm the transaction; there is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority; and there is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company.”⁷⁰¹

⁶⁹⁹ [1982] Ch 204.

⁷⁰⁰ [1950] 2 All ER 1064, 1066-1069.

⁷⁰¹ [1982] Ch 204 at 210-211. These exception principles were summarised in four headings (i) actions relating to personal rights (ii) actions relating to *ultra vires* and illegality; (iii) actions relating to transactions which require a special majority; (iv) actions relating to transactions which constitute a “fraud on the minority”. However, it was said that the first three categories are usually treated as personal actions, while the only true exception to the rule of *Foss v Harbottle* is the fourth category – “fraud on minority”. See Law Commission, *Shareholder Remedies* (Law Commission Report No.246, Cm 3769, Stationary Office, 1997) p.28; Wedderburn, K. W. 1957. *Shareholders' Rights and the Rule in Foss v Harbottle*, *Cambridge Law Journal*. 194, 203, P. L. Davis, *op cit.* fn.251, pp460-461. J.H.Farrar et al., *op cit.* fn.245. pp433-436.

The scope of the exception principles to the rule in *Foss v. Harbottle* described above is important in determining the extent to which minority shareholders may enforce the duties owed by directors to their company by way of a derivative action. In the *Prudential* case, Vinelott J based his decision on the derivative action against the directors on the doctrine that a minority action should be allowed if “the interests of justice require that a minority action should be permitted.”⁷⁰² The fraud on minority exception is typically an example created by the court to allow the injured shareholders to bring a derivative action on behalf of the company. However, to bring a derivative action within the scope of fraud on a minority a shareholder must establish: (i) the breach of duty by directors necessarily amounts to a fraud; and (ii) wrongdoer control which prevents an action being brought to vindicate the rights of the company.⁷⁰³ The first proposition is concerned with the kind of wrong for conduct for which the minority may maintain a derivative action. A clear example of wrongful conduct giving rise to a derivative action is the misappropriation of “money, property or advantages which belong to the company or in which the other shareholders are entitled to participate”.⁷⁰⁴ Such conduct amounts to a fraud on the minority if the majority attempt to sell worthless assets to the company,⁷⁰⁵ or to divert business from the company to themselves in breach of fiduciary duties,⁷⁰⁶ or to act in bad faith in

⁷⁰² [1982] Ch 204, 327.

⁷⁰³ See *Burland v. Earle* [1902] AC 83 (PC), at 93, and also *Estmanco (Kilner House) Ltd v. Greater London Council* [1982] 1 All ER 437 at 444. also see Brenda Hannigan, *op cit.* fn.221, p458.

⁷⁰⁴ See *Burland v Earle* [1902] AC 83 at 93.

⁷⁰⁵ See *Arwood v. Merryweather* (1867) LR 5 Eq 464, where the plaintiff claimed rescission of a contract entered into by directors and the return of money and shares paid to them in consideration for the sale, claiming that they had made a concealed profit. The court held that the directors had acted fraudulently and upheld the plaintiff's claim.

⁷⁰⁶ See *Cook v. Deeks* [1916] 1 AC 554, where the directors appropriated to themselves a contract which the company was actively pursuing, the court refused to permit the general meeting to ratify such conduct. This question is discussed further below.

exercising their power against a litigation for their own person benefit, rather than in the interests of the company,⁷⁰⁷ and the minority shareholders are entitled to bring derivative actions.

However, mere negligence by directors, even when it causes significant losses to the company, will not normally be sufficient,⁷⁰⁸ unless it is self-serving negligence where the directors have profited from their wrongdoing.⁷⁰⁹ In the case of *Daniels v. Daniels*, Templeman J said that: “to put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit of £150,000 odd at the expense of the company is something entirely different.”⁷¹⁰ Templeman J concluded that directors who exercised their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company was within the scope of fraud on the minority exception and a minority shareholder could bring an action against them on behalf of the company.⁷¹¹ This decision was affirmed in *Estmanco (Kilner House) Ltd. V. Greater London Council*, where Sir Robert Megarry V-C states that “fraud in the phrase ‘fraud on a minority’ seems to be being used as comprising not only fraud at common law but also fraud in

⁷⁰⁷ See *Menier v. Hooper's Telegraph Works* (1874) 9 Ch App 350.

⁷⁰⁸ see *Pavides v Jensen* [1956] Ch 565. where a minority shareholder was denied standing to sue in respect of an allegedly negligent sale of a corporate asset at an excessively low price, the court held that there is no “allegation of fraud on the part of the directors or appropriation of assets of the company by the majority shareholders in fraud of minority, the action did not fall within the admitted exceptions to the rule in *Foss v Harbottle...*”. Per Danckwerts J. at 576.

⁷⁰⁹ See *Daniels v. Daniels* [1978] Ch 406, where minority shareholders brought an action against the company's directors, alleging they had caused the company to seek a piece of land to one of them at an undervalued price. Templeman J states that “if minority shareholders can sue if there is fraud, I see no reason why they cannot sue where the action of the majority and the directors, though without fraud, confers some benefit on those directors and majority shareholders themselves”. Per Templeman J. at 414.

⁷¹⁰ *Ibid.*

⁷¹¹ *Ibid.*

the wider equitable sense of that term, as in the equitable concept of a fraud on a power".⁷¹² The term "fraud" interpreted above is valuable in clarifying the meaning of 'fraud on minority' and restricting the scope of *Pavlides v Jensen*⁷¹³ where although directors had been guilty of gross negligence in selling a valuable asset of the company at a price greatly below its true market value, the action was not held within the fraud on minority as no benefits accrued to the directors.

In addition to establishing a fraud on minority, the court in the UK has always required a shareholder to satisfy the second proposition which is concerned with the degree of control of the wrongdoers in the company. The court will not allow a derivative action to proceed unless it is clear that the person who has committed a wrong against the company is also in control of that company.⁷¹⁴ It might be enough to show "wrongdoer control" of the company if, for example, the wrongdoers had *de jure* control over a majority of the votes, or controlled another company and it owned a majority of votes to which the wrong had been done. The case of *Cook v Deeks*⁷¹⁵ is the leading authority which entails the wrongdoers being the owners of a majority of the company's shares. In this case, three directors who held three-quarters of the company's issued shares, diverted a contract that "belonged in equity to the company and ought to have been dealt with as an asset of the company" to another company which they also controlled. Subsequently, a resolution was passed at a general

⁷¹² See *Estmanco (Kilner House) Ltd. V. Greater London Council* [1982] 1 All ER 437 at 445.

⁷¹³ [1956] Ch 565.

⁷¹⁴ See *Burland v Earle* [1902] AC 83 (PC) at p93.

⁷¹⁵ See *Cook v. Deeks* [1916] 1 AC 554.

meeting to ratify what they had done since the wrongdoing directors commanded the majority votes. The Privy Council refused to permit the general meeting to ratify such conduct by noting that:

“...a resolution that the rights of the company should be disregarded in this matter would amount to forfeiting the interests and property of the minority shareholders in favour of the majority and that by the votes of those who are interested in securing the property for themselves, such use of voting power has never been sanctioned by the courts.”⁷¹⁶

However, the difficulty which might arise in a public listed company with a large number of dispersed shareholders, as we have discussed in Chapter 4, and many shares are held by nominees and trustees, causes *de facto* control or the rational apathy and the free rider problem. Therefore, there is a risk that a minority shareholder will be denied seeking to bring a derivative action even if the wrongdoers may deserve to be litigated. The courts were aware of considerations like the one discussed above. In *Prudential Assurance Co Ltd v. Newman Industries Ltd (No.2)*⁷¹⁷, Vinelott J held that there was “no good reason why the court should not have regard to any other circumstances which show that the majority cannot be relied on to determine in a disinterested way whether it is truly in the interests of the company that proceedings should be brought”.⁷¹⁸ English courts have adopted a conservative approach to the rule of fraud on minority exception which requires the minority

⁷¹⁶ *Ibid*, at 564.

⁷¹⁷ See [1981] Ch 257, [1980] 2 All ER 841.

⁷¹⁸ *Ibid*, [1981] Ch 257 at 324, [1980] 2 All ER 841 at 857.

shareholders to show that defendants control a majority of the voting rights in the company, and this has rendered the minority shareholders unlikely to bring an action under this exception.⁷¹⁹ The Law Commission Report on Shareholder Remedies argues that the law has provided little guidance in the cases for a minority shareholder seeking to prove 'wrongdoer control' for the purpose of the 'fraud on minority' exception to the rule.⁷²⁰ The difficulties of determining 'wrongdoer control' act as a major curb on derivative actions, particularly in large public companies.

8.2.3 Personal Actions

As noted in the statement of the *Edwards v. Halliwell* case discussed above, a shareholder may bring an action against a director of a company in respect of transactions requiring a special majority, or an *ultra vires* or illegal act; or breaches of personal rights arising from the company's constitution.⁷²¹ However, these actions are to be thought of as personal actions, not true exceptions to the rule of *Foss v Harbottle*, as the wrong was done to the shareholders' personal rights as opposed to wrongs done to the corporate body.⁷²² The shareholders' personal rights arise in part from the memorandum and articles of a company which constitute a contract between the company and the members and the member *inter se*,⁷²³ and in part from the general law.⁷²⁴ However, unlike any other contract, this arrangement creates

⁷¹⁹ See A. J. Boyle, 2002, *Minority Shareholders' Remedies*. Cambridge University Press, p29.

⁷²⁰ See Law Commission, *Shareholder Remedies*, *op cit.* fn.701. p32

⁷²¹ See *Simpson v Westminster Palace Hotel Co.* (1860) 8 HL, Cas 172, *Wood v Odessa Waterworks Co.* (1889) 42 ChD 636.

⁷²² See J.H.Farrar et al., *op cit.* fn.245, p433.

⁷²³ See section 14 (1) of the Companies Act 1985. *Wood v Odessa Waterwork Co.* (1889) 42 ChD 636.

⁷²⁴ Pennington surmised that under the contract (the memorandum and articles of association) a shareholder has a right to be entered on the register of members; to transfer shares; to vote and participate in shareholder meeting, to receive dividends properly declared or capital payments validly determined upon. See R. R. Pennington, (2001),

individual legal rights in the parties which may not be enforced by the courts.⁷²⁵ A director acts *ultra vires* which amounts to a breach of the 'statutory contract' constituted by the articles and will be actionable by an individual shareholder.⁷²⁶ The standing given the right of a shareholder to bring an action restraining an *ultra vires* transaction by case law is expressly recognised in s.35 (3) of the CA1985. However, it is notable that if the *ultra vires* or illegal act has been completed, any loss accruing to the company can be recoverable in an action brought by the company itself, so the individual shareholder will lose the right to bring an action to recover that loss, unless he/she can bring a derivative action as an exception to the rule in *Foss v Harbottle*.⁷²⁷

In addition, the directors and the majority must follow the procedure specified in the articles, otherwise the minority shareholders can bring an action to restrain them.⁷²⁸

Moreover, the courts have allowed personal actions to enforce a wide range of personal rights which accrue to a shareholder. For example, a shareholder has been entitled to enforce a right in the articles to be paid a cash dividend,⁷²⁹ to challenge the resolution that was not passed *bona fide* in the interests of the company,⁷³⁰ or to bring

Pennington's Company Law, 8th ed. Butterworths, p794

⁷²⁵ For example, breaches of certain provisions relating to the conduct of general meetings are mere 'internal irregularities' for which no personal action may lie if the majority can ratify these irregularities. See *Cotter v National Union of Seamen* [1929] 2 Ch 58, the court refused to allow the shareholder to bring a personal action to restrain the carrying out of certain resolutions passed at improperly convened meetings.

⁷²⁶ see *Soden v British and Commonwealth Holding plc* [1998] AC 298, it was observed by Lord Browne-Wilkinson that: 'to the bundle of rights and liabilities created by the memorandum and articles of the company must be added those rights and obligations of members conferred and imposed by the Companies Act. For ease of reference I will refer to the combined effect of section 14 and the other rights and liabilities of members imposed by the Companies Acts as the "statutory contract".'; also see *Simpson v Westminster Palace Hotel Co* (1860) 8 HL Cas 712; *Hoole v Great Western Rly Co* (1867) 3 Ch App 262 at 277. s.35 (2), CA 1985.

⁷²⁷ See *Smith v Croft (No.2)* [1988] Ch 114.

⁷²⁸ See *Automobile Self-Cleaning Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34; *Quin & Axtens Ltd v Salmon* [1909] AC 442; *Edwards v Halliwell* [1950] 2 All ER 1064.

⁷²⁹ *Woods v Odessa Waterworks Co* (1889) 42 Ch D 636

⁷³⁰ *MacConnell v E Prill & Co* [1916] 2 Ch57; *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503

claims based on irregularities in voting procedures.⁷³¹ Nevertheless, there does not seem to be any generally accepted test of what is and what is not a personal right so that the court will normally incline to treat a provision in the memorandum or articles as conferring a personal right on an individual only if the rights have accrued to the shareholder individually and not simply to him/her in common with other shareholders.⁷³² If a wrong is alleged to have been done to the company, a shareholder with only an equitable interest in shares of a company will not be allowed to bring a derivative claim unless it falls into the exception of the rule in *Foss v Harbottle*.

8.2.4 *The Unfairly Prejudicial Remedy*

In addition to the fraud on minority and certain personal actions discussed above, sections 459 to 461 of the CA 1985 provide shareholders with a remedy where the company's affairs are conducted in a manner that is unfair to their interests.⁷³³ There is no statutory definition to confine what might constitute the "unfair prejudicial conduct" in the context of s.459. However, according to case law, it includes: (i) exclusion of a minority shareholder from management;⁷³⁴ (ii) misappropriation or diversion of corporate assets;⁷³⁵ (iii) failure to provide information;⁷³⁶ (iv) improper

⁷³¹ *Oliver v Dalglish* [1963] 1 WLR 1274; *Re British Sugar Refining Co* (1857) 3 K&J 408; and *Wood & Odessa Waterworks Co* (1889) 42 Ch D 636.

⁷³² See R. R. Pennington, op cit. fn.724, p795.

⁷³³ See s.459(1) of the CA 1985 provides that "a member of a company may apply to the court by petition for an order under this Part (Pt XVII of the CA 1985) on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."

⁷³⁴ See *Re Saul D Harrison* [1995] BCLC 14, *Re Haden Bill Electrical Ltd* [1995] 2 BCLC 280 and *Re a Company* (No 007623 of 1984) BCLC 362.

⁷³⁵ See *Re London School of Electrics Ltd* [1986] Ch 211; *Re Stewarts (Brixton) Ltd* [1985] BCLC 4; *Re Elgindata Ltd* [1991] BCLC 959; and *Re Little Olympian Each-Ways Ltd (No.3)* [1995] BCLC 4.

⁷³⁶ See *Re Ringtower Holding plc* [1989] BCLC 427; *Re Elgindata Ltd* [1991] BCLC 959; and *Re Blue Arrow plc* [1987] BCLC 585

increases in share capital;⁷³⁷ (v) excessive remuneration;⁷³⁸ (vi) non-payment or payment of inadequate dividends;⁷³⁹ (vii) mismanagement and oppression;⁷⁴⁰ and (viii) alteration of articles of association.⁷⁴¹ In addition, the court always has wide discretion to interpret the concept of 'unfair prejudice' in accordance with the relevant background and the context in which the term is used.⁷⁴² But this does not mean that the court can do whatever the individual judge happens to think fair. The concept of fairness must be applied judicially and based on rational principles. If the unfairly prejudicial circumstances are established, the court may make a variety of orders as it thinks fit for giving relief in respect of the matters which the petitioner complained of under s.461 of the CA 1985. There are four main orders, namely: (i) an order regulating the future affairs of the company;⁷⁴³ (ii) an order requiring the company to act or to restrain from acting;⁷⁴⁴ (iii) an order authorising the shareholder to bring civil proceeding on the company's behalf;⁷⁴⁵ (iv) an order requiring the company or other shareholders to purchase the complainant's shares.⁷⁴⁶ It was said that the restriction on the use of the derivative action caused by the *Foss v Harbottle* may be avoided in some, but not all, cases by petitioning the court under the unfairly prejudicial remedy.⁷⁴⁷

⁷³⁷ See *Re Saul D Harrison* [1995] 1 BCLC 14; *Re a Company* (No 002623 of 1984) [1985 BCLC 80; *Re DR Chemicals Ltd* [1989] BCLC 383.

⁷³⁸ See *Re a Company* (No.002612 of 1984) (1986) BCC 99.

⁷³⁹ See *Re a Company* (No. 00370 of 1987), ex parte Glossop [1988] 1 WLR 1068; *Re Sam Weller & Son Ltd* [1990] Ch 682

⁷⁴⁰ See *Re Five Minute Car Wash Service Ltd* [1966] 1 WLR 745; *Re Elgindata Ltd* [1991] BCLC 959; and *Re Macro (Ipseich) Ltd* [1994] 2 BCLC 354

⁷⁴¹ See *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 and *Greenhalgh v Anderne Cinemas Ltd* [1951] Ch 286.

⁷⁴² See *O'Neill v Phillips* [1999] 1 WLR 1092.

⁷⁴³ S.461 (2)(a) of the CA 1985

⁷⁴⁴ *ibid* s.461 (2)(b)

⁷⁴⁵ *ibid*, s.461 (2)(c).

⁷⁴⁶ *ibid*, s.461 (2)(d).

⁷⁴⁷ See Anthony L. Marks and William M. Rees, Shareholders' Actions, *International Company and Commercial*

8.2.5 *A New Derivative Action*

As we have seen from the above analysis, UK company law has imposed strict principles for governing shareholder actions which constitute the proper plaintiff rule, the principle of majority rule, the rule of fraud on minority, the rule of personal right actions and the rule on unfairly prejudicial remedy.⁷⁴⁸ These principles have been “problematic and unsatisfactory”⁷⁴⁹ since they have made it difficult for an individual shareholder to bring an action against the wrongdoing directors. Davis argues that directors’ duties are not likely to play a significant role in the governance of UK companies as they are rarely enforced, either in actual litigation or in the threat of it.⁷⁵⁰ Parkinson observes that directors’ duties are better regarded as playing an educative role rather than as acting as a mechanism of control because strict enforcement of those rules is impracticable.⁷⁵¹

The rationale behind these notions can be attributed to the rule in *Foss v Harbottle* that the duties of directors are owed to the company rather than to individual shareholders. If a wrong is done by a director, the company is the proper person to sue for the damage. However, directors are unlikely to cause the company to commence a claim in negligence against its own board members for breach of duty because the wrongdoers may be a majority of the board or may be able to influence a majority of

Law Review, 1991, 2(2), 39-46.

⁷⁴⁸ See Law Commission, *Shareholder Remedies*, *op cit.* fn.701, para.1.9, p5.

⁷⁴⁹ Richard C. Nolan, 2006. *The Legal Control of Directors’ Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*. *Theoretical Inquiries in Law* Vol. 6, pp363-412.

⁷⁵⁰ See P. L. Davis, *op cit.* fn.251, p443,

⁷⁵¹ Parkinson, J. 1997. *Reforming Directors’ Duties*. Policy Paper No.12. University of Sheffield: Political Economy Research Centre.

the board. On the other hand, where the board declines to sue, the general meeting may be able to do so.⁷⁵² In this circumstance, it is open to a majority of the shareholders to decide not to sue the wrongdoing director or to ratify the director's breach of duty.⁷⁵³ However, Davis points out that it has long been recognised that an ordinary majority of the shareholders in a general meeting may release the directors from many of their fiduciary duties, including duties of care and skill, provided at least the company is a going concern.⁷⁵⁴ Indeed, in practice, even if it is impossible for directors to control the general meetings, through their own shareholdings alone or in combination with those of other shareholders whose decision they can influence, the majority shareholders, for instance, might properly take the view that the publicity, costs, and the inevitable loss would outweigh the benefit to the company successfully prosecuting an action, and therefore might properly decide not to sue.⁷⁵⁵

Apart from the arguments above, the traditional view of 'fear of floodgates opening' – namely, the courts' belief that to allow a minority shareholder to commence an action on behalf of a company whenever the company has suffered some alleged wrong would be to open the floodgates to many future actions, has obliterated the potential for derivative action.⁷⁵⁶ Moreover, the courts have always feared that, if a minority is able to bring all its grievances to court, the company and its management may become

⁷⁵² see *Alexander Ward & Co Ltd v. Samyang Navigation Co Ltd* [1975] 1 WLR 673 at 679.

⁷⁵³ See *Taylor v. National Union of Mineworkers* [1985] BCLC 237 at 254-5

⁷⁵⁴ See P. L. Davis, *op cit.* fn.251, p437.

⁷⁵⁵ see *Taylor v. National Union of Mineworkers* [1985] BCLC 237 at 254-5

⁷⁵⁶ See, e.g. the judgment of Mellish LJ in *MacDougall v. Gardiner* [1875] 1 Ch 13.

bogged down in the distractions and costs of litigation at the expense of its business and, ultimately, of all the members.⁷⁵⁷

The Law Commission Report on “Shareholder Remedies” which identified the problems of the rule in *Foss v Harbottle* – “the uncertainty of its exceptions for a shareholder bringing proceedings on behalf of a company” and recommended that there should be “a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action”.⁷⁵⁸

The Report suggests that the proposed new derivative action would enable a shareholder to enforce any cause of action vested in the company against any person arising from any breach or threatened breach of duty by any director of any of his or her duties to the company.⁷⁵⁹ In May 2005, the Department of Trade and Industry (DTI) published Company Law Reform White Paper setting out its proposal which confirmed that the derivative action is an important mechanism by which shareholders can hold directors to account for the proper exercise of their duties in pursuit of their company’s short and long-term interests.⁷⁶⁰ The Bill has proposed, as recommended by the Law Commission Report, to put derivative action on a statutory footing.⁷⁶¹

⁷⁵⁷ Loose, P., M. Griffiths and D. Impey, 2000. *Company Director: Power, Duties and Liabilities*, p 237, 8th ed. Jordans.

⁷⁵⁸ See Law Commission, Shareholder Remedies, *op cit.* fn.701, para.6.15.

⁷⁵⁹ See *ibid* para.15.2

⁷⁶⁰ See DTI, Company Law Reform White Paper, March 2005, Ch3, available from: <http://www.dti.gov.uk/cld/WhitePaper.htm> [Accessed 25 September 2005]

⁷⁶¹ See part 11 of the Bill

Under the Bill, a derivative action may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company,⁷⁶² or in pursuance of an order of the court in proceedings under section 459 of the CA 1985⁷⁶³ which we have discussed above. The cause of action may be against the directors (include shadow directors) or another person or both.⁷⁶⁴ The derivative action shall be available not only to a member of a company, but also a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law.⁷⁶⁵ The Bill stipulates that a shareholder who brings a derivative action must apply to the court for permission to continue it.⁷⁶⁶ The court may give permission to continue the claim as it thinks fit, or refuse permission and dismiss the claim, or adjourn the proceedings on the application and give such directions as it thinks fit, or refuse permission and dismiss the claim, or adjourn the proceedings on the application and give such directions as it thinks fit.⁷⁶⁷ The Bill also specifies that a shareholder may apply to the court for permission to continue the derivative action on the ground that:

- (a) the manner in which the company commenced or continued the claim amounts to an abuse of the process of the court;
- (b) the company has failed to prosecute the claim diligently, and

⁷⁶² *ibid.* cl.239 (2) and (3).

⁷⁶³ *ibid.*

⁷⁶⁴ *ibid.* cl.239 (3)

⁷⁶⁵ *ibid.* cl.239 (4)

⁷⁶⁶ *ibid.* cl.240 (1)

⁷⁶⁷ *ibid.* cl.240 (2)

(c) it is appropriate for the shareholder to continue the claim as a derivative action.⁷⁶⁸

In considering the issues of leave, the court should take into account all relevant circumstances, in particular:

(a) whether the shareholder is acting in good faith in seeking to continue the claim;

(b) the importance that a person acting in accordance with clause 156 (duty to promote the success of the company) would attach to continuing it;

(c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be, authorised by the company before it occurs, or ratified by the company after it occurs;

(d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;

(e) whether the company has decided not to pursue the claim; and

(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.⁷⁶⁹

⁷⁶⁸ *ibid.* cl.240

⁷⁶⁹ *ibid.* cl.242(3).

Nevertheless, permission must be refused if the court is satisfied on the following circumstance:

- (a) a person acting in accordance with clause 152 (duty to promote the success of the company) would not seek to continue the claim, or
- (b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission had been authorised by the company, or
- (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission was either authorised by the company before it occurred or has been ratified by the company since it occurred.⁷⁷⁰

La Porta et. al. conclude that a strong system of legal enforcement could substitute for weak rules since active and well-functioning courts can step in and rescue investors abused by management.⁷⁷¹ It can be seen that the Bill not only provided a statutory circumscription of the availability of the derivative action, but also made it clear that the action would be subject to tight judicial control at all stages. To be sure, it is evident that the new derivative procedure is actually governed by rules of court, as new rules of procedure could easily be amended in the light of changing circumstances. Operating the new derivative action in this way, the new derivative action will undoubtedly result in the more effective enforcement of directors' duties in the UK.

⁷⁷⁰ *Ibid.* cl.242 (2).

⁷⁷¹ See La Porta, et al., 1998. *op cit.* fn.6.

8.3 Enforcement of Directors' Duties in China

8.3.1 *Law Enforcement Problems under Incomplete Law*

In respect of the breach of directors' duties, Art.63 of the CCL 1994 stipulates that "a director, supervisor or manager of a company who violates the law, administrative regulations or the company's articles of association while performing his corporate duties resulting in harm to the company, shall be liable for damages."⁷⁷² Similar to the UK, this provision intends to ensure that directors who breach their duties to the company are made accountable. However, whether such a strict provision can be enforced in practice is dependent upon whether the law provides effective ways in which the damages caused by the wrongdoers can be remedied. Under this provision, it seems that only the company can take an action to hold the directors, supervisors or managers liable for their acts that violate the law, administrative regulations or the articles of the company. Added to this is the doubt whether, because the company is an artificial person run by the board, the directors can be relied upon to invoke the legal remedies against themselves. If the company is unwilling to proceed or is prevented from bringing an action against the wrongdoers, the question is whether the shareholders could be endowed with the right to bring derivative actions whenever the company's interest is damaged or threatened by directors' or managers' breach of duties. Compared with the UK, where an action was taken in breach of a requirement in the articles of association requiring a special resolution to ratify the action, a

⁷⁷² Art.63 of the CCL 1994.

derivative action could be brought by a shareholder against a director for the breach of duty if the breach was unable to be ratified by the company. However, the CCL 1994 is silent on the issue of shareholder derivative suits.

Pistor and Xu argue that because law is incomplete, law enforcement by courts cannot be expected effectively to deter violations.⁷⁷³ The lack of provisions dealing with derivative actions inevitably poses difficulties to both injured shareholders and local people's courts to enforce directors' duties through civil litigation proceedings. For example, in September 2001, the CSRC discovered that Sanjiu plc had allowed its majority shareholders and other affiliated parties, without proper disclosure, to misappropriate RMB 2.5 billion (£192 million) of corporate funds in violation of securities laws and other regulations. The misappropriated funds amounted to ninety-six per cent of Sanjiu's corporate net assets, and posed a considerable threat to the corporation's operation. On July 4, 2002, the CSRC fined Sanjiu plc RMB 500,000 (£38.5K), its chairman Zhao Xinxian RMB 100,000 (£7700), and its board secretary RMB 50,000 (£3850). The CSRC also imposed fines of RMB 30,000 (£2300) on each of the seven board members. On April 8, 2003, one of Sanjiu's individual shareholders in Shanghai applied to the Shenzhen Futian District People's Court to file a lawsuit against its chairman Zhao. There were three claims in his petition: (i) that Zhao should pay RMB 10,000 (£770) to Sanjiu plc as compensation for damages in connection with the misappropriations in Sanjiu plc; (ii) that Zhao should pay RMB

⁷⁷³ K. Pistor and C. Xu, 2003. *Deterrence and Regulatory Failure in Emerging Financial Markets: Comparing China and Russia*, April, 2003, working paper available from: http://www.wcfia.harvard.edu/papers/660_pistorxu.pdf. [Accessed 25 September 2005].

10,000(£770) to Sanjiu plc as compensation for mismanagement that resulted in the CSRC fine for disclosure irregularities; and (iii) that the filing fee of this lawsuit should be paid by Zhao.⁷⁷⁴ The court ruled that the claimant “must obtain authorization from all shareholders of Sanjiu before bringing the lawsuit to the court if he wants to institute an action in the interest of all Sanjiu plc shareholders”.⁷⁷⁵

Clearly, in the Sanjiu case, the defendant has breached his fiduciary duties and should be liable under Article 63 of the CCL 1994 for violating the Securities Law and relevant regulations on information disclosure, as well as Article 80 of the CSRC Directive 1997 which we have discussed in Chapter 7. However, the court ruled that the claim had to be approved by the unanimous consent of the shareholders. In the UK, the courts have the power to permit a shareholder to bring an action despite the rule in *Foss v. Harbottle* (the majority rule) when the interest of justice required it.⁷⁷⁶ Compared with the UK, the Chinese court primarily applied the majority rule, which was curiously borrowed from common law, without being aware that the rule must prevent a director or a majority shareholder from using their position to commit a fraud on the minority or have been conducted in an ‘unfairly prejudicial’ manner.⁷⁷⁷

In fact, there are certain cases that have recently been initiated by injured shareholders

⁷⁷⁴ See Wang, L., 2003. Another First Case Arose in Stock Market – Shareholder Sue Chairman of the Board on Behalf of Company, *Shanghai Securities News*, 9 April.

⁷⁷⁵ See Wang, L., 2003. The First Derivative Action was not Accepted, *Shanghai Securities News*, 22 April.

⁷⁷⁶ See *Foss v Harbottle* and its exceptions discussed in section 8.2 above.

⁷⁷⁷ According to Sanjiu plc 2002 -2003 annual report, the total number of shareholders was 117,174, and the top two shareholders collectively held 72.91% of company shares. Both of them were Sanjiu plc’s affiliates which were involved in the misappropriation of Sanjiu’s corporate funds. In addition Zhao was the CEO of the two largest shareholder companies. Obviously, the court simply relied on the majority rule which partially borrowed from the common law rule, and disregarded the concentrated ownership structure and other special circumstances, would allow the wrongdoers to escape redress.

in China, in which there appears to be reluctance on the part of the courts to hear a case through a derivative action because of a lack of detailed procedures applicable to derivative actions. Consequently, although many company directors have been punished by either administrative sanction or criminal prosecution as a result of making false disclosures, frauds and market manipulations, the injured shareholders have been left without proper remedies in respect of matters of illegal actions.

Article 111 of the CCL 1994 seems to empower the shareholders with the right to assert claims in the event where a resolution of the shareholders' general meeting or a resolution of the board of directors violates the law or administrative regulations or infringes the lawful rights and interests of the shareholders.⁷⁷⁸ This provision seems to allow a shareholder to sue in his/her own name to protect his/her personal rights within a company. Compared with the rule of personal action in the UK, however, this provision fails to specify any necessary substantive and procedural conditions of such an action. Firstly, in the context of Article 111 of the CCL 1994, the shareholders can only bring an action against the violation of the law or administrative regulations, but not in respect of violating the memorandum and articles of association.⁷⁷⁹ There appear to be no remedies available to the shareholders of a company where there is a breach of articles of association of the company by directors or managers of the company, or its controlling shareholders. Secondly, this

⁷⁷⁸ See Art.111 of the CCL 1994

⁷⁷⁹ Art.11 of the CCL 1994 stipulates that the articles of association of a company shall be binding on its shareholders, directors, supervisors and managers. Art. 118 of the CCL 1994 also provides that any directors, supervisors or managers acting in breach of the articles of association of a company shall be liable to compensate the company for its loss. It is not clear why the violation of articles of association should be excluded from Art.111 of the CCL 1994.

provision only provides that the shareholders have a right to bring an action to the court for an injunction to stop the illegal acts or infringing acts, but fails to guarantee any equitable remedies for injured shareholders.⁷⁸⁰ Thirdly, the provision provides limited scope for shareholder actions. As the provision stipulates, the actionable wrongdoing is limited to violation of the law and regulations by a resolution of the shareholder meeting or of the board of directors and prejudices the interests of shareholders. It is not clear at all whether other conduct of the company such as *ultra vires*, which is not violating any law or regulation but is only beneficial to the majority shareholders (e.g. a resolution for providing a loan guarantee for the majority or controlling shareholder of the company), can be challenged by the minority shareholders. Finally, the provision fails to indicate any procedural rule on shareholder litigation. It is far from clear that an action brought by shareholders under Article 111 of the CCL 1994 should be a direct action (personal action) or a derivative action. It also fails to indicate whether the shareholders can sue directors or managers or the majority shareholders who are harmed the interest of the company and its minority shareholders.

8.3.2 Private Securities Litigation against Misrepresentation

Apart from those actions concerning unlawful decisions made at shareholder meetings and board meetings under the CCL 1994, the Chinese Securities Law (the CSL)⁷⁸¹ provides other grounds for shareholder litigation. Article 63 of the CSL states that

⁷⁸⁰ See X. C. Zhang, 1998. Practical Demands to Update the Company Law, 28 *Hong Kong Law Journal*, 248.

⁷⁸¹ The Chinese Securities Law (the CSL) was promulgated on December 29, 1998 and came into effect on July 1, 1999

“[I]f the share prospectus, measures for offer of corporate bonds, financial or accounting report, listing report document, annual report, interim report or *ad hoc* report announced by an issuer or securities underwriting company contain any falsehood, misleading statement or major omission, thus causing losses to investors in the course of securities trading, the issuer or the company shall be liable for the losses and the responsible director(s), supervisor(s) and/or the manager of the issuer or the company shall be jointly and severally liable for such losses.”⁷⁸² Article 207 of the CSL also stipulates that “[I]f the property of a person, who violates the provisions of the law and who therefore bears civil liability for damages and is required to pay a fine, is insufficient to pay both the damages and the fine, such person shall first bear the civil liability for damages.”⁷⁸³ However, such provisions have never been properly enforced due to a lack of detailed procedure rules for how such a private securities litigation (PSL) should be initiated by injured investors and heard by the court.

For example, in April 1999, a shareholder in Shanghai filed a civil suit against Hongguang Enterprise plc. and its directors and managers for financial damage due to the defendant’s accounting fraud, but the court decided not to hear the case even though the CSRC previously determined that the company engaged in fraudulent activities including falsely inflating profits and hiding negative financial information to the public.⁷⁸⁴ The case was dismissed by the court on the ground of that the case

⁷⁸² See Article 63 of the CSL.

⁷⁸³ See Article 207 of the CSL.

⁷⁸⁴ According to the CSRC, Hongguang Enterprise had been engaged in fraudulent behaviour such as: 1) the company falsely reported its 1996 profits and fraudulently obtained qualification to publicly issue shares; 2) the company underreported its 1997 deficit, which defrauded investors; 3) the company concealed a major event when it did not disclose production problems; 4) the company used capital raised from the offering to pay back bank

should be referred to the CSRC to determine and the court had 'no jurisdiction' to hear such a case.⁷⁸⁵

As a result of a series of corporate scandals involving a large number of false disclosures, accounting frauds and market manipulation perpetrated by listed companies, the Supreme People's Court of the People's Republic of China (SPC) enacted new rules entitled "Several Regulations Regarding the Adjudication of Civil Compensation of Securities Cases on the Ground of Misrepresentation" (the Misrepresentation Regulation) which attempts to deal with the irregularity of the procedural and jurisdictional issues.⁷⁸⁶ The Misrepresentation Regulations which contain 37 articles provide detailed rules on the jurisdiction of the courts,⁷⁸⁷ the proper plaintiffs and defendants,⁷⁸⁸ definition of misrepresentation,⁷⁸⁹ the form of PSL litigation,⁷⁹⁰ prerequisites of litigation,⁷⁹¹ and damages.⁷⁹²

loans and make up for past losses, uses which were not in the company prospectus; 5) the company illegally used funds raised from the public offering to buy and sell its own securities in 217 individual securities accounts; and 6) the company was also under suspicion for bribery because 1.66 million yuan could not be accounted for. See Zhengjiacazi [1998] No.75, (CSRC Administrative Investigation No.75, 1998); Cai, W. 1999, *Private Securities Litigation in China: Of Prominence and Problems*, 13, *Columbia Journal of Asian Law*, 135-51, p146.

⁷⁸⁵ See Jiang, D. 2003. *Company Law Report (II)*, Citic Publishing House, p454.

⁷⁸⁶ See "Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding (Several Regulations Regarding the Adjudication of Civil Compensation of Securities Cases on the Ground of Misrepresentation), S.P.C. 2003 No.2. The Misrepresentation Regulations were promulgated on January 10, 2003 and came into effects on February, 2003. Before the promulgation of the Misrepresentation Provisions, the SPC issued a circular on September 21, 2001, imposing a temporary ban on acceptance any personal action against securities fraud by lower courts of on the ground that legislative and judicial conditions were not ripe for hearing such cases. The ban was lifted on 15.01.2002, but only allowed shareholder to sue after the CSRC or its local branches had imposed administrative sanctions. See Lu, G., 2003. *Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme Peoples' Court 2003 Provisions Concerning Private Securities Litigation*, 12, *Pacific Rim Law and Policy Journal*, 718; Hutchens, W., 2003. *Private Securities Litigation in China: Material Disclosure about China's Legal System*, 24, *University of Pennsylvania Journal of International Economic Law*, pp599-689; also see J. Deng, *op cit* fn.675.

⁷⁸⁷ Articles 8, 9 and 10 of the Misrepresentation Regulation provide that the PLS can only be heard by an intermediate-level courts at the place where a defendant is located

⁷⁸⁸ Article 2 of the Misrepresentation Regulations articulates the proper plaintiffs include individuals, legal person or other organisations investing or trading securities in the approved primary or secondary securities markets by the state. However, if the securities transaction is conducted outside the approved securities markets or transactions made by agreements in the approved securities markets could not be sued under the Misrepresentation Regulations. Article 7 of the Misrepresentation Regulations stipulates the proper defendant should be a person who committed misrepresentation, include: (i) promoters and controlling shareholders; (ii) issuers or listed companies; (iii) security underwriters; (iv) listing sponsors; (v) accounting firms, law firms, assets appraisal firms and other

The rules established by the Misrepresentation Regulations could certainly deal with the fraud on minority issues. Compared with the rule of fraud on minority in the UK, however, the Misrepresentation Regulations provide far more restrictive standing requirements which have made it difficult for shareholders to bring an action and recover sufficient damages. Under Misrepresentation Regulations, the shareholders who have been injured by a misrepresentation, made by a person with a duty of disclosure in violation of the law, may bring an action to the people's court to assert a claim for damages. However, in order to bring an PSL, the plaintiff has to overcome many procedural and substantive hurdles, such as jurisdiction limitations, prerequisites of litigation, and burden of proof of the causal connection between the shareholders' loss and defendants' misrepresentations. By the end of 2003, as many as 14 companies were involved in shareholder litigation, and more than 900 cases were accepted by the nine courts across the country.⁷⁹³ Some cases have been heard by the

professional intermediaries; (vi) directors, supervisors and senior executives of the firms listed in (ii), (iii) and (iv) above and individuals who employed by the professional intermediaries listed in (v), are directly responsible for the misrepresentation; and (vii) a misrepresentation is committed by other organisations or individuals.

⁷⁸⁹ The misrepresentation is clearly defined as "a misrepresentation made by a person who is with a disclosure duty, violates the securities law and regulations in the process of issuing or trading securities, provides an untrue statement of fact in the form of materially false records, misleading statements, material omission, or inappropriate disclosures". See Article 17 of the Misrepresentation Regulations.

⁷⁹⁰ The PSL may be filed by the plaintiff either as an individual action or a joint action. If two or more litigations arose by multiple plaintiffs on the ground against the same defendant for the same misrepresentation, the court may merge these litigations into a joint action. The court may notify those plaintiffs who filed an individual action to join a joint action if individual actions and joint actions arose by multiple plaintiffs on the ground of the same misrepresentation against the same defendant. The number of plaintiffs in a joint action must be fixed before the case is heard. A representative action is allowed if there are numerous plaintiffs in a joint action.

⁷⁹¹ Article 6 of the Misrepresentation Regulations that shareholders cannot bring an action until an administrative or criminal sanction has been imposed on the defendant.

⁷⁹² Under article 30 of the Misrepresentation Regulations, the injured shareholders are only allowed to claim the actual damages. The damages are counted including the differences between the buying and selling price, commissions and stamp duty paid by transaction, and interests which computed in reference to the bank deposit interest rate. See Article 30 of the Misrepresentation Regulations.

⁷⁹³ Companies as defendants sued by shareholders include: ST Shandong Bohai, ST Tongda, ST Dongfang Dianzi, Daqing Lianyi, ST Jiabao Shiye, ST Yinguangxia; Sanjiu Yaoye; ST Hongugang; ST Jiuzhou; Jinzhouguang; ST Shengfangke; Hubei Tianyi; PT Zhengbaiwen; Shenxinkai. See N. Li, 2004. Civil Litigation against China's Listed Firms: Much ado about nothing?" Asia Programme Working Paper, No.13, February; J. Yang, 2005. Comparative Corporate Governance: Reforming Chinese Corporate Governance. *International Company and Commercial Law Review*, 16(1), 8-17.

courts and a few cases have been withdrawn because of an inconsistency with Arts 18 and 19 of the Misrepresentation Regulations.⁷⁹⁴ Nevertheless, there has been no single compensation judgment made by any of the courts; instead some of them have been settled out of court.⁷⁹⁵ In some cases, judgment is overdue according to the Chinese Civil Procedural Rules.

8.3.3 *New Rules Governing Shareholder Actions*

In China, apart from the inadequacy of the law in respect of directors of duties, the other problem which is often discussed by both academics and legal practitioners is the lack of an effective mechanism for shareholders to bring an action against directors for wrongdoing. For example, Liu points out that “to make directors and managers accountable to the corporation and its stakeholders, it is urgent to deal with the loopholes in current legislation and enforce the responsibility of the directors and managers through various means, in particular the shareholders’ derivative actions.”⁷⁹⁶ Lee argues that the lack of express remedies for the aggrieved shareholders in the Securities Law creates unnecessary ambiguity and confusion which is wholly inconsistent with other statutory remedies in Chinese Law.⁷⁹⁷ Hu argues that due to the insufficient legal infrastructure in China, it will be difficult to hold violators of the laws accountable for their wrongdoings.⁷⁹⁸ Indeed, although the

⁷⁹⁴ Arts 18 and 19 of the Misrepresentation Regulations provide certain elements of the legal reliance and causation for testing the link between the alleged misrepresentation and the claimant’s buy-sell decision and the link between the securities transaction and the claimant’s loss.

⁷⁹⁵ To date, only two cases have been settled through court mediation in Chengdu and Shanghai.

⁷⁹⁶ see Liu, J., 1999. *Legal Reforms in China*, ZEF Discussion Papers on Development Policy 13, Centre of Development of Research, Bonn, August.

⁷⁹⁷ See Lee, S. M., 2001. *The Development of China’s Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law*, (14) *New York International Law Review*, 1.

⁷⁹⁸ Hu, R., 2002. *The Recent Development of Corporate Governance in Great China Area, Shareholder Rights and*

CCL 1994 demonstrates significant effects in making directors and managers perform their duties in the best interests of companies and their shareholders, evidence shows that the enforcement of the law has been very problematic in China.

The recently published “Regulation on Some Issues Concerning Trials for Corporate Dispute Cases (I)” by the Supreme People’s Court (the “SPC Regulation”) contains twelve provisions regarding shareholder actions, aimed at improving minority shareholder protection.⁷⁹⁹ Under the SPC Regulation, besides being able to sue a company for wrongs committed directly against them (including the infringement of shareholders’ right to corporate information, violation of articles of association; dividends paid against the resolution of the shareholder meeting etc.), individual shareholders may bring derivative actions against directors, supervisors, managers or other members of senior management for violation of their fiduciary duty of loyalty, and the controlling shareholders who take advantage of their controlling power to the detriment of the company’s interests.⁸⁰⁰

Article 44 of the SPC Regulation stipulates two prerequisites for a derivative action. First, it requires the derivative suit shareholders to meet the ‘contemporaneous ownership rule’, which means the derivative suit plaintiff must have been a

the Equitable Treatment of Shareholders, The Fourth Asian Roundtable on Corporate Governance, November.
⁷⁹⁹ See Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Guiding (Yi) (Zhengqiu Yijian Gao), [The Regulations on Some Issues Concerning Trials for Corporate Dispute Case (I) of the Supreme People’s Court. November 04, 2003. Available from: http://www.chinacourt.org/public/detail.php?id=88551&show_all_img=1 [Accessed 15 October 2005].

⁸⁰⁰ See Article 36-43 of the SPC Regulation.

shareholder and continuously held shares at the time that the cause of action arose.⁸⁰¹

Second, it requires the derivative suit shareholders to satisfy “threshold requirements”- a complainant shareholder of a limited liability company filing a derivative action shall hold not less than 10% of company issued shares, and a complainant shareholder of a publicly listed company should hold not less than 1%.⁸⁰²

Although the first prerequisite is not grounded on antipathy to derivative action, it is still difficult to justify the contemporaneous ownership rule because, on the one hand, the existence of the rule might prevent the buying of shares by litigious persons who might bring frivolous suits.⁸⁰³ On the other hand, the rule might allow the wrongdoers to escape from damages which they deserved to compensate the shareholders because those shareholders did not hold the stock before the wrongdoing has been discovered.⁸⁰⁴ Nevertheless, the second prerequisite is somewhat unrealistic because apart from the top three shareholders, no individual shareholder in general can meet this requirement individually.⁸⁰⁵ Consequently, a collective action is required for minority shareholders to initiate a derivative action.

Under Article 45 of the SPC Regulation, the demand requirement for a derivative action is specified. Before bringing a derivative action, a complainant shareholder

⁸⁰¹ There is an alternative opinion stipulated in Article 44 (1) of the SPC Regulation, which is the so-called “six-month shareholding rule” which requires that the plaintiff shareholder own shares of the company for an uninterrupted six-month period to the occurrence of the wrongdoing. The rule was derived from the Japanese law. See Shiro Kawashima and Susumu Sakurai, 1997. *Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms*; 33 *Stanford Journal of International Law*. 9-60, at 10.

⁸⁰² See art.44(2) of the SPC Regulation.

⁸⁰³ See Robert Clark, 1997, *Corporate Law*, Aspen Law & Business, Panel Publisher, §15.4 at p651.

⁸⁰⁴ *Ibid.*

⁸⁰⁵ According to our survey of the ownership structure of companies listed on the Chinese Stock Exchange, the median proportion of shares held by the largest shareholder is in excess of 45%, the second largest is about 5%, the third is about 3%, and afterwards, no individual shareholder held more than 1% of company's issued shares. See Table 4.4(a) in Chapter 4.

shareholder and continuously held shares at the time that the cause of action arose.⁸⁰¹

Second, it requires the derivative suit shareholders to satisfy "threshold requirements"- a complainant shareholder of a limited liability company filing a derivative action shall hold not less than 10% of company issued shares, and a complainant shareholder of a publicly listed company should hold not less than 1%.⁸⁰²

Although the first prerequisite is not grounded on antipathy to derivative action, it is still difficult to justify the contemporaneous ownership rule because, on the one hand, the existence of the rule might prevent the buying of shares by litigious persons who might bring frivolous suits.⁸⁰³ On the other hand, the rule might allow the wrongdoers to escape from damages which they deserved to compensate the shareholders because those shareholders did not hold the stock before the wrongdoing has been discovered.⁸⁰⁴ Nevertheless, the second prerequisite is somewhat unrealistic because apart from the top three shareholders, no individual shareholder in general can meet this requirement individually.⁸⁰⁵ Consequently, a collective action is required for minority shareholders to initiate a derivative action.

Under Article 45 of the SPC Regulation, the demand requirement for a derivative action is specified. Before bringing a derivative action, a complainant shareholder

⁸⁰¹ There is an alternative opinion stipulated in Article 44 (1) of the SPC Regulation, which is the so-called "six-month shareholding rule" which requires that the plaintiff shareholder own shares of the company for an uninterrupted six-month period to the occurrence of the wrongdoing. The rule was derived from the Japanese law. See Shiro Kawashima and Susumu Sakurai, 1997, *Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms*; 33 *Stanford Journal of International Law*. 9-60, at 10.

⁸⁰² See art.44(2) of the SPC Regulation.

⁸⁰³ See Robert Clark, 1997, *Corporate Law*, Aspen Law & Business, Panel Publisher, §15.4 at p651.

⁸⁰⁴ *Ibid.*

⁸⁰⁵ According to our survey of the ownership structure of companies listed on the Chinese Stock Exchange, the median proportion of shares held by the largest shareholder is in excess of 45%, the second largest is about 5%, the third is about 3%, and afterwards, no individual shareholder held more than 1% of company's issued shares. See Table 4.4(a) in Chapter 4.

must first make a demand on the company to act so as to remedy the situation about which he/she complains.⁸⁰⁶ Only if the company fails to act within two months may the demanding shareholders initiate a derivative action on behalf of the company.⁸⁰⁷

The exemptions from this prerequisite are: (i) the property stake related to the action will be transacted to the third party and the related rights allegation period or limitation of action will expire; or (ii) any other case of urgency forcing the plaintiff to initiate an immediate action. The demand requirement is apparently derived from the common law system which aimed at implementing the basic principle that directors owe duties to the company, not to the shareholders.⁸⁰⁸ Whether to sue or not to sue is ordinarily a matter for the business judgement of directors.

The demand requirement has been supported for the judicial economy purpose in practice. It seems to be justified because:

- (i) if the directors decide that the company should take an action against the wrongdoer, then making the derivative action would be unnecessary.⁸⁰⁹
- (ii) in some cases the directors may take such steps as to correct or remedy the situation that formed the basis for the derivative action, thus the courts will be saved from ruling such cases.⁸¹⁰

⁸⁰⁶ See art.45 of the SPC Regulation.

⁸⁰⁷ see art.45 (1) of the SPC Regulation.

⁸⁰⁸ See Robert Clark, *op cit.* fn.803. p641

⁸⁰⁹ *ibid.*

⁸¹⁰ *ibid.*

- (iii) the demand requirement will also prevent the litigious shareholders from bringing frivolous suits and for personal gains.⁸¹¹

Although the benefit of having the demand requirement for derivative action cannot be denied, many commentators have felt that the approach may still require clarification or elaboration. For example, in China, the publicly listed companies operate a two-tier board system with independent directors incorporated in the board of directors. Therefore, when it is alleged that directors or supervisors or managers have breached their duties, who should be responsible on the demand requirement to decide whether the company should initiate litigation against the wrongdoers or not? In addition, the SPC Regulation fails to specify what happens if a shareholder does make a demand to the company to sue someone and the directors refuse to do so or the company commences an action, but fails to prosecute diligently. In both situations, the question arises as to whether the individual shareholders can apply to the court for leave to take over the action. Finally, the notice requirement seems to be sound. However, given that the intention of the notice requirement is to allow the company to decide whether to bring proceedings itself, it must be considered doubtful that some companies may not make a proper response in the time specified, while a long waiting period can potentially cause irreparable harm to the company.⁸¹² Indeed, the derivative action rule aims initially to promote a more rational process with less cost and more time efficiency than the traditional litigation process. Clearly, the SPC

⁸¹¹ *ibid.*

⁸¹² see J. Deng, *op cit.* fn.675.

Regulation requiring the derivative action's plaintiff to serve a notice to the company two months before instituting a derivative action would be time consuming and expensive for the individual shareholders.

The problems mentioned above reveal some aspects of inefficiency and ineffectiveness of the Chinese judicial system. Lack of the basic principles, rules and standards that govern the proper behaviour of directors is very cumbersome for an individual shareholder to sue directors who breach their duties. The loopholes of the CCL 1994 certainly made it difficult for the court to deliver the law to protect the interests of the company and its shareholders. The proposed new measures under the SPC Regulation seem to have not been formulated properly during the development of the proposal. Nevertheless, the CCL 2006 envisages the foregoing problems. Article 150 of the CCL 2006 states that a director, a supervisor or any senior officer shall be liable for any losses of the company if he/she violates any provisions of laws, or administrative regulations, or the articles of association of the company in performance of his/her official duties.⁸¹³ In addition, Article 152 of the CCL provides certain procedural rules, stating that shareholder(s) who have either individually or collectively held more than one per cent of the shares of the company for more than 180 consecutive days may petition in writing to the supervisory board to initiate legal proceedings against the wrongdoing director or senior officers in the people's court. If a supervisor commits any of the acts described in Article 150 of the CCL 2006, the

⁸¹³ See art.150 of the CCL 2006

aforementioned shareholders may petition in writing to the board of directors to initiate civil proceedings against the supervisor in the people's court.⁸¹⁴ If the supervisory board or the board of directors refuses or fails to initiate any legal proceedings upon receipt of the written petition put forward by the shareholders, or fails to initiate any proceedings within 30 days of the receipt of shareholders' petition, or the situation is so emergent that the company will suffer irreparable losses if legal proceedings are not initiated immediately, the shareholders as prescribed above shall have the right to directly initiate legal actions in the people's court in their own name for the benefits of the company.⁸¹⁵ The CCL 2006 also extends the right for shareholders to sue any person who encroaches upon the lawful rights and interests of the company, thus causing any loss to the company in accordance with the provisions of Article 152. Inevitably, the CCL 2006 has strengthened the position of both minority shareholders and the supervisory board.

Nevertheless, certain rules governing the derivative action, such as the threshold requirement and the demanding requirement under the CCL 2006 may still be quite expensive and burdensome, and could unduly deter the bringing of derivative actions by minority shareholders in China.⁸¹⁶ In comparison, in the UK, the need for a particular number of shareholders or a percentage threshold of shareholding to launch

⁸¹⁴ *ibid.* art.152

⁸¹⁵ *ibid.*

⁸¹⁶ In China, on the one hand, 1% of company issued share capital in most listed companies would mean hundreds of thousands of shares and a collective action by minority shareholder will be always necessary to satisfy the threshold requirement. On the other hand, most companies are controlled by the majority/controlling shareholders who have their representatives seating in the boards. Therefore, both demands on shareholders based on a percentage and demands on the board of directors/supervisory board will make it difficult for minority shareholders to initiate a derivative action.

a derivative claim is not literally stated in the Bill. Instead the Bill leaves the power to the court to exercise its discretion to refuse or grant permission to continue a derivative claim based on the facts of the breach and the principle of good faith. Note, however, this approach would need strong courts as independent institutions and ensure that they have sufficient resources to fulfil this task. However, it seems unwise to transplant this approach to China because the Chinese courts are widely perceived to lack independence or inexperience in dealing with corporate and securities' disputes or both. While in China, some problems seem to remain, implementation of the new rules will take time. The key question of whether the amended rules governing shareholder derivative action have any real 'teeth' against the wrongdoing directors in China remains to be seen.

8.4 Conclusion and Comparative Perspectives

An effective corporate governance system comprises a series of laws, regulations, voluntary codes and by-laws, along with well-established enforcement mechanisms to govern the relationships between the people who effectively control corporations (directors or majority shareholders) and those who invest in them (minority shareholders). From a comparative perspective, the enforcement rules in China are essentially weak and incomplete compared with the UK. Although there is the case law in the UK spawned by the rule in *Foss v Harbottle* which has made it difficult for minority shareholders to bring an action on behalf of a company against wrongdoing directors, certain exceptions have been formulated and affirmed to allow minority

shareholders to enforce directors' duties by the courts. In comparison, in China, the Misrepresentation Regulations seem to have provided shareholders with a private right of action against wrongdoing parties, including directors. However, the incomplete procedural and substantive rules and an insufficient justice system have inevitably been barriers to the effectiveness of law enforcement in China. In addition, both China and the UK have proposed to incorporate statutory derivative action into their company law. In this way, there is no doubt that China has decided to encourage shareholders to use the statutory derivative action to improve the enforcement of directors' duties. Technically, however, a derivative action rule would not work without a clearly defined procedural framework. By examining the proposed provisions of derivative action, it is evident that the proposed new derivative action by the SPC has limitations in many aspects, including the prerequisites to the derivative action and demanding requirements. Some provisions are enacted merely in an abstract way which may cause some difficulties for the shareholders and the courts to apply them in practice. Therefore, the derivative action rules drafted by the SPC need to be modified in the light of the CCL 2006 before they come into operation.

Effective enforcement also demands a properly functioning, creditable, and independent judicial system. In the UK, the courts have long wrestled with the issue of when and with what degree of scrutiny they should consider a shareholder's entitlement to bring an action on behalf of the company. However, the Chinese courts and judges have not been empowered in the same way as in the UK. Although China

has adopted the principles of minority shareholder protection from the Anglo-American system under the CCL 2006, Chinese courts have not yet fully evolved to deal effectively with disputes among company minority shareholders, directors and majority shareholders by a derivative action or private securities litigation for the infringement of rights in the securities markets, and to provide a specific and effective juridical basis for the protection of the lawful rights and interests of investors. Government intervention, political influence, local protectionism and other forms of corruption significantly affect judicial independence and impartiality in the litigation process. The legal and judicial independence assumes greater importance in safeguarding the interests of minority shareholders in China. If the courts do not act independently, they will be unable to deliver real justice and remedies for injured shareholders.

CHAPTER 9

CORPORATE GOVERNANCE AND CORPORATE PERFORMANCE: AN EMPIRICAL ANALYSIS

9.1 Introduction

From an economic perspective, the corporate governance system is concerned with the creation of wealth through the maximisation of the economic efficiency of corporations. The previous chapters explored how the corporate governance system was formed and evolved in China compared with the UK and identified the key factors that have significantly influenced the health of corporations and the institutional environment for better corporate governance in China, using a functional comparative approach. However, it is difficult to predict how China could improve its corporate governance system without a further investigation of the relations between Chinese corporate governance mechanisms and corporate performance. Therefore, this chapter reviews empirical evidence concerning the impact of corporate governance on economic performance and investigates the relationship between corporate governance and corporate performance in Chinese listed companies, which will be highly valuable for the development of the Chinese corporate governance system. However, this study does not measure the market for corporate control as an external mechanism in determining the changes of firm value because it is virtually non-existent in China. In addition, as the legal duties imposed on directors and the role of shareholders in enforcing directors' duties through shareholder litigation

cannot be precisely quantified, this study does not assess their relationship with corporate performance either. Thus, the focus of this investigation is to test mainly the relationship between the internal part of corporate governance (specifically the ownership structure, shareholder activism, and internal monitoring and control of management mechanisms) and corporate performance.

9.2 Literature Review and the Development of Hypotheses

9.2.1 Ownership Structure and Corporate Performance

Property rights have been broadly discussed by both law and economic theory for many decades. Property rights in a firm confer shareholder's ownership with the residual right over the firm's assets.⁸¹⁷ But shareholders in a modern publicly listed company may not be able to make such a claim effectively because of the separation of ownership and control emphasised by Berle and Means.⁸¹⁸ The dispersion of ownership which creates agency problems has an important impact on the objective of implementing value maximisation for shareholders.⁸¹⁹

Studies directly applying insights from property rights theory and investigating the link between ownership structure and corporate performance began to appear in the 1980's. The characteristics of these studies focus on the relationship between

⁸¹⁷ Hart and Moore state: "we identify a firm with the assets it possesses and take the position that ownership confers residual rights of control over the firm's assets: the right to decided how these assets are to be used except to the extent that particular usages have been specified in an initial contract". Hart, O. and J. Moore, *op cit.* fn.70, at 1120.

⁸¹⁸ See Berle and Means, *op cit.*fn.1.

⁸¹⁹ M. Jensen and J. Meckling, *op cit.* fn.84. and Fama, E. and M. Jensen, *op cit.* fn.547.

concentration of shares and firm performance. For example, an empirical study based on a cross-section of 511 U.S. firms by Demsetz and Lehn claims that there is no cross-sectional relation between accounting rates of return and the concentration of shareholding.⁸²⁰ Mehran finds no significant relation between firm performance and the holdings of a variety of different types of blockholders, including individuals, institutions, and corporations.⁸²¹ Goergen examines the relationship between financial performance and ownership in German and UK firms, by classifying the identity of shareholders into six categories – families, domestic companies, foreign companies, banks, non-bank institutional investors, and charities. He finds that the evolution of ownership depends on certain corporate characteristics, but that differences in financial performance cannot be explained simply by differences in the concentration of ownership.⁸²²

In contrast, Morck, Shleifer, and Vishny find that there is a nonlinear relationship between board ownership and company performance, as measured by Tobin's Q.⁸²³ McConnell and Servaes finds that the relationship between insider equity ownership and Tobin's Q is an "inverse U-shape", with Tobin's Q reaching its maximum value when insiders own approximately 40 per cent of the shares.⁸²⁴ In a study of 435 of the

⁸²⁰ This study was conducted by an OLS regression of ownership concentration on size, control potential, regulation, and amenity potential and a recursive regression of the mean accounting rate of return on the alternative predicted values of ownership concentration, regulations, book value of assets, capital expenditure, advertising and R&D expenses. Ownership concentration is defined as a continuous variable representing either the holding of the top five shareholders and of the top twenty shareholders. See Demsetz, H. and Lehn K. *op cit.* fn.110.

⁸²¹ Mehran, H. *op cit.* fn.112.

⁸²² Goergen, M. 1998. *Corporate Governance and Financial Performance: A Study of German and UK Initial Public Offerings*, Cheltenham: Edward Elgar

⁸²³ See Morck, R., A. Shleifer, and R. Vishny, *op cit.* fn.38.

⁸²⁴ McConnell, J.J. and Servaes, H. 1990. Additional Evidence on Equity Ownership and Corporate Value. *Journal of Financial Economics* 27, 595-612

largest European companies, Thomsen and Pedersen also find that the relationship between ownership concentration and economic performance is nonlinear so that ownership concentration beyond a certain point leads to entrenchment and has adverse effects on performance.⁸²⁵ To reflect ownership identity on firm performance, Agrawal and Knoeber argue that concentrated shareholding by institutions or by blockholders can increase managerial monitoring and improve firm performance.⁸²⁶ Using a cross-section study of 706 firms from the Czech Republic for the period 1992-97, Claessens et al find that there is a significant positive relationship between the concentrated ownership and firm market valuation or profitability.⁸²⁷ Compared with other owner identities, Thomsen and Pedersen also find that financial investor ownership is associated with higher shareholder value and profitability.⁸²⁸

Several empirical studies of China have demonstrated that ownership structure is an important determinant of the performance of a corporation. For instance, Xu and Wang find that a firm's profitability is correlated with the fraction of legal person shares, but is negatively correlated with the fractions of state shares and tradable A-shares held mostly by individuals.⁸²⁹ Hovey et al claim that ownership concentration has little explanatory power but ownership structure does matter. Legal persons' shareholdings are positively related to firm valuation.⁸³⁰ Chen and Gong suggest that

⁸²⁵ Thomsen, S. and T. Pedersen, 2000. Ownership Structure and Economic Performance in the Largest European Companies, *Strategic Management Journal*, 21: 689-705.

⁸²⁶ Agrawal, A. and C. R. Knoeber, *op cit.* fn.174.

⁸²⁷ Claessens, S., Diankov, S. and Pohl, G. 1997. *Ownership and Corporate Governance: Evidence from the Czech Republic*, World Bank Policy Research Working Paper No.1737.

⁸²⁸ See S. Thomsen and T. Pedersen, *op cit.* fn.825.

⁸²⁹ Xiaonian Xu and Yan Wang, *op cit.* fn.214.

⁸³⁰ M. Hovey, L. Li and T. Naughton, 2003. The Relationship between Valuation and Ownership of Listed Firms in China. *Corporate Governance*. 11(2), 112-122.

there is a strong relation between ownership concentration and corporate performance, measured by Tobin's Q. A further classification of owners reveals that while shares held by the state play a negative role in corporate governance, domestic institutional and managerial shareholdings improve the firms' performance.⁸³¹ Tian finds an "inverse U-shaped" relationship between the shareholding stakes of the government and corporate value. His results indicate that corporate value is lower with a larger stake of government ownership when the government is a small shareholder, but it increases with increased state shareholding when the government is a large shareholder.⁸³²

Although the relationships between ownership structure and firm performance have been investigated by many empirical researchers over many countries, it is noteworthy that they have yielded some mixed or inconsistent results. This inconsistency can be attributed in part to the measure of ownership structure used by different researchers in different countries. Indeed, since ownership structure varies greatly across countries,⁸³³ while firm performance may have a positive relationship with ownership structure in one country, it may have a negative or no relationship in another country. Therefore, the findings in a particular country cannot be generalised to other countries. In addition, there is a unique classification of shares in China which differs quite substantially from that observed in the Anglo-American system.

⁸³¹ Y. M. Chen and S. C. Gong, 2000. Ownership Structure and Corporate Performance – Some Chinese Evidence, *Advances in Pacific Basin Financial Markets*, 6, 177-193.

⁸³² G. L. Tian, 2000. *State Shareholding and the Value of Chinese Firms*. Working paper London Business School.

⁸³³ See La Porta et al. 1999. *op cit.* fn.154.

As we discussed in Chapter 4, a typical listed company in the Chinese stock markets has a mixed ownership structure comprising three predominant groups of shareholders – the state, legal person and tradable A shareholders. Therefore, a set of variables that is used to study a specific country cannot be an appropriate set of variables in China. Simply following the empirical method and the definition of ownership structure or concentration of ownership without taking into account the essential insight on the identity of the shareholders may lead to a wrong conclusion.⁸³⁴

Both theoretical and empirical studies on the relationship between firm performance and ownership structure reviewed above have motivated this study to use a multivariate approach by considering both ownership concentration and identification of ownership to capture the relationship with firm performance. The descriptive data on ownership concentration and the identity of shareholders in China have been discussed in Chapter 4. The results indicate that the shareholding and identity of the largest shareholder is a fairly good measure of ownership structure because in China the largest shareholder generally holds a high proportion of a company's shares with their unique identities. Based on the distinctive features of ownership structure of Chinese listed companies, the tested hypotheses are as follows:

H_{1a}: *There is an inverted U-shaped relationship between ownership concentration and company performance (first increasing, then decreasing).*

⁸³⁴ Liu, G. S. and P. Sun, 2005. Ownership and Control of Chinese Public Corporations: A State-dominated Corporate Governance System, in *Corporate Governance: Accountability, Enterprise and International Comparisons*, ed. K. Keasey, S. Thompson and M. Wright, John Wiley & Sons Ltd.

H_{1b}: *Where the government agency retains a substantial stake, company performance is lower.*

H_{1c}: *Where an SOE retains a substantial stake, company performance is higher.*

H_{1d}: *Where a non-financial company retains a substantial stake, company performance is higher.*

H_{1e}: *Where a family or individual investor retains a substantial stake, company performance is higher.*

9.2.2 Shareholder Activism and Corporate Performance

Shareholder activism is defined as a process in which the shareholders exercise the rights of share ownership to influence management decisions and enhance the benefits of the company's shareholders. There are many ways for shareholders to get involved in corporate control, including correspondence and meetings with management, communication with other shareholders, raising questions at the AGM, proposing shareholder resolutions, and proxy voting. In the UK and the US, large companies are listed in the stock markets and have their ownership dispersed among institutional and individual investors. By the end of 20th century, institutional shareholders had begun to perform a very significant function in challenging management over matters of corporate governance through shareholder activism to prevent directors from abusing their power.⁸³⁵ Despite some successes resulting from the implementation of

⁸³⁵ For example, the Investor Responsibility Research Centre (IRRC) survey shows in 1987, the average vote in favour of proposal opposing poison pill was 29.4%, and the vote in favour of proposal to declassify the board was 17.5%. By the year 2002, both sets of votes averaged more than 60%. See Klausner, M., 2003. Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage, 152 *University of Pennsylvania Law Review*.755, at 757.

shareholder activism, there has been very limited empirical research investigating the effects of shareholder meeting-related mechanisms on firm performance.

Nevertheless, there are several empirical works concerned with the activities of particular institutional investors in the US. Michael Smith, for example, focuses on the California Public Employees' Retirement System (CalPERS) and finds statistical evidence that shareholder activism results in a significant increase in shareholder wealth.⁸³⁶ Carleton et al examine shareholder proposals produced by the Teachers Insurance Annuity Association – College Retirement Equity Fund (TIAA-CREF) and argue that the benefits from activism are highly related to the type of governance issue targeted. The average abnormal return for proposals to increase board diversity is negative, whereas the proposals for blank check preferred issues are significantly and positively associated with the average abnormal returns. However, they find no significant changes in accounting measures of performance surrounding targeting or changes, regardless of the issues.⁸³⁷ To measure the success of shareholder mechanisms, Gillan and Starks examine the short-term stock market reaction to the revelation of a corporate governance proposal in the proxy statement. They find that the market reaction differs somewhat across issues, with significant investor reaction only in the case of institutional or co-ordinated 'poison pill' and individual proposals seeking the adoption of cumulative voting.⁸³⁸ It is clear that this literature on

⁸³⁶ Smith, M. 1996. Shareholder Activism by Institutional Investors: Evidence from CalPERS, *Journal of Finance* 51, 227-252, at 251.

⁸³⁷ Carleton, W. T., J. M. Nelson, and M. S. Weisbach, *op cit.* fn. 111.

⁸³⁸ Stuart L. Gillan and Laura T. Starks, 2000. Corporate Governance Proposals and Shareholder Activism: the Role of Institutional Investors. *Journal of Financial Economics* 57, pp275-305, at 209.

shareholder activism which is mainly based on the activities of US institutional shareholders, offers some ambiguous evidence on corporate performance.

It is apparent that the shareholder meeting has provided a permanent platform for the emergence of shareholder activism. The effectiveness of shareholder activism is supposed to lead to better corporate performance by generating shareholder engagement and interference as necessary in a shareholder meeting to ensure an appropriate board with an incentive to deliver long-term shareholder value. Edkins and Bush argue that any movement towards “activism” without an economic focus on outcomes could result in more voting and more meetings with companies, but no improvement in performance.⁸³⁹ Thus, this study measures the relationship between corporate performance and shareholder activism through a broader set of activities at shareholder meeting, including the turnout ratio at the AGM, voting level at the AGM, and shareholder proposals submitted at the AGM.

The AGM is a central element of the corporate governance system in every jurisdiction. The study’s emphasis on the empirical implication of the impact of the turnout ratio of the AGM on firm performance is novel in corporate governance studies. Under agency cost theory, on the one hand, there are definitely some costs generated by taking part in the shareholder meeting, including both time and travel

⁸³⁹ Edkins, M., and T. Bush, 2002. Encouraging Shareholder Activism: An Consultation Document, 17 May. Hermes, at p1. The document is available from: http://www.hermes.co.uk/pdf/corporate_governance/commentary/encouraging_shareholder_activism_170502.pdf [Accessed 22 February 2005].

expenses for any active individual shareholder. On the other hand, there are also benefits, including seeking to influence management decisions, exercising voting power on controversial or exceptional resolutions, and appointment or removal directors. If certain shareholders are acting as monitors of management behaviour, corporate performance will be better, and the turnout ratio at the AGM is a good proxy for the measurement of the active monitoring of the board of directors, which will reduce agency costs, and in turn, increase firm value.

Under contractual theory, voting exists in corporations because shareholders must have the residual power to act or delegate when contracts are not complete.⁸⁴⁰ The exercise (or rather non-exercise) of voting rights by the eligible shareholders at the shareholder meetings has been a matter of concern in many countries. As we have discussed in Chapter 5, the company law and the constitutional document of the company do not actually require the shareholders to exercise their votes in China and the UK. The voting level entirely depends on shareholders' incentive and their capacity which are again in line with agency cost theory. In China, there has been some evidence that the shareholder meetings in listed companies have, in general, a lower attendance ratio with a higher voting level, which results from the concentrated ownership structure.⁸⁴¹ A common approach in empirical studies in corporate governance has been to focus on the impact of ownership structure. However, little

⁸⁴⁰ Easterbrook and Fischel, 1983, *op cit.* fn. 82, p403.

⁸⁴¹ The survey of the 2002/2003 AGMs of Chinese listed companies conducted by the author shows that the average turnout at the AGM was about 15 people, which means only about six in ten thousand shareholders attend the AGM. About 64% of companies had less than 10 shareholders attending the AGM. However, the average voting level represented by these shareholders was about 57% of the total voting capital of the company. See chapter 5.

has been said about how voting rights are exercised and the impact on corporate performance. This study will fill a gap in this field, and test the hypothesis that the shareholder voting level is positively associated with corporate performance.

Shareholder proposals represent direct attempts to improve the operating and governance performance of publicly listed companies.⁸⁴² Smith examines the wealth effects of 51 US firms during the period of 1987-1993 and finds that for the shareholder proposals passed at annual meetings, abnormal returns are positive and significant on proxy mailing dates. For those proposals that fail, abnormal returns are negative and significant. He concludes that the largest and most powerful institutional investor, such as CalPERS, plays an important role in monitoring managers, improving performance, and increasing firm value.⁸⁴³ In China, shareholder proposals are normally filed by the top three shareholders of the company either individually or jointly⁸⁴⁴ and most of these shareholders are either SOEs or non-financial companies.⁸⁴⁵ Although they differ from institutional investors in terms of identity, as commercial entities both SOEs and non-financial companies have the power and incentive to exert influence on a company's operational management or general and

⁸⁴² J. M. Forjan, 1999. The wealth effects of shareholder-sponsored proposals, *Review of Financial Economics* 8, p61-72.

⁸⁴³ M. Smith, *op cit.* fn.836, at251.

⁸⁴⁴ In the 2002/2003 survey, out of 22 proposals put forward by shareholders at the AGM in 18 Chinese listed companies, 18 proposals were submitted by the top three shareholders individually, and 11 of them were from the largest shareholders, 6 of them were from the second largest shareholder and 1 of them was from the third largest shareholder; 2 proposals were submitted by the largest shareholder and the third largest shareholder jointly; 1 proposal was submitted by the top two shareholders jointly; and 1 proposal was submitted by the top three shareholders jointly. See chapter 5.

⁸⁴⁵ In the 2002/2003 survey, out of the 22 proposals put forward by the shareholders at the AGM in 18 Chinese listed companies, 20 proposals involved either SOE shareholders or non-financial company shareholders or both, whereas only 2 proposals had institutional shareholders involved. See chapter 5.

specific policies. Therefore, the study expects that there is a positive effect of shareholder proposals on corporate performance.

The hypotheses on the relations between shareholder activism and firm performance are as follows:

H_{2a}: Where the turnout ratio at the AGM is higher, company performance is higher.

H_{2b}: Where the company voting level at the AGM is higher, company performance is higher.

H_{2c}: Where the company has shareholder proposals put forward at the AGM, company performance is higher.

9.2.3 The Board of Directors and Corporate Performance

There are a large number of academic studies that have investigated the role and characteristics of the board of directors and their effects on firm performance. Fama and Jensen focus on contract theory and suggest that the separation of decision management and decision control in the decision process can alleviate the agency problem.⁸⁴⁶ Fama and Jensen argue that there are internal control devices, such as outside board members and mutual monitoring systems to limit the discretion of executive directors. Outside directors have an incentive to monitor management actions since they have staked their reputation as professional corporate referees. Consequently, the board of directors with a higher proportion of independent directors

⁸⁴⁶ Eugene F. Fama and Michael C. Jensen, *op cit.*fn.547.

will perform the critical function of monitoring and rewarding top executives to ensure maximisation of shareholders' wealth.⁸⁴⁷

Fama and Jensen's theory has motivated much of the discussion of the influence of the board, non-executive directors, separate chairperson and chief executives, and the board committees on different dimensions of company performance. Baysinger and Butler examine the relationship between board composition and corporate financial performance. They find that outside directors monitor management, reduce agency costs and therefore increase profitability.⁸⁴⁸ Weisbach shows that there is a close relation of CEO turnover to performance in firms where non-executive directors dominate the board.⁸⁴⁹ Rosenstein and Wyatt also find that outside directors are perceived to improve shareholder wealth.⁸⁵⁰

In addition, many board composition studies state that independent directors are better monitors because their interests are less likely to be aligned with those of management and they have the incentive to 'develop reputation as experts in decision control'.⁸⁵¹ Some research presents a different view on the effects of board composition on firm performance. For example, Hermalin and Weisbach study a sample of 134 NYSE firms from 1971 to 1983 to test the relationship between

⁸⁴⁷ *ibid.*

⁸⁴⁸ Baysinger, B.D. and H.N. Butler, 1985, *op cit.* fn.94.

⁸⁴⁹ Weisbach, M.S. 1988. Outside Directors and CEO Turnover, *Journal of Financial Economics*, Vol.20, pp431-460.

⁸⁵⁰ Their study shows that there is a positive stock price reaction to the announcement of the appointment of an additional outside director. See Rosenstein, S. and Wyatt, J.H. 1990. Outside directors, Board Independence, and Shareholder Wealth, *Journal of Financial Economics*, 26, 175-191.

⁸⁵¹ Eugene F. Fama and Michael C. Jensen, *op cit.* fn.547.

Tobin's Q and the fraction of outside directors of the boards with various control variables. Their regression analysis shows that firm performance is not significantly correlated with the fraction of outsider directors.⁸⁵² Bhagat and Black's study finds that firms experiencing poor performance may tend to appoint more outside directors, but no significant relationship between board composition and various measures of firm performance including Tobin's Q, return on total assets ratio, sale/assets ratio, and long-term stock returns.⁸⁵³

Audit committees have long been part of the traditional framework of corporate governance. Deli and Gillan show that audit committee independence and activity are positively related to proxies for a firm's need for accounting certification.⁸⁵⁴ Klein evaluates the link between board composition and firm performance for firms listed on the S&P 500 by assessing the composition of boards' committee structures and finds little association between firm performance and the existence of an audit committee.⁸⁵⁵ The literature on executive compensation as a control device has also been well established. Ellingson finds that the association between CEO compensation and firm performance is stronger when the board is composed of a majority of outside directors.⁸⁵⁶ Shleifer and Vishny argue that a proportion of executive directors' remuneration should be structured so as to link the rewards to

⁸⁵² Hermalin, B. E. and Weisbach, M. S., *op cit.* fn.112

⁸⁵³ See Bhagat, S. and Black, B., *op cit.* fn.112

⁸⁵⁴ Deli, D. and Gillan S. 2000. On the Demand for Independent and Active Audit Committees, *Journal of Corporate Finance*, 2000, Vol. 6, Issue 4. pp427-445.

⁸⁵⁵ Klein A., *op cit.* fn.112

⁸⁵⁶ Ellingson, Dee Ann Hetland, 1996, Board Composition and the Use of Accounting Measures: The effects of the Relationship Between CEO Compensation and Firm Performance, PhD. Dissertation, Virginia Polytechnic Institute of and State University.

corporate and individual performance.⁸⁵⁷ Core et al give their attention to how board characteristics are related to the composition of executives. They use CEO compensation as a metric for assessing the effectiveness of corporate governance in aligning the conflicts of interest between shareholders and management.⁸⁵⁸ However, by using 10 variables to assess board characteristics, Dulewicz and Herbert find that board composition and structure have no visible impact on company performance.⁸⁵⁹

As a contributor to the effectiveness of the board of directors, the intensity of board activity has been measured by the frequency of board meetings and corporate performance. Vafeas argues that board meeting frequency which is an important dimension of board operation is consistent with contracting and agency theory. He finds that the annual number of board meetings is inversely related to firm value.⁸⁶⁰ However, he further finds that the firm's operating performance improves following years of abnormal board activities.⁸⁶¹ He concludes that the board responds to poor performance by raising the level of board activities in order to improve operating performance.⁸⁶²

⁸⁵⁷ Shleifer and Vishny, 1986, *op cit.* fn.38.

⁸⁵⁸ Core, J., Holthausen R. and Larcker, D. 1999. Corporate Governance, Chief Executive Officer Compensation and Firm Performance. *Journal of Financial Economics* 51, pp.371-406.

⁸⁵⁹ The measures used to assess board characteristics include (1) total number of directors (board size); (2), number of executive and non-executive directors (with and without the chairman); (3) proportion of NEDs in relation to total board and to number of executive directors, (4) tenure of chairman, executive (average) and NEDs (average) and all directors; (5) pay (average) (6) potential equity held by all directors, (7) chairman/CEO separation; (8), Chairman: executive or non executive; (9) audit committee's existence; (10) remuneration committee existence. See Victor Dulewicz and Peter Herbert, 2004. Does the Composition and Practice of Boards of Directors Bear any Relationship to the Performance of Their Companies? *Corporate Governance*, v.12, No.13, July.

⁸⁶⁰ The research finds that the higher board activity is associated with poor prior firm performance. See Nikos Vafeas, 1999. Board Meeting Frequency and Firm Performance, *Journal of Financial Economics* 53, p113-142.

⁸⁶¹ *ibid*

⁸⁶² *ibid*

As discussed above, the various studies of the relationship between board characteristics and company performance appear to show that the size of the board, board composition, the existence of an audit committee, directors' compensation and the frequency of board meetings may (or may not) affect the way in which boards accomplish certain tasks in corporate governance in the developed Western economies. This is because differences in economic conditions and institutional environment have an influence on the effectiveness of the board as an important determinant of effective corporate governance. However, in China, as discussed in Chapter 6, the hybrid two-tier board system has not been well-established. Although the CCGC ⁸⁶³ recommends that listed companies establish audit committees comprising a majority of independent directors in order to monitor companies' internal control system, whether the implementation of the audit committee is able to improve the corporate performance merits further monitoring. In addition, in China, compensation packages are mainly salary-based and equity-based compensation (such as stock options) was not adopted until early 2003.⁸⁶⁴ Whether corporate performance is sensitive to the salary-based compensation system is problematic. Moreover, as far as the board meeting is concerned, Art.116 of the Chinese Company Law stipulates that the board of directors shall hold meetings at least twice a year. However, whether the minimum requirement on the board meeting can be sufficient to ensure that the board fulfils its duties effectively has never been tested. Therefore, the hypotheses on

⁸⁶³ See the CCGC, *op cit.* fn.28.

⁸⁶⁴ In China, less than 10% of listed companies adopted stock option incentive plan and only two of them (*Dongfang Tongxin and Shanghai Beiling*) were approved by the CSRC as Stock Option plan experimental company in 2003. see Long, Xudong, 2003. Stock Option Dream Hardly Becomes True (*Gupiao Qiquan de Nanyuan Zhimeng*), *International Finance News. (Guoji Jinrong Bao)*, 28 April.

the relationship between characteristics of the boards and firm performance are as follows:

H_{3a}: Where the company has a larger size of board, company performance is higher.

H_{3b}: Where the company has more independent directors in the board, company perform is higher.

H_{3c}: Where there is an audit committee in the company, company performance is higher.

H_{3d}: Where the roles of Chairperson and CEO are separated, company performance is higher.

H_{3e}: Where the company pays higher compensation to its executives, company performance is higher.

H_{3f}: Where the company convenes more board meetings, company performance is lower.

9.3 Data and Methodology

9.3.1 Data Sources

Since the introduction of the independent director system and the CCGC in 2001, a new area of corporate governance has emerged in China in pursuit of proper and efficient corporate practice. Unlike previous empirical research, this study uses the data available after the new system came into existence in China and so is more

relevant to understanding of the impact of corporate governance on corporate performance.

As described in Chapter 3, the original sample for this study consisted of 300 listed companies which were randomly selected from the Shanghai and Shenzhen stock markets for the 2002/2003 financial year. A random sample was selected so that the sample results can reasonably be regarded as representative of the population. In order to compile a complete dataset at the firm level on ownership structure, shareholder activism, board characteristics, and firm performance, data were collected from a wide variety of sources available at the Thomson Analytics database, official and professional securities analysis bodies' websites, and companies' websites. However, 33 companies had to be eliminated because of data deficiencies. For the remaining 267 firms, performance data were collected from the Thomson One Banker database and company's annual reports (2002/2003). The data for ownership structure, shareholder meetings and board characteristics were collected mainly from company's annual reports (2002/2003), supplemented by referring to official and professional securities analysis bodies' websites, including the CSRC website (<http://www.csrc.gov.cn>), the *Huaxia Security House* website (<http://www.csc108.com/>), the *Zhongguo Shangshi Gongsi Zixun* website (<http://www.cnlist.com/search/search.htm>), and the *Hexun* company website (<http://www.hexun.com>).

9.3.2 Variable Description

- Firm Performance Measures

The concept of corporate performance can be interpreted by either accounting-based measures such as the rate of return on total assets (ROA) and the rate of return on equity (ROE), or by market-based measures such as Tobin's Q.⁸⁶⁵ Accounting-based ratios measure the past and current performance of the firm whereas Tobin's Q captures the expected future performance of the firm. Although both measurements are well accepted in the literature, recent research has tended to use Tobin's Q to measure the valuation of listed companies. In many cases, Tobin's Q is measured by the sum of the market value of common stock, book value of preferred stock, long-term debt, and short-term debt, divided by total assets.⁸⁶⁶ However, the calculation of the market values of Chinese listed companies is obviously complex and cumbersome as the state shares and legal person shares are not traded in the stock markets. Although in practice all classes of shares of listed companies in China have enjoyed the same voting and residual rights, in theory, the state and legal person share price would be neither treated as the same as the market price of shares, nor simply treated as preferred stock shares measured only by the book value. Chen and Xiong's research focuses on the price differences between the state and legal person shares which are not traded in the stock exchange markets and common shares of the same

⁸⁶⁵ For example, as discussed in section 9.2.1 of the chapter, Demsetz and Lehn (1985) employ accounting rate of return (average annual net income/book value of shareholders equity) whereas Morck, Shleifer and Vishny and McConnell and Servaes use Tobin's Q to measure firm performance. See Demsetz, H. and Lehn K. *op cit.* fn.110; Morck, R., A. Shleifer, and R. Vishny, *op cit.* fn.38; McConnell, J.J. and Servaes, H. 1990. Additional Evidence on Equity Ownership and Corporate Value. *Journal of Financial Economics* 27, 595-612

⁸⁶⁶ Kee H. Chung and Stephen W. Pruitt, 1994. A Simple Approximation of Tobin's Q, *Financial Management*, 23(3):70-74

company, observing both auction and private-transfer transactions for non-tradable shares. They found that the average discount for non-tradable shares relative to their floating counterpart was 77.93% and 85.59%.⁸⁶⁷ Thus, how to compute the market value of the state shares and legal person shares is still an unsolved problem. Therefore, this study adopts the accounting-based ratio ROA as a measurement of firm performance.⁸⁶⁸ Table 9.1 shows that the mean value of ROA is 3.64 in the sample with a standard deviation of 7.05.

● Corporate Governance Characteristics

Corporate governance characteristics in this study comprise three groups of proxy variables - ownership structure, shareholder activism and the characteristics of the board of directors.

Ownership structure is measured by both ownership concentration and shareholder identity. Initially, the study attempts to investigate the impact of ownership concentration on corporate performance. The proportion of shares held by the largest shareholder (PLS) is used to capture concentration of share ownership. The PLS data was collected from companies' annual reports and the descriptive statistics are presented in Table 9.1. To measure the potential nonlinear relationship between ownership concentration and firm performance, the study constructs the square of the PLS variable (PLSS) as an additional independent variable in the regression analysis.

⁸⁶⁷ See Zhiwu Chen and Peng Xiong, 2001, *Discounts on Illiquid Stocks: Evidence from China*, Yale ICF Working Paper No. 00-56, September.

⁸⁶⁸ The study also uses ROE (return on equity) and ROIC (return on invested capital) as alternative measures of

In addition, consistent with existing evidence on the relationship between shareholder identity and economic performance, the study proposes that the identity of the largest shareholder is important as an influence on shareholder value. Shareholder identity in China can be classified as state-owned enterprises (SOE), government agencies (GA), non-financial companies (COM), financial institutions (FIS), family and individual shareholders (FAI) and foreign investors (FIN). In our sample, 142 companies (accounting for 53% of the sample size) have an SOE as their largest shareholder, 41 companies (accounting for 15% of the sample size) have a GA as their largest shareholder, 52 companies (accounting for 19% of the sample size) have a COM as their largest shareholder, and 26 companies (accounting for 10% of the sample size) have an FAI as their largest shareholder. However, there are no foreign investors and only 6 companies (accounting for 2.2% of the sample size) have the largest shareholder from financial institutions. Hence their relationship with corporate performance is not predicted in this study. With respect to other identities, the study includes them as dummy variables. Thus, if a state-owned enterprise is the largest shareholder, the variable $SOE = 1$, and 0 otherwise. If a government agency is the largest shareholder, $GA = 1$, and 0 otherwise. If a non-financial company is the largest shareholder, $COM = 1$, and 0 otherwise. If a family or individual investor is the largest shareholder, $FAI = 1$, and 0 otherwise.

firm performance and all results are qualitatively the same.

Shareholder activism is measured by three shareholder meeting variables. They are the turnout ratio (TR), voting level (VL) and shareholder proposals (SP). All these data are collected from company annual reports and shareholder meeting resolution statements. Table 9.1 shows that the average turnout is less than 6 out of ten thousand shareholders at the AGM. The voting level on average is 56.79% of total company voting rights. The firm reporting the lowest voting level at the AGM has a VL of 1.30%, while the highest voting level is 89.95% of the company's total voting right. However, the distribution of the raw data for TR is very skewed. To obtain a more symmetric distribution of the measure of shareholder activism, the TR data are converted to natural logarithms for the regression analysis (denoted by LTR). Shareholder proposals are included as a dummy variable in this study, so $SP = 1$ where a company has a shareholder proposing a resolution at the AGM, and 0 otherwise. The incidence of shareholder proposals was not high in the 2002-2003 financial year with only 6.74% of the firms having shareholders proposing resolutions to the AGM.

Six variables are selected to measure the characteristics of the board of directors: the size of the board (SBOD), the proportion of independent directors on the board (PIND); the presence of an audit committee (AUC), CEO/chairperson duality (CCD), executive compensation (EC), and frequency of board meetings (FBM). Table 9.1 shows the descriptive statistics for the characteristics of the board of directors of the sample companies. SBOD shows that the size of the boards varies from 5 to 19. The

average board size is 10. PIND shows that the proportion of independent directors on the board is less than the one-third required by the Corporate Governance Code, with a mean of 25.16%. AUC is defined as a dummy variable which equals 1 if the company has established an audit committee, and 0 otherwise. AUC shows that there are only 31.34% of companies with audit committees. EC is calculated as the average annual salary of the highest paid three executive directors.⁸⁶⁹ The figures in Table 9.1 indicate that the average compensation of executives is 187,717 Yuan (approximately £14,440).⁸⁷⁰ The distribution of the raw data for EC is also very skewed, so logarithms are used to reduce the skew (denoted by LEC). CCD is defined as a dummy variable taking a value of 1 if the company's CEO is also chairperson of the board of directors, and 0 otherwise. In about 11.57% of listed companies the CEO and chairperson positions are held by one individual at the same time. Finally, FBM shows that the board, on average, held about eight meetings during the 2002-2003 financial year with a range of 3 to 27. However, the nature of the association between the frequency of board meetings and corporate performance is complex and its causality may run in both directions. For firms experiencing poor performance the board of directors will be under pressure and tend to convene more meetings to improve performance. Therefore, the raw data for the frequency of board meetings are

⁸⁶⁹ In China, executive compensation is normally disclosed by company's annual report showing either total annual remuneration of the board (some may include supervisors' salaries) or the total annual salary of the highest paid three executive directors. No equity-based compensation (e.g. stock option) has been disclosed in our sample companies' annual report. Thus, the data for executive compensation in this study adopted the total annual salary of the highest paid three executive directors and divided it by three in order to reflect executive compensation.

⁸⁷⁰ Exchange rate base on £1 = RMB 13.00 according to Bank of China exchange rate on 31st December 2002.

converted to a new variable by using instrumental variables in order to avoid simultaneous equation bias in the regression analysis.⁸⁷¹

● Control Variables

There are two principal control variables employed in this study. They are company size and company age. Company size is measured by the natural logarithm of the company's total assets (LTA). Since larger companies have a greater capacity for financing expansion, LTA can have a significant influence on corporate performance. Company age (AGE) has been used in many studies to explain firm performance since the profit of older firms may be enhanced by productivity gains resulting from learning by doing or reputation effects leading to increased demand; on the other hand, new firms may tend to have higher value as they use up-to-date technology and modern management.⁸⁷² In addition, since the company's business sector can have a potential impact on corporate performance, the study also includes industrial sectors as dummy variables. All companies are classified into three main industrial categories, included as dummy variables – primary industry (PI), which includes agriculture, forestry and fishing; secondary industry (SI), which includes manufacturing, production and distribution of electricity, gas and water, and construction; and tertiary industry (TI), which includes wholesale and retail trade, real estate, tourism, banking and financial industries, information transfer, computer

⁸⁷¹ When causality runs “backwards” from Y to X as well as “forwards” from X to Y, there is simultaneous causality bias which multiple regression simply cannot eliminate. Instrumental variable regression uses additional variables as tools to isolate the movements in X that are uncorrelated with the error term ‘u’, which in turn permits consistent estimation of the regression coefficients. See Stock and Watson, 2003, *Introduction to Econometrics, International Edition*, Addison Wesley. pp331-335.

services and software etc.⁸⁷³ The descriptive statistics of the control variables are also provided in Table 9. 1.

Table 9.1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA (%)	267	-50.03	32.09	3.64	7.05
PLS (%)	267	.39	85.00	45.39	18.57
PLSS	267	.15	7225.00	2403.98	1726.03
SOE	267	.00	1.00	.54	.50
GA	267	.00	1.00	.15	.36
COM	267	.00	1.00	.19	.40
FAI	267	.00	1.00	.10	.30
VL (%)	267	1.30	89.95	56.79	14.88
TR (per thousand)	267	.01	13.24	.5737	1.26
LTR	267	-4.65	2.58	-1.35	1.19
SP	267	.00	1.00	.07	.25
SBOD	267	5.00	19.00	10.04	2.38
PIND (%)	267	.00	66.00	25.16	8.73
AUC	267	.00	1.00	.31	.47
EC (RMB,000)	267	14.40	3493.590	187.717	309.71
LEC	267	2.67	8.16	4.62	1.04
CCD	267	.00	1.00	.12	.32
FBM	267	3.00	27.00	7.75	3.18
FBMP	267	6.59	14.07	7.76	1.05
AGE	267	1.00	10.00	4.60	2.50
TA (RMB, million)	267	5.07	7427.87	295.75	614.59
LTA	267	1.62	8.91	8.15	0.97
PI	267	.00	1.00	.07	.26
SI	267	.00	1.00	.49	.50
TI	267	.00	1.00	.43	.50

ROA (return on total assets) = (Net Income before Preferred Dividends + ((Interest Expense on Debt-Interest Capitalized) * (1 - Tax Rate))) / Last Year's Total Assets * 100. The cited formulas are from Thomson Analytics database (Thomson One Banker data); PLS (the proportion of shares held by the biggest shareholder); PLSS (the square of PLS); SOE (identity of the largest shareholder is an SOE); GA (identity of the largest shareholder is a government agency); COM (identity of the largest shareholder is a non financial company); FAI (identity of the largest shareholder is a family or individual); VL (voting level at the AGM); TR (turnout ratio at the AGM); LTR (logged turnout ratio at the AGM); SP (shareholder proposals submitted at the AGM); SBOD (size of board of directors) PIND (proportion of independent directors in the board); AUC (audit committee); EC (executive compensation); LEC (logged executive compensation) CCD(chairperson and CEO duality); FBM (frequency of board meetings); FBMP(frequency of board meetings – coefficient estimated by instrumental variable method); TA (total assets); AGE (age of the company); PI (primary sector); SI (secondary sector); TI (tertiary sector).

⁸⁷² See Leech, D. and Leahy, J. op cit. fn.113.

⁸⁷³ Industrial classification standard employed in this thesis is based on "Industrial Classification in Chinese National Accounts". See Tonglu Zhao, (2004), Zhao, Tonglu, Comparison between Industrial Classification in Chinese National Accounts and International Standard Industrial Classification for All Economic Activities (ISIC), (Nov. 30, 2004). Available at <http://www.oecd.org/dataoecd/32/25/33982328.pdf> (last visited Sep. 28, 2005).

9.3.3 Correlation Matrix

Table 9.2 presents Pearson's correlation matrix for the variables employed in this study. The results indicate that the independent variable ROA is significantly correlated with some ownership structure variables, including a positive correlation with ownership concentration measured by PLS ($p < 0.01$), a positive correlation with the identity of the largest shareholders SOE ($p < 0.05$). In addition, the results also show that ROA is significantly correlated with shareholder activism measured by voting level at the shareholder meetings ($p < 0.01$) and the logged turnout ratio ($p < 0.01$). Furthermore, the relationship between board characteristics and ROA shows a positive correlation with audit committee AUC ($p < 0.05$) and logged executive compensation ($p < 0.01$). However, Table 9.2 also reports that ROA is negatively correlated with company age ($p < 0.01$) and positively correlated with logged total assets. It is also noted that there is some correlation among the independent variables and control variables, but none of the correlation coefficients are sufficiently high to create multicollinearity problems in the regression analysis.

Table 9.2: Pearson correlation matrix

	ROA	PLS	PLSS	SOE	GA	COM	FAL	VL	TR	LTR	SP	SBOD	PIND	AUC	LEC	CCD	FBMP	AGE	LTA	PI	SI	TI	
ROA	1																						
PLS	.213**	1																					
PLSS	.186**	.981**	1																				
SOE	.135*	.315**	.306**	1																			
GA	-.071	-.055	-.058	-.451**	1																		
COM	-.030	-.113	-.110	-.528**	-.206**	1																	
FAI	.011	-.218**	-.215**	-.353**	-.138*	-.162**	1																
VL	.345**	.729**	.720**	.237**	-.072	-.034	-.156*	1															
TR	.95	-.018	-.031	.057	-.031	-.027	-.017	-.054	1														
LTR	.138*	-.178**	-.195**	-.064	.056	.033	.016	-.128*	.647**	1													
SP	.013	-.109	-.105	-.019	.096	-.019	-.088	-.037	.045	-.065	1												
SBOD	.038	.134*	-.139*	.221**	-.020	-.103	-.144*	.145*	-.111	-.131*	.002	1											
PIND	.114	-.032	-.024	-.029	-.036	-.015	.082	-.014	-.038	.014	.029	-.210**	1										
AUC	.156*	-.019	-.029	.016	-.013	-.048	.050	.013	.066	.080	-.053	-.021	.308**	1									
LEC	.173**	-.007	-.005	.010	-.018	.060	-.015	.094	-.080	-.022	-.033	.087	.070	.127*	1								
CCD	-.067	-.119	-.110	-.038	.077	-.031	.039	-.101	-.041	-.012	-.051	-.006	.148*	.157*	.022	1							
FBMP	-.053	-.051	-.051	-.057	-.115	.040	.151*	.000	-.125*	-.160**	-.061	.060	-.021	.091	.057	.064	1						
AGE	-.365**	-.286**	-.276**	-.180**	.177**	-.061	.098	-.411**	.075	.120	-.065	-.016	-.103	-.056	-.066	.040	-.066	1					
LTA	.323**	.281**	-.297**	.203**	.002	-.134*	-.119	.312**	-.040	-.154*	.048	.214**	.046	.088	.238**	.044	-.068	-.126*	1				
PI	.065	.115	.133*	-.020	-.040	.040	.051	.106	-.048	-.097	.037	.026	.083	.022	.069	-.014	.101	-.171**	.098	1			
SI	.088	.268**	.237**	.095	-.058	.043	-.123*	.278**	.035	-.060	.003	-.044	-.006	-.009	-.128*	-.101	-.031	-.169**	.046	-.281**	1		
TI	-.123*	-.331**	-.310**	-.085	.080	-.065	.097	-.337**	-.010	.112	-.023	.031	-.038	-.003	.093	.110	-.022	.261**	-.099	-.248**	-.860**	1	

** Correlation is significant at the 0.01 level (2-tailed); * Correlation is significant at the 0.05 level (2-tailed).

ROA (return on total assets) = (Net Income before Preferred Dividends + (Interest Expense on Debt-Interest Capitalized) * (1-Tax Rate)) / Last Year's Total Assets * 100. PLS (the proportion of shares held by the biggest shareholder), PLSS (the square of PLS); SOE (identity of the largest shareholder is an SOE); GA (identity of the largest shareholder is a government agency); COM (identity of the largest shareholder is a non financial company); FAI (identity of the largest shareholder is a family or individual); VL (voting level at the AGM); TR (turnout ratio at the AGM); LTR (logged turnout ratio at the AGM); SP (shareholder proposal submitted at the AGM); SBOD (size of board of directors) PIND (proportion of independent directors in the board); AUC (audit committee); LEC (logged executive compensation), CCD (Chairperson and CEO duality); FBMP (frequency of board meetings - coefficient estimated by instrumental variable method); LTA (logged total assets), AGE (age of the company), PI (primary sector), SI (secondary sector), TI (tertiary sector).

9.4 Multivariate Analysis

The study comprises two stages to present the results of the empirical work. In the first stage the study provides preliminary evidence on the association between each corporate governance mechanism and corporate performance. In the second stage the study provides a systematic measurement, examining a number of governance variables that have not been previously examined simultaneously, in order to find the relationships between the strategic governance configurations and corporate performance. The estimated regression models are designed as follows:

Model (1)

$$ROA = f_1\{\textit{ownership structure variables} + \textit{control variables}\}$$

Model (2)

$$ROA = f_2\{\textit{shareholder activism variables} + \textit{control variables}\}$$

Model (3)

$$ROA = f_3\{\textit{board characteristics variables} + \textit{control variables}\}$$

Model (4)

$$ROA = f_4\{\textit{ownership structure variables} + \textit{shareholder activism variables} + \textit{board characteristics variables} + \textit{control variables}\}$$

9.4.1 The Effects of Ownership Structure on Corporate Performance

Table 9.3 reports the results of the main effects of ownership concentration on corporate performance. According to the regression results, it is noted that the nature of the relationship between ownership concentration and firm performance is not

monotonic, but rather a curved relation with an 'inverse U-shape' which is consistent with H_{1a}. Table 9.3 shows that the ROA is influenced positively and significantly by the largest ownership shareholding (p<0.01) and negatively and significantly by the square of the largest ownership shareholding (p<0.01). The parameter estimates indicate that corporate performance begins to increase as the ownership concentration ratio rises to certain point, and then drops with further increases the ownership concentration ratio. This result is consistent with related studies such as Morck et al, McConnell and Servae and Thomsen and Pedersen.⁸⁷⁴ Figure 9.1 suggests that the ROA increases with the largest shareholder's shareholding up to approximately 48.83 per cent of company's issued shares and decreases afterwards in China.⁸⁷⁵

Table 9.3 The effects of ownership concentration and corporate performance*

Model	ROA*				
	B	Std. Error	Beta	t	Sig.
(Constant)	-8.922	3.273		-2.726	.007
PLS	.293	.108	.771	2.708	.007
PLSS	-.003	.001	-.738	-2.603	.010
AGE	-.894	.164	-.317	-5.453	.000
LTA	2.089	.415	.288	5.036	.000
PI	-.297	1.579	-.011	-.188	.851
SI	-.192	.854	-.014	-.225	.822
R ²	.233				
Adjusted R ²	.216				
F	13.197***				

* Dependant variable: ROA (return on total assets). Independent variables: PLS (the proportion of shares held by the biggest shareholder), PLSS (square of the proportion of shares held by the biggest shareholder. Control variables: LTA (logged total assets), AGE (age of the company), PI (primary sector), SI (secondary sector)

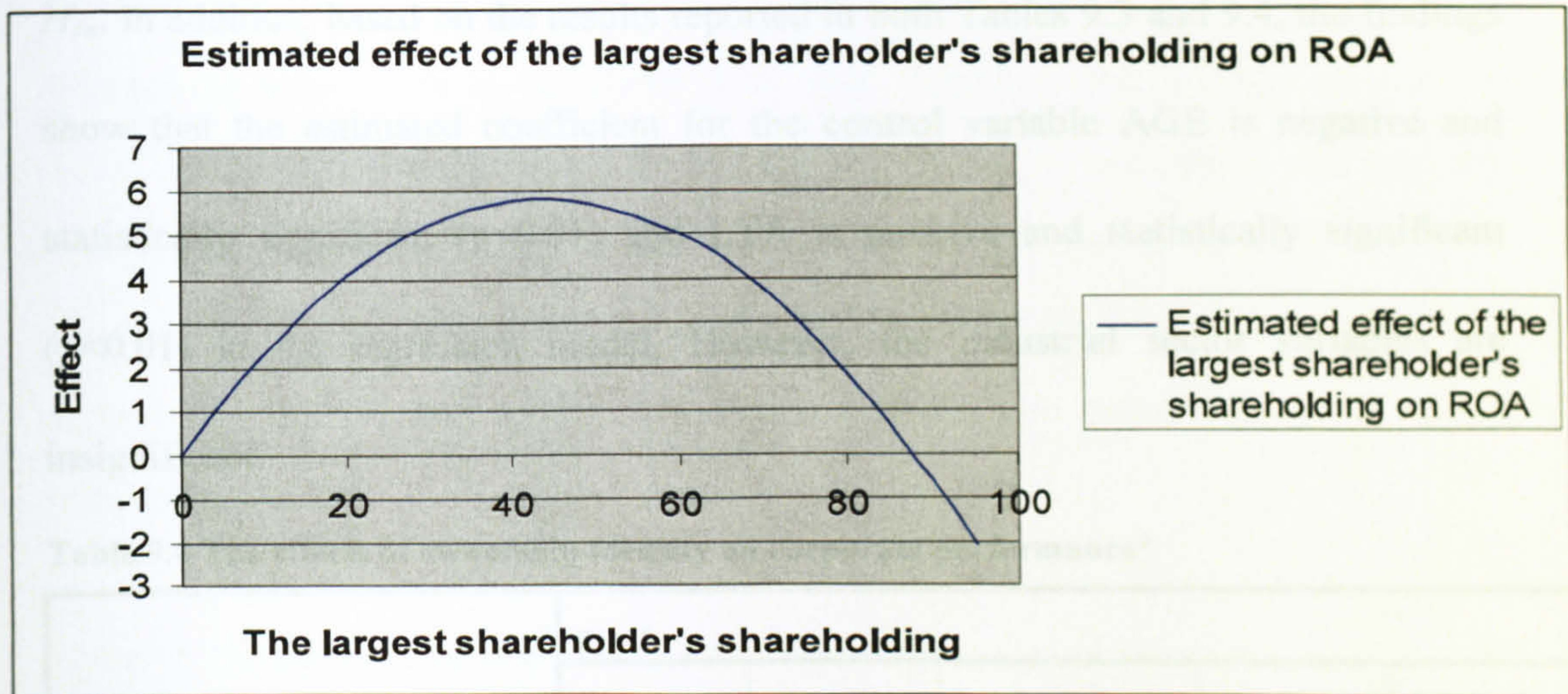
a. Model, $ROE = \alpha + \beta_1 PLS + \beta_2 PLSS + \beta_3 AGE + \beta_4 LTA + \beta_5 SI + \beta_6 TI + \varepsilon$

Note: A plot of the standardised residuals against standardised predicted values was inspected and no evidence of the heteroscedasticity or non-linearity was detected.

⁸⁷⁴ McConnell, J. J. and Servaes, H. 1990. "Additional Evidence on Equity Ownership and Corporate Value," *Journal of Financial Economics*, 27, 595-612; Morck, R., A. Shleifer and R. W. Vishny, *op cit* fn.38; and Thomsen, S. and T. Pedersen, *op cit*.fn.825.

⁸⁷⁵ To find the turning point in Figure 9.1, the estimated equation for model 1 was differentiated with respect to PLS and the derivative set equal to zero.

Figure 9.1



Previous studies argue that both ownership concentration and owner identities are embedded in the corporate ownership structure which must be taken into account when assessing the implication of corporate governance mechanisms for corporate performance.⁸⁷⁶ Table 9.4 explores the effects of the identity of the largest shareholders on corporate performance. The findings show that the effect of ownership concentration on corporate performance is qualitatively unchanged by including the identity of the largest shareholder as a categorical variable. However, Table 9.4 indicates that the coefficients of SOE, GA and COM are positive and significant at the 5% level and FAI is positive and significant at the 1% level. The results suggest that the companies tend to have higher ROA if the largest shareholder is a family or individual investor. In contrast, if the largest shareholder is a government agency, corporate performance is lower compared with the others. Overall, the results are consistent with all the hypothesized relationships H_{1b} through

⁸⁷⁶ See S. Thomsen and T. Pedersen, *op cit* fn.825.

H_{1e}. In addition, based on the results reported in both Tables 9.3 and 9.4, the findings show that the estimated coefficient for the control variable AGE is negative and statistically significant ($p < 0.01$) and LTA is positive and statistically significant ($p < 0.01$) in the regression model. However, the industrial sector variables are insignificant.

Table 9.4 The effects of ownership identity on corporate performance*

Model	ROA ^a				
	B	Std. Error	Beta	t	Sig.
(Constant)	-14.684	3.957		-3.711	.000
PLS	.263	.108	.692	2.421	.016
PLSS	-.003	.001	-.666	-2.352	.019
SOE	6.349	2.692	.450	2.358	.019
GA	5.973	2.770	.303	2.157	.032
COM	6.225	2.735	.350	2.276	.024
FAI	8.063	2.839	.340	2.840	.005
AGE	-.859	.166	-.304	-5.166	.000
LTA	2.077	.417	.286	4.980	.000
PI	-.471	1.577	-.018	-.299	.765
SI	-.109	.851	-.008	-.128	.898
R ²	.257				
Adjusted R ²	.228				
F	8.873***				

* Dependant variable: ROA (return on total assets). Independent variables: PLS (the proportion of shares held by the biggest shareholder), PLSS (square of the proportion of shares held by the biggest shareholder), SOE (identity of the largest shareholder is an SOE); GA (identity of the largest shareholder is a government agency); COM (identity of the largest shareholder is a non financial corporation); FAI (identity of the largest shareholder is a family or individual. Control variables: LTA (logged total assets), AGE (age of the company), PI (primary sector), SI (secondary sector)

a. Model, $ROA = \alpha + \beta_1 PLS + \beta_2 PLSS + \beta_3 SOE + \beta_4 GA + \beta_5 COM + \beta_6 FAI + \beta_7 AGE + \beta_8 LTA + \beta_9 SI + \beta_{10} TI + \epsilon$

Note: A plot of the standardised residuals against standardised predicted values was inspected and no evidence of the heteroscedasticity or non-linearity was detected.

9.4.2 The Effects of Shareholder Activism on Corporate Performance

Table 9.5 considers the effects of shareholder activism on corporate performance. The regression model comprises three explanatory variables – VL (voting level at the AGM), LTR (logged turnout ratio) and SP (shareholder proposing resolutions at the AGM), all of which proxy shareholder activism. The regression results show that the

estimated coefficients for VL and LTR are both positive and statistically significant, whereas SP appears not to be related with ROA. Based on the findings reported in Table 9.5, there is strong support for H_{2a} and H_{2b}, but H_{2c} is rejected. In addition, the findings also show that the estimated coefficients for the control variable “AGE” is negative and statistically significant (p<0.01) and “LTA” is positive and statistically significant (p<0.01), and with no significant relation with industrial sectors in this regression model.

Table 9.5 The effects of the shareholder activism on corporate performance*

Model	ROA ^a				
	B	Std. Error	Beta	t	Sig.
(Constant)	-5.425	2.588		-2.096	.037
VL	.084	.030	.177	2.829	.005
LTR	1.391	.319	.235	4.364	.000
SP	.097	1.488	.003	.065	.948
AGE	-.819	.166	-.290	-4.920	.000
LTA	1.951	.406	.269	4.803	.000
SI	-.267	1.525	-.010	-.175	.861
TI	-.162	.821	-.012	-.197	.844
R ²	.284				
Adjusted R ²	.265				
F	14.705***				

* Dependant variable: ROA (Return on Total Assets). Independent variables: LVL (logged voting level at the AGM); LTR (logged turnout ratio at the AGM); SP (shareholder proposal submitted at the AGM). Control variables: LTA (logged total assets), AGE (age of the company), PI (primary sector), SI (secondary sector)

a. Model, $ROA = \alpha + \beta_1 LVL + \beta_2 LTR + \beta_3 SP + \beta_4 AGE + \beta_5 LTA + \beta_6 SI + \beta_7 TA + \epsilon$

Note: A plot of the standardised residuals against standardised predicted values was inspected and no evidence of the heteroscedasticity or non-linearity was detected.

9.4.3 The Effects of the Characteristics of the Board of Directors on Corporate Performance

Table 9.6 presents the estimated regression results of the relation between the board characteristics and corporate performance. The results show that only the presence of an audit committee (H_{3c}) is positive and statistically significant at 10% level. The findings indicate that the coefficient for Chairperson and CEO duality (H_{3d}) is

negative, but not significant at conventional levels. There is no empirical evidence to support the relationship between ROA and board size (H_{3a}), the proportion of independent directors on the board (H_{3b}), executive compensation (H_{3c}) and the frequency of board meetings (H_{3f}) in this regression model. However, the coefficient for the control variable AGE still remains negative and statistically significant (p<0.01) and “LTA” remains positive and statistically significant (p<0.01), but the industrial sectors remains insignificant.

Table 9.6 the effects of the characteristics of board of directors on corporate performance*

Model	ROA ^a				
	B	Std. Error	Beta	t	Sig.
(Constant)	-1.923	4.449		-.432	.666
SBOD	-.040	.170	-.013	-.234	.815
PIND	.032	.048	.039	.658	.511
AUC	1.701	.883	.112	1.926	.055
LEC	.578	.388	.085	1.488	.138
CCD	-1.873	1.229	-.085	-1.524	.129
FBM	-.424	.375	-.063	-1.132	.259
AGE	-.896	.162	-.317	-5.528	.000
LTA	1.842	.425	.254	4.335	.000
SI	-.388	1.576	-.015	-.246	.806
TI	.273	.835	.019	.327	.744
R ²	.244				
Adjusted R ²	.214				
F	8.253***				

* Dependent Variable: ROA (return on total assets). Independent variables: SBOD (size of board of directors) PIND (proportion of independent directors in the board); AUC (audit committee); EC (executive compensation), CCD (Chairperson and CEO duality); FBM (frequency of board meetings – coefficient estimated by instrumental variable method). Control variables: LTA (logged total assets), AGE (age of the company), PI (primary sector), SI (secondary sector).

$$a. \text{ Model, } ROA = \alpha + \beta_1 SBOD + \beta_2 PIND + \beta_3 AUC + \beta_4 CCD + \beta_5 LEC + \beta_6 FBMP + \beta_7 AGE + \beta_8 LTA + \beta_9 SI + \beta_{10} TI + \epsilon$$

Note: A plot of the standardised residuals against standardised predicted values was inspected and no evidence of the heteroscedasticity or non-linearity was detected.

9.4.4 *The Effects of the Strategic Corporate Governance Mechanisms on Corporate Performance*

While all of the work discussed in the previous sections focuses on the impact of individual governance mechanisms on corporate performance, recent research by Coles et al and Sundaramurthy et al argue that the independence assumption may have some problems since firms are more likely to use governance packages to deal with agency issues and various corporate control mechanisms co-exist within the company, so that corporate governance mechanisms may substitute for or enhance each other.⁸⁷⁷ The study adopts this perspective and expands on this view by proposing a framework for examining how a company selects a package of governance mechanisms, and the impact of this selection on performance. Table 9.7 explores the regression results by combining all corporate governance mechanisms employed in this study. The findings show that the “inverse U-shaped” relationship between ownership concentration and corporate performance still exists with significance at the 10% level for PLS and the 5% level for PLSS. The effect of the identity of the largest shareholder qualitatively also remains the same on ROA, but is less strong and less significant compared with the regression results shown in Table 9.4. Similarly, the voting level and logged turnout ratio at the AGM qualitatively remain positive and significant, but seem also less strong and less significant compared with the previous results showed in Table 9.5. Nevertheless, although the estimated coefficient on the presence of an audit committee remains qualitatively unchanged, it is not significant at the conventional

⁸⁷⁷ Coles, J.W., V. B. McWilliams and N. Sen, *op cit.* fn.114; C. Sundaramurthy, J. M. Mahoney and J.T. Mahoney, Board Structure, 1997. Antitakeover Provisions, and Stockholder Wealth, *Strategic Management Journal*, Vol.18:3 231-245.

level any more. The coefficient for the control variable AGE remains negative and statistically significant at 1% level and LTA continues positive and statistically significant at 1% level, but the industrial sector variables are still insignificant in this regression model.

Table 9.7 The effects of the strategic corporate governance mechanisms on corporate performance*

Model	ROA ^a				
	B	Std. Error	Beta	t	Sig.
(Constant)	-15.920	5.377		-2.961	.003
PLS	.192	.106	.504	1.813	.071
PLSS	-.002	.001	-.572	-2.088	.038
SOE	5.324	2.666	.377	1.997	.047
GA	4.845	2.740	.246	1.769	.078
COM	4.994	2.703	.281	1.847	.066
FAI	6.988	2.776	.294	2.517	.012
VL	.096	.039	.202	2.452	.015
LTR	1.156	.327	.195	3.539	.000
SP	.340	1.508	.012	.225	.822
SBOD	-.033	.167	-.011	-.198	.843
PIND	.046	.046	.057	1.001	.318
AUC	1.207	.850	.080	1.421	.157
LEC	.394	.376	.058	1.047	.296
CCD	-1.695	1.187	-.077	-1.428	.155
FBMP	-.226	.370	-.033	-.610	.542
AGE	-.740	.169	-.262	-4.383	.000
LTA	1.904	.428	.262	4.447	.000
SI	-.274	1.528	-.010	-.179	.858
TI	-.196	.837	-.014	-.234	.815
R ²	.340				
Adjusted R ²	.289				
F	6.696***				

*Dependent Variable: return on total assets. Independent variables: PLS (the proportion of shares hold by the biggest shareholder), PLSS (squared the proportion of shares hold by the biggest shareholder), SOE (identity of the largest shareholder is an SOE); GA (identity of the largest shareholder is a government agency); COM (identity of the largest shareholder is a non financial corporation); FAI (identity of the largest shareholder is a family or individual); LVL (logged voting level at the AGM); LTR (logged turnout ratio at the AGM); SP (shareholder proposal submitted at the AGM); SBOD (size of board of directors) PIND (proportion of independent directors in the board); AUC (audit committee); EC (executive compensation), CCD (Chairperson and CEO duality); FBM (frequency of board meetings – coefficient estimated by instrumental variable method). Control variables: LTA (logged total assets), AGE (age of the company), PI (primary sector), SI (secondary sector).

a. Model, $ROA = \alpha + \beta_1 PLS + \beta_2 PLSS + \beta_3 SOE + \beta_4 GA + \beta_5 COM + \beta_6 FAI + \beta_7 LVL + \beta_8 LTR + \beta_9 SP + \beta_{10} SBOD + \beta_{11} PIND_1 + \beta_{12} AUC + \beta_{13} CCD + \beta_{14} LEC + \beta_{15} FBMP + \beta_{16} AGE + \beta_{17} LTA + \beta_{18} SI + \beta_{19} TI + \epsilon$

Note: A plot of the standardised residuals against standardised predicted value was inspected and no evidence of the heteroscedasticity or non-linearity was detected.

9.5 Discussion and Conclusion

This chapter incorporates recent data on Chinese listed companies in a study of the impact of corporate governance on corporate performance. This study is distinctive in a number of ways. Conceptually, it provides an analysis of the relationship between corporate governance mechanisms and corporate performance, and it considers each mechanism including ownership structure, shareholder activism and board of directors separately, as well as jointly. In considering the effects of ownership structure on corporate performance, the findings confirm previous studies suggesting that the relationship between ownership concentration and economic performance is nonlinear, so that ownership concentration beyond a certain point leads to entrenchment and has adverse effects on performance. The findings imply that expropriation problems may be incurred if the largest shareholder holds more than 48.83 per cent of company's shares in China. In addition, the findings also support the hypothesis that the identity of the largest shareholder is important as an influence on corporate performance. For example, government ownership is associated with lower performance of the company, whereas family and individual ownership is found to have a significantly positive effect on performance. This result is consistent with the literature (e.g. Thomsen and Pedersen) and suggests that the government is likely to pay more attention to political goals, such as low output prices, employment or other

external effects relative to profitability.⁸⁷⁸ The implication is that there is a need for China to consider the innovation of the ownership structure in order to improve corporate performance. In principle there will be potential gains for all shareholders if the Chinese government decides to privatise, especially if a dominant ownership stake can be transferred to family and individual investors.⁸⁷⁹

We also find a particularly strong effect of shareholder activism on corporate performance based on its estimated coefficients of the voting level and the turnout ratio at the AGM. The way voting at the AGM is carried out by shareholders in person, which is an important corporate governance mechanism, can further enhance corporate performance. However, the available evidence is not convincing that shareholder activism can perform a significant function in corporate governance in China because shareholder activism, heavily dependant on the monitoring role of the large shareholders, has limitations. Firstly, the low turnout ratio with high voting level indicates that the minority shareholders typically do not attend the AGM and the conflicts of interest between the controlling shareholders and minority shareholders becomes the main agency problem which has led to the expropriation of minority shareholders in many Chinese listed companies. Secondly, there are a limited number of financial institutions or families and individual investors in the largest shareholder group. The government usually directly or indirectly owns substantial shareholdings

⁸⁷⁸ Thomsen, S. and T. Pedersen, *op cit.* fn.825.

⁸⁷⁹ As the institutional shareholder system is underdeveloped in China, the results are based on limited identity categories. In other words, institutional shareholders were excluded from this study, and so cannot provide any information with regard to the effect of institutional shareholders on performance.

and is often heavily involved in corporate decisions, so that the shareholder meeting system is less likely to evolve in a manner to protect minority shareholders, and more likely to promote the controlling shareholder's interests. Finally, it should also be pointed out that, as discussed in Chapter 5, the shareholder meetings are frequently convened in many listed companies, even though the costs are obviously sizable for minority shareholders. Under such a scenario, only the shareholders who hold substantial shareholdings have an incentive and capacity to attend all the meetings. This might result in the large shareholder extracting more private benefits and diverting corporate assets at some level of shareholdings.

The board of directors seems to have a very limited effect on corporate performance in China. Board size, the proportion of independent directors, the separation of the chairman and CEO, executive compensation and the frequency of board meetings seem to have no significant effects on corporate performance. This finding is consistent with some previous studies (such as Hermalin and Weisbach, 1991, Klein, 1998 and Bhagat and Black, 2002). A number of possible explanations for this finding may be proposed. Firstly, in this study, Table 9.1 reports that among the 267 Chinese companies in our sample, the proportion of directors who are independent averages just over one quarter. This figure is consistent with the CSRC report⁸⁸⁰ which

⁸⁸⁰ In August 2001, the China Securities Regulatory Commission (CSRC), authorised by the State Council, promulgated the "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies" (the Guidelines). The Guidelines require that by June 30th, 2002, at least two members of the board of directors should be independent directors; and by June 30th, 2003, at least one-third of the board should be independent directors. According to the CSRC report, a total of 1,244 companies out of 1,250 listed companies on the Shanghai and Shenzhen Stock Exchanges has established independent directors by the end of June 2003. Among 1244 listed companies, only 800 companies (accounting for 65%) have satisfied the requirement in respect of at least one-third of board members being independent, and 1023 companies (accounting for 82%) have one-quarter independent directors in the boardroom. See Lu et al. *Corporate Governance Correspondence*, vol.1, 2004.

indicates that the independent board system has not been well established in China by the date of this study. The primary intent of the independent board system is to encourage listed companies to establish and develop a modern enterprise system, regulate the business operations of listed companies, and to foster higher corporate productivity and economic performance. However, its implementation will take time.

Secondly, although the study shows that the majority of companies separated the roles of the chairman and CEO in China, this does not mean that the chairman was an independent outside member of the board. Ho argues that in most cases the chairman of the board in China represents the controlling shareholders who are former general managers in the state-owned enterprise or party secretaries being dominant on the board.⁸⁸¹ Obviously, this form of leadership structure could make listed companies much like wholly-owned subsidiary companies of the controlling shareholders, so that board decisions would normally be in the interests of the controlling shareholders rather than in the interests of the company as a whole. In addition, it is evident that the titles of chairman and CEO can be very misleading in China because many chairmen of the board who work full-time for the companies are executives in all but name.⁸⁸² This scenario suggests that the leadership structure of Chinese listed companies is not truly captured in customary definitions of the separation of the role of chairman and CEO.

available at http://www.iwep.org.cn/eccg/pdf/tongxun_2003-5.pdf [Accessed 28 September 2005].

⁸⁸¹ Ho, S. M. 2003. *Corporate Governance in China: Key Problems and Prospects*, Centre for Accounting Disclosure and Corporate Governance, School of Accountancy, The Chinese University of Hong Kong

⁸⁸² Zhong, Juyin, *op cit.* fn.491.

Finally, the data analysed in this study are limited to the 2002/2003 financial year. Further research which extends the period of the study may result in different conclusions. In addition, although the study finds evidence for a positive influence of the presence of an audit committee by assessing board characteristics only, this result is not confirmed when all corporate mechanisms are included in model 4. The evidence seems to suggest that the effectiveness of the board system is dependent upon the effectiveness of the integration of the overall system of corporate governance on economic performance.⁸⁸³

The control variables measured by LTA (logged total assets) and AGE (the age of the company) are strong and significant drivers of performance in all regression equations. These results show that, on the one hand, larger firms perform better on average in China. The reason may be that the large listed companies have the priority which they attach to shareholder value such as market environment, financial capacity, as well as business network relationships. On the other hand, given the negative and significant relationship in this study between AGE and corporate performance, the logical explanation would be that the older companies are mainly formed by government agencies which represent a trade off between shareholder value and other goals, or to some extent, may be due to a lack of renovation of products and out-dated management. The study does not find any impact of industrial sectors on corporate performance. However, further research by using the

⁸⁸³ In unreported results, where estimates exclude SBOD, PIND, and FBM variables in the Model 4, the presence of audit committee is positive and significant related to ROA (sig.=.085).

specified measurement of industry categories may potentially change the statistical significance of these findings.

In conclusion, this study presents empirical evidence on the effects of ownership structure, shareholder activism and the characteristics of the board on corporate performance, both separately and as interactions. The results explored in this chapter indicate the need to take the interaction of corporate governance mechanisms into account when assessing their impact on corporate performance. In terms of further research, there is a need to apply a cross-country approach to examine the relative effectiveness of corporate governance mechanisms in relation to corporate performance in different countries.

CHAPTER 10

ESTABLISHING EFFECTIVE CORPORATE GOVERNANCE IN CHINA

10.1 Introduction

In the previous chapters, we have examined the evolution and development of the corporate governance systems in China and the UK and, where appropriate, we have used empirical evidence to assess the ongoing evolution of the governance structures of Chinese publicly listed companies with reference to the governance structures of UK companies. By means of a functional comparison of both countries' systems, many problems in current Chinese corporate governance practices have been identified, including the concentration of state ownership, the expropriation of minority shareholders by controlling shareholders, the relative ineffectiveness of the hybrid two-tier board system and the lack of independence of the supervisory board, as well as an inadequate (or incomplete) law in respect of directors' duties and enforcement. In addition, given the distinctive features of the Chinese corporate governance system, we have estimated a regression model to investigate the relationship between corporate governance and corporate performance in China. The empirical evidence provides statistical insights on how the current corporate governance system affects the performance of the listed companies in China. The functional comparative analysis, supplemented by the regression analysis on the relationship between corporate governance and corporate performance in China,

provides empirical evidence confirming that the weakness of the Chinese corporate governance system is not simply a consequence of the concentrated ownership structure. The weakness is also in part due to the ineffectiveness of internal monitoring rules, inadequate or incomplete law and poor law enforcement.

The numerous findings presented in this thesis give us very strong reasons to believe that although the Anglo-American corporate governance system has been largely adopted by China, the current Chinese corporate governance system has not benefited from the advantages generally associated with the Anglo-American model. The thesis focuses on the institutional differences in ownership structures, board structure and accountability, and the impact of legal rules and enforcement on the efficient operation of companies in China and the UK in order to identify some solutions to the problems of creating a strong corporate governance environment for the success of China's economic reform. In section 10.2, we present a summary of findings and discuss their implications. In section 10.3 we provide some suggestions for the Chinese government to improve the Chinese corporate governance system. In Section 10.4, we outline the limitations of the research and offer some suggestions for future research.

10.2 Summary of Findings

Ownership structure is one of the key determinants of corporate governance. The empirical evidence presented in Chapter 4 shows how Chinese publicly listed companies are structured, who controls Chinese listed companies, how they differ from companies in other jurisdictions and whether the conflict of interest between the controlling shareholders and minority shareholders, which is created by the existing ownership structure, represents an important problem in the Chinese corporate governance system. By investigation of three key aspects of ownership structure – the types of ownership, ownership concentration, and the identities of shareholders - the findings suggest that high ownership concentration and *de facto* state control of Chinese publicly listed companies have resulted in the potential expropriation of minority shareholders by the controlling shareholders in China. Ownership without owner and *yigu dada* (big brother ownership/directorship) which support ‘tunnelling’ activities by controlling shareholders, government influence over management appointments and management political incentives have seriously affected the operation and performance of listed companies, and these have led to some listed companies being temporarily suspended from listing. To some extent, the results obtained here are consistent with the available evidence in most developing countries (including emerging and transition economies) with similar corporate governance problems.⁸⁸⁴

⁸⁸⁴ For example, Du and Dai investigate the effects of ownership structure in East Asian corporations showing that the controlling shareholder may excessively raise debt and increase the corporate leverage ratio which leads to intensive corporate value losses during a financial crisis. Julian Du and Yi Dai, 2005. *Ultimate Corporate*

In addition, the findings from our regression analysis of the relationship between corporate governance and corporate performance in China in Chapter 9 of the thesis indicate that the relationship between ownership concentration and economic performance exhibits an inverted U-shaped pattern. This result suggests that the ROA will increase with the largest shareholder's shareholding up to approximately 48.83% of company's shares and decrease afterwards. This result is consistent with related studies such as Morck et al, McConnell and Servaes, and Thomsen and Pedersen.⁸⁸⁵

We also find that the identity of the largest shareholder is important as an influence on corporate performance. The regression results suggest that Chinese listed companies tend to have a higher ROA if the largest shareholder is a family or individual investor. In contrast, if the largest shareholder is a government agency, corporate performance is lower compared with other identities. The implications of these findings are two-fold. On the one hand, a concentrated ownership structure is not always the best approach to minimise agency costs. Firms with a controlling shareholder are more likely to experience expropriation of minority shareholders. On the other hand, ownership concentrated in the hands of private owners is likely to lead to better performance. Regarding this, we conclude that privatisation – the transfer of ownership from state to the private sector - may stimulate a sufficient number of private owners to use their resources efficiently, which, in turn, will help Chinese

Ownership Structures and Capital Structures: Evidence from East Asian Economies, *Corporate Governance: An International Review*, Vol.13, pp60-71. Similarly, Lemmon and Lins also demonstrate that the expropriation of minority shareholders by the controlling shareholders and managers directly resulted in a low stock value in the Asian financial crisis period. See Lemmon, M and Lins, K. V. 2003, Ownership Structure, Corporate Governance and Firm Value: Evidence from the East Asian Financial Crisis, *Journal of Finance*, 58, pp1445-1468.

⁸⁸⁵ McConnell, J. J. and Servaes, H. 1990. "Additional Evidence on Equity Ownership and Corporate Value," *Journal of Financial Economics*, 27, 595-612; Morck, R., A. Shleifer and R. W. Vishny, *op cit* fn.38; and Thomsen, S. and T. Pedersen, *op cit*.fn.825.

listed companies to improve their economic performance. However, it should be noted that privatisation itself is unlikely to resolve the problem of corporate governance and managerial motivation. Indeed, disappointment with the results of privatisation in Russia, voucher privatisation in the Czech Republic and infrastructure privatisation in many developing countries has led to some new critiques of privatisation.⁸⁸⁶ Some argue that where markets are fully competitive, ownership does not have an impact on efficiency.⁸⁸⁷ As far as the operation of privatised companies in transition countries is concerned, Lojpuer suggests that the main objective of privatisation in transition economies is not to eliminate state or social property but, primarily, to merge a new ownership structure with efficient management structures which should result in corresponding corporate success.⁸⁸⁸ Thus, we stress that in addition to privatisation, mechanisms to ensure that shareholders possess sufficient power, initiative and capability to supervise and scrutinise management are also seen as necessary to the development of the Chinese corporate governance system.

The general principles of shareholder rights are enshrined in company law in every jurisdiction. However, how voting rights should be exercised in shareholder meetings depends largely on the jurisdiction of incorporation of the company. Shareholder voting and procedural rules are discussed by La Porta et al, who specify six key

⁸⁸⁶ Mary M. Shirley and Patrick Walsh, "Public versus Private Ownership: The current State of the Debate", available at http://econ.worldbank.org/files/1175_wps2420.pdf.

⁸⁸⁷ Borchering, Thomas E.; Schneider, Friedrich and Pommerehne, Werner. "Comparing the Efficiency Private and Public Production", *Zeitschrift für Nationalökonomie*, 1982 Supplement. Whitehead, C. "Introduction, Theory and Practice", in Whitehead, ed., *Reshaping the Nationalised Industries*. New Brunswick: Transaction Books, 1988.

⁸⁸⁸ Anelko Lojpuer, 2004, *Corporate Governance in the Transition Process*, *South-East Europe Review*, Vol.3, pp.107-118

shareholder rights in relation to shareholder meetings and voting issues: the right to *mail* their proxy vote to the firm; the right to participate in the general shareholders' meeting without having previously deposited their shares with the company; the rights to benefit from cumulative voting or proportional representation of minorities on the board of directors; the rights to benefit from the existence of an oppressed minorities mechanism; the right to hold an extraordinary shareholders' meeting if it is called for by a minimum of no less than 10 per cent of share capital; and the existence of preemptive rights to new security issues that can only be waived by a shareholders' vote.⁸⁸⁹ However, they failed to observe how these rights are operated in each country. The research into shareholder meetings and voting rights in Chapter 5 of this thesis covers a detailed comparative discussion of the legal and technical rules on shareholder meetings. By examining how the legal rules of shareholder meetings are applied in relation to publicly listed companies in China, we find that although Chinese company law empowers shareholder meeting sovereignty, the shareholder meeting does not in practice play the role envisioned by the legal model. Too much power located in the shareholder meeting has resulted in a higher frequency of shareholder meetings in China, which obviously adds an administrative and economic burden on to companies and shareholders alike. In addition, we note that the introduction of the rule of cumulative voting to regulate controlling shareholders in exercising their voting rights for the appointment of directors and supervisors would be useful as a means of mitigating conflicts of interest. However, such a rule would be

⁸⁸⁹ see La Porta et al. 1998, *op cit*, fn.6.

unlikely to produce the desired benefits of conflict monitoring because the controlling shareholders would still possess a powerful ability to influence corporate behaviour and decisions. In order to gain the desired result of effective monitoring by minority shareholders, it would be necessary to change the ownership structure and create a new breed of private institutional owners, holding much larger stakes in their portfolios, which would then be dependent on the long-term performance of those companies.

Moreover, the empirical evidence demonstrates that the shareholder meeting is ineffective as a corporate governance mechanism in China because of incomplete or inadequate procedural rules of voting which have resulted in poor attendance, a low voting ratio, and minority shareholders having very limited power and incentive to involve themselves in or challenge corporate decisions. This reflects the fact that although the existing corporate legal system in China provides certain mechanisms for enhancing effective conduct of the shareholder meetings and voting rights, minority shareholders still face significant practical difficulties in exercising voting rights, as well as economic disincentives to participate in shareholder meetings. In order to improve the passive role of minority shareholders and mitigate the conflicts of interest between the controlling shareholders and minority shareholders, the rules governing shareholder voting rights should be designed, on the one hand, to facilitate the exercise of voting rights by minority shareholders, and on the other hand, to impose necessary measures to prevent the controlling shareholders from abusing of their

voting rights. Indeed, our regression analysis supports the hypothesis that the turnout ratio and voting levels at the shareholder meetings have a particularly strong positive effect on corporate performance. One implication of this finding is that shareholders should be encouraged to exercise their voting rights either by participating, in person, in the shareholder meeting, or voting through proxy. In the light of considerable developments in electronic communication and the growing trend of individual shareholders, it will be desirable that Chinese listed companies should be able to vary the voting methods to facilitate the exercise of voting rights by shareholders.

The role and structure of boards of directors have been studied by many researchers. The issues relating to the structure and role of the board of directors are closely examined in Chapter 6 of the thesis. At present, China has borrowed both the two-tier board system and the independent director system from Western corporate governance practices. However, our empirical analysis provides evidence that the hybrid system adopted by Chinese listed companies does not promote a strong and responsive board to ensure directors' accountability. For example, evidence has shown that the two-tier board system in the Chinese context is not effective as it is often unclear whose interest is being represented by the supervisory board. In many cases, the supervisory board which has acted as an honoured guest, a friendly advisor, or a censored watchdog rather than an independent watchdog,⁸⁹⁰ has little influence on the decisions made by the board of directors and management. The establishment

⁸⁹⁰ Jason Zezhong Xiao, Jay Dahya and Zhijun Lin, 2004, A Ground Theory Exposition of the Role of the Supervisory Board in China. *British Journal of Management*, Vol.15, pp39-55.

of the independent director system is intended to prevent controlling shareholders from expropriation of minority shareholders and to monitor management integrity and performance. However, experience has shown that the independent director system has not been well-established in Chinese listed companies. Although a majority of companies have appointed independent directors, like many developing countries, the independent board and specialised committees are largely non-existence because most independent directors, who are not sufficiently independent, are often nominated by the controlling shareholders or by executives who are also representatives of the controlling shareholders rather than independent nomination committees.⁸⁹¹ In addition, the co-existence of independent directors and the supervisory board in China's corporate governance structure has created potential problems for effective monitoring because the monitoring functions overlap which not only increases the cost of corporate governance, but also leads to confusion between the roles and functions of the supervisory board and independent directors in practice.

The ineffectiveness of the hybrid board system in Chinese listed companies is confirmed in our regression analysis where we examine various aspects of the relationship between the board of directors and corporate performance. We find that

⁸⁹¹ For example, Chen, Fan, and Wong present data on the boards of directors of 621 companies that went public from 1993 through 2000 in China. They report that almost 50 percent of the directors are appointed by state controlling owners, and another 30 percent are affiliated with various layers of governmental agencies. There are few professionals (lawyers, accountants, or finance experts) on Chinese boards and almost no representatives of minority shareholders. See Chen, D. H., J.P.H. Fan and T.J. Wong, 2002. Do Politicians Jeopardize Professionalism? Decentralization and the Structure of Chinese Corporate Boards, Working Paper, Shanghai University of Finance & Economics and Hong Kong University of Science & Technology. In comparison, Goswami states: "perhaps the greatest drawback of corporate governance in India is the *de facto* lack of independent directors on the vast majority of boards". See Omkar Goswami, 2000. op cit. fn.118. Jamal Uddin Ahmad identifies the lack of independent of directors as one of the primary obstacles to good corporate governance in Bangladesh. See Jamal Uddin Ahmad, 2000, Corporate Governance for Transparency and Accountability, The Bangladesh Account, Vol.29. No.2.

the structure of the board of directors seems to have a very limited effect on corporate performance. This result suggests that although the board system reform implemented in China is based on the idea that shareholder welfare should be enhanced by independent directors who are capable of mitigating agency problems, improving corporate performance, in reality the independent directors are likely to remain mere formalities. Building on these findings, we argue that further reform of the board system is still critical to the evolution of corporate governance in China.

Corporate governance is an institutional framework defined in large part by law. Some argue that all developing countries (including emerging and transition economies) need to incorporate substantial aspects of the Anglo-American model of corporate governance, in particular, the development of legal rights and the procedural mechanisms for their enforcement to support the functioning and development of corporate governance regimes as a whole.⁸⁹² In Chapters 7 and 8, we examine how well the legal duties have been imposed on directors, and analyse the role of shareholders in enforcing directors' duties and the current development of company law in respect of shareholder legal actions, and assess the uncertainty and ambiguity surrounding the civil proceeding regimes in China compared with the UK. By comparison, we find that the rules governing directors' fiduciary duties and duty of care, skill and diligence are incomplete in China compared with the UK. Although

⁸⁹² Dennis C Mueller, 2006, *The Anglo-Saxon Approach to Corporate Governance and Its Applicability to Emerging Markets*, *Corporate Governance: An International Review*, Vol.14, pp207-219. Boris Z. Marinov, 1998, *Company Law and Corporate Governance Renewal in Transition Economies: The Bulgarian Dilemma*, *European Journal of Law and Economics*, 6:231-261. Soederberg, S, 2003. *The Promotion of 'Anglo-American' Corporate Governance in the South: Who Benefits from the New International Standard?* *Third World Quarterly*, 24, pp7-28.

China has transplanted certain common law rules into the Chinese corporate governance system, the validity, legality and enforceability of directors' duties has become more problematic in practice because the transplanted common law rules only exist in the CSRC's directive or corporate governance code. The directive and code of corporate governance is neither the formal law nor a judicial explanation promulgated by the Supreme People's Court, so they carry very weak legal authority in the litigation process. In addition, the enforcement of directors' duties and the rights and remedies of shareholders raise not only substantive provisions in company law, but also inevitably involve procedural issues that would enable shareholders to bring and pursue a lawsuit. By looking at the CCL 1994, the thesis finds that the legal framework provided very limited procedural rules governing shareholder litigations, and the shareholder protection is rather weak compared with the UK. Although the recent development of Chinese company law and securities law gives various forms of protection to minority shareholders, evidence shows that minority shareholders' interests are not properly protected because of the absence of judicial independence and impartiality.

The institutional mechanisms of corporate governance discussed in this thesis comprise a system which is critical to the enhancement of corporate performance in China. A number of studies look at the relationship between corporate performance and the combination of various instruments of corporate governance suggesting that the interaction of corporate governance mechanisms is important in determining

corporate performance.⁸⁹³ Consistent with these studies, our regression results also indicate there is a need to consider the interaction of the corporate governance mechanisms when assessing their impact on corporate performance. For example, in the combined model [model (4)], the effect of the identity of the largest shareholder qualitatively remains the same on ROA, but is less strong and less significant compared with the regression results shown in the model (1), where we test the relationship between ownership structure and corporate performance separately. Similarly, the relationship between the voting level and logged turnout ratio at the AGM qualitatively remains positive and significant, but also seems less strong and less significant compared with the results shown in model (2), where we test the relationship between shareholder activism and corporate performance respectively. Moreover, although the estimated coefficient on the presence of an audit committee remains qualitatively unchanged, it is not significant at the conventional level in the combined model (4) compared with model (3), where we test the relationship between the board of directors and corporate performance respectively. The implication of these findings is that corporate governance mechanisms have been developed over time in a specific economic, legal and political environment within a country, and no single mechanism can provide a solution for the entire set of corporate governance problems, but rather certain mechanisms are interdependent and sometimes substitutes or complements.

⁸⁹³ Coles et al, 2001, *op cit.* fn.114, Sundaramurthy et al, 1997, *op cit.* fn.877.

An open question in relation to the issues discussed in this thesis is: if China's current corporate governance system is inefficient, can China's governance systems be expected to converge to a new internal governance system, comprising the best practices in the UK? Comparative corporate governance debates on the issue of convergence have suggested that although there has been some convergence in states' governance systems, considerable differences remain.⁸⁹⁴ These differences, in turn, raise important questions about the reasons for their continued existence, about the comparative merits of alternative governance schemes and about the possibility of states improving their own governance schemes by borrowing the best practices from other states. From a comparative perspective, China is experiencing some form of convergence along the Anglo-American lines. However, the complex ownership structure and inadequate existing legal rules need to be recognised as the elements of 'path dependence' in shaping China's corporate governance system. With these unique characteristics in mind, we now attempt to provide some constructive suggestions to the Chinese government to improve the Chinese corporate governance system.

⁸⁹⁴ John C. Coffee, 1999, *The Future as History: The Prospects of Global Convergence in Corporate Governance and Its Implications*. *Northwestern University Law Review*, 93 (3):639-707. John C. Coffee, 2001. *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, vol.111, *Yale Law Journal*, 1. Christel Lane, 2003. *Changes in Corporate Governance of German Corporations: Convergence to the Anglo-American Model?* ESRC Centre for Business Research, University of Cambridge, Working Paper No.259, M.J. Rubach and T. C. Sebor, 1998, *Comparative Corporate Governance: Competitive Implications of an Emerging Convergence*, 33. *Journal of World Business*, 167.

10.3 Recommendations

10.3.1 Reforming Ownership Structure

The comparison of the corporate governance systems in China and the UK seems to suggest that the effectiveness of corporate control mechanisms differs as a result of differences in the corporate ownership structure and the identities of shareholders. The concentrated corporate ownership structure and the existence of state-owned shares and legal person shares have clearly reduced the effectiveness of the shareholding system as a vehicle of corporate control in China. The problems of the ownership structure have been recognized by the Chinese government and attention is being given to reducing the proportion of shares owned by the state. Indeed, in July 2001, the Chinese government announced that the principle of the reduction of state shareholdings was commencing. However, in the following months, the share price in Shanghai and Shenzhen Stock Exchange markets dropped by approximately 40%. In October 2001, China Securities Regulatory Commission (CSRC) had to make an announcement to stop the reduction of state stakes.⁸⁹⁵

Although the reduction of the state's shareholdings should in theory make internal monitoring and the market for corporate control more effective, the reality shows that

⁸⁹⁵ By observation of the China's stock markets, Liu summarised that "during 2000-2004, as China's GDP grew by 53%, the Shanghai and Shenzhen benchmark indexes fell by more than one third each. A recent on-line survey on 25,675 Chinese investors conducted by the internet portal sina.com showed that 94.28% of investors lost money in their stock investment, 67.34% of whom claimed to have lost more than half of their investment...., after four years' bear market, the market capitalization of tradable shares in China has dropped from close to 1.7 trillion yuan to 0.7 trillion yuan (up to early May of 2005). Nearly one trillion yuan worth of wealth disappeared in just 4 years and the trend is still continuing." See Qiao Liu, 2006, *Corporate Governance in China, Current Practices, Economic Effects and Institutional Determinants*, CESifo Economic Studies, 52 (2):415-453.

it may give rise to sharp fluctuations in the market and may even cause a collapse of the Chinese security market. Bebchuk and Roe's path dependency theory suggests that the current ownership structure is influenced by the initial ownership structure, which implies that the corporate structure will vary among countries and continue to do so over time.⁸⁹⁶ So, how can China improve the effectiveness of its corporate control mechanisms? The following are possible ways forward:

(a) Privatization

This approach is a transfer of the state-owned shares from the public sector to the private sector. The privatization process is extremely complex, time consuming and costly. It cannot change the ownership structure overnight. The reduction of the state stakes has to be conducted in a steady and gradual way. As we have seen, it cannot go beyond the market's capacity for acceptance, otherwise it may destroy the whole securities market.

(b) Specialized ownership management

This approach is to retain state ownership, but place state shares under the control of specialized ownership management institutions (e.g. fund management institutions which act on behalf of both individual investors and pension and insurance companies, and which are accountable to their own customers).⁸⁹⁷ At the same time, efforts

⁸⁹⁶ L. A. Bebchuk and M. J. Roe, *op cit.* fn.154.

⁸⁹⁷ These institutions which are different from the government established investment intermediaries which staffed by the government officers, are created initially by private funds with market-based incentives and fiduciary responsibilities.

should be made to develop corporate governance by institutional shareholder activism, and truly transform the corporate control mechanism of companies. In fact, China has allowed qualified foreign institutional investors to invest directly and trade Chinese publicly listed companies' securities.⁸⁹⁸ The competition between domestic and foreign institutional investors on the management of state shares may help to improve corporate governance in China.

(c) Stock options approach

Both international practice and China's practical situation have shown that the reduction of state shareholdings must take into account the process of pricing the state shares. A viable way is to price state shares on the basis of the movement of the value of state assets with a full consideration of market capacity and acceptance. Therefore, the state shareholdings could be transferred by means of stock options which give the recipients, especially institutional shareholders, the right to buy a share of stock at a pre-specified exercise price for a pre-specified term. This should reduce the instant pressure created by capital inadequacy or lower share prices. At the same time, as investors hold stock options with potential interests, they would have an incentive to monitor the management for better performance.

⁸⁹⁸ see the QFII, art. 2, *op cit.* fn.211.

10.3.2 Improvement of Law and Judicial Efficiency

Whichever approach of reducing the state shareholdings is exercised in China, there are no guarantees that a restructuring of ownership will eventually increase the effectiveness of Chinese corporate governance, because a system without a strong legal enforcement system will never succeed. Therefore, China also needs to strengthen the legal enforcement system. There are three fundamental ways which will provide a sound institutional basis for the enforcement of prudential requirements on the management of companies and an appropriate procedural rule for shareholder litigation against the directors for breaching their duties.

(a) Strengthening the judicial enforcement system

Although directors' duties and shareholder protection rules are adopted in China, the courts and judges have not been empowered as effectively as judges in the 'common law' countries. Government intervention significantly affects judicial independence and impartiality in the litigation process.⁸⁹⁹ In addition, the company law and other legislation afford protection to the minority by providing that they may, in certain circumstance, bring a personal, representative or derivative action to enforce a right or seek a redress. However, several hurdles currently stand in the way. For example, the Misrepresentation Regulation clearly stipulates that the courts will not have the power to adjudicate in false statement cases before an administrative sanction comes into effect.⁹⁰⁰ So the result is that this requirement creates some complexity and

⁸⁹⁹ See Hutchens, W., *op cit.* fn.786.

⁹⁰⁰ See the Misrepresentation Regulations, the SRC January 15, 2002.

uncertainty for shareholders filing an action against wrongdoers. It also puts shareholders at a disadvantage in seeking economic remedies because administrative sanctions always impose economic penalties to the wrongdoing companies and their directors. The conflict between the administrative sanctions and shareholder remedies in a serious securities fraud case may significantly dilute the potential for shareholder compensation. Taking all these factors into consideration, the solution for China is to strengthen the judicial enforcement system by establishing a fair and independent judicial environment, which is a key component of reforming Chinese corporate governance.

(b) Completing the shareholder remedies system

As discussed earlier, China has adopted the principle of minority shareholder protection from the Anglo-American system. However, this does not mean that a shareholder remedies system has been properly established in China. For example, the Misrepresentation Regulation stipulates that only cases involving misrepresentation issues (such as false record of major transactions, misleading statements, material omission and acting in an inappropriate manner in information disclosure) can be sued through shareholder litigation. Clearly, its scope is far too narrow in response to all kinds of securities fraud, such as insider dealing, market manipulation and other unfair prejudice to minority shareholders in China. With regard to derivative action, however, the minority shareholder must satisfy the prerequisites and the demanding requirements before they may commence action. This can lead to very protracted and

costly proceedings in practice. Therefore, Chinese policymakers should invoke a comparative approach in order to complete the existing law in shareholder remedies.

(c) Improving the shareholder litigation services system

Although in recent years the number of Chinese lawyers has grown dramatically and securities and corporate lawyers have become fashionable and popular, the number of securities and corporate lawyers is still inadequate. Most lawyers who practice in securities law and the corporate governance fields are located in provincial capitals. At the regional level, few lawyers have the knowledge and experience in corporate governance to deal with shareholder litigation against a corporation or to bring a derivative action against directors. Therefore, we can see that the solution for China does not only lie in enacting more laws, but also in stimulating an awareness of the benefits of good corporate governance, as well as improving both the quantity and quality of the corporate and securities lawyers engaged in shareholder litigation and other corporate governance-related legal service practices.

10.3.3 Constructive Use of Shareholder Meetings, Resolutions and Shareholder Voting Rights

The shareholder meeting is the pre-eminent occasion for shareholders to exercise their property rights within the company they have invested in. The legal status of the shareholder meeting and the procedural rules regulating the shareholder meeting are the important elements in a country's corporate governance system. In China, the

shareholder meeting is “the organ of power of the corporation”,⁹⁰¹ encompassing the superior corporate control authority, which differs significantly from the UK corporate governance system where the boards of directors are expected, in their fiduciary capacity, to control or approve the corporate affairs. The rationale behind this institutional arrangement in China is that the shareholders are considered to be the ultimate source of authority. However, as shareholders are generally free to act in their own interests and have no legal duty to act in the best interests of their fellow shareholders and the corporation, they are likely to exercise their power to pursue the maximisation of short-term gains rather than long-term shareholder value, or adopt an agenda that may favour themselves, to the detriment of others.

In China, in companies with concentrated ownership, the attendance and voting level at the shareholder general meeting largely depend on the controlling shareholders rather than institutional shareholders, as in the UK. By observation of the data of shareholder meetings and voting on the resolutions of shareholders in both countries, it is apparent that the main potential conflicts of interest lie between the controlling shareholders and minority shareholders in China, whereas in the UK the main conflicts of interest rest on the relationship between directors and shareholders. As a result, in China, evidence suggests that although legally the general meeting of shareholders is very powerful, in reality the meeting is often simply a rubber stamp for the wishes of the controlling shareholders. To solve this problem, we recommend

⁹⁰¹ See art.37 of the CCL 2006.

that shareholder meetings should be designed to ensure that, on the one hand, shareholders have the flexibility to influence board decision making, while on the other hand, the controlling shareholders should act responsibly and exercise their ownership and voting rights for the benefit of the company and not for any self-interest.

Comparing the two countries' systems, the procedural lacuna existing in Chinese company legislation with respect to the shareholder meeting is to afford the minority shareholders more opportunities to participate effectively and vote on resolutions at the shareholder meetings. In the UK, the Myners Report investigated the impediments of the UK voting system and developed a comprehensive programme of action aimed at removing impediments to the voting process in the UK.⁹⁰² The report emphasised that various parties, including the beneficial owners of shares, companies, investment managers, custodians, proxy voting agencies and registrars, should participate in the voting process to ensure that it is being operated in an effective, efficient and transparent way.⁹⁰³ The report argues that electronic voting remained the key to a more efficient voting system and called for beneficial owners, fund managers and custodians to play their part in embracing electronic voting so that votes are properly cast and counted.⁹⁰⁴ Among the recommendations presented in the Myners Report, the importance given to electronic voting is valuable for China too, because electronic

⁹⁰² See P. Myners, 2005. Review of the Impediments to Voting UK Shares, Report by Paul Myners to the Shareholder Voting Working Group, January, available at http://www.manifest.co.uk/links_search/votingUKshares.pdf [Accessed 25 April 2006]

⁹⁰³ *ibid*

⁹⁰⁴ *ibid*

voting provides an efficient means for shares to be voted in a direct, efficient and timely manner and this should help to overcome the problem of the conflicts of interest between the controlling shareholders and minority shareholders. In addition, the threshold for tabling shareholder resolutions (3% of the company's shares is the current criterion under the CCL 2006) still remains fairly stringent in China compared with the UK system. It may also be more appropriate to allow a certain number of shareholders, having an average shareholding at a certain market value, to table such resolutions and have them circulated at no cost to themselves.⁹⁰⁵ Furthermore, the rule of quorum and vote by show of hands should be incorporated into the voting rules of China's company legislation. This is a more fundamental way to improve the voting system in China as it would give minority shareholders a sense of participation in the shareholder meeting.

10.3.4 Establishment of the New Board System

China's board system was initially based on the German two-tier board structure. However, important differences between the German model and the Chinese model have resulted in ineffective and unsustainable practices in the Chinese corporate governance system. The German two-tier board structure creates a management board that is responsible for managing the company and a supervisory board responsible for supervising the decisions of the management board. In contrast, China's two-tier board system does not provide the supervisory board with the legal power to influence

⁹⁰⁵ In the UK, 100 members having an average holding of £100 market value may submit shareholder resolutions to the shareholder meeting at the expense of the company. See s.376 the CA 1985 and cl.290 (2) of the Bill

board of directors' decisions. In practice, the supervisory board is only symbolic and has no real function in promoting good corporate governance. The emergence of the independent director system in China represents an attempt to increase board independence and enhance board effectiveness, but evidence suggests that the independent director system has not been well established in Chinese listed companies, and the duplication of functions between the supervisory board and the independent directors creates further ambiguity in China's board system. Although the CCL 2006 has clarified and strengthened the role of the supervisory board, it is still doubtful that supervisory boards will play any substantive monitoring functions on behalf of all shareholders and other stakeholders, because they lack independence.

Considering the many drawbacks of China's board system, we suggest that the law should integrate independent directors into the supervisory board and give the supervisory board wide powers over boards of directors, assuming that China continues to employ the two-tier board system. For example, the supervisory board should comprise independent directors, shareholder and employee representatives divided into proportion of one-third from each group. The combination of independent directors, shareholder representatives and employee representatives should be an important feature of the new Chinese corporate governance system which might be expected to solve the potential conflict between the controlling shareholders and minority shareholders, as well as other stakeholders. In addition, the new supervisory board should set up subcommittees for remuneration, nomination

and audit, each with a majority of independent directors. The powers and functions of the supervisory board may extend to the appointment or dismissal of members of the board of directors and approval of the level of remuneration of directors. The new relationship between the supervisory board and the board of directors under the new model will be capable of avoiding the costly role confusion between independent directors and the supervisory board and enhancing the effectiveness of independent directors in disciplining executive directors.

10.4 Limitations and Suggestions for Further Research

This thesis has concentrated on the roles of shareholders and directors, and has only made limited references to the corporate governance roles played by creditors and employees. Particularly with regard to employees, what role they play and how much influence they have on the governance of companies in China are interesting and important questions. Under China's two-tier board system, further research could examine whether the current structures of employee involvement assist good governance and whether employees actually feel inclined to participate in the governance of companies. In addition, the empirical data used in Chapter 9 were limited to the 2002/2003 financial year. Further research which extends the period of the study may reach different conclusions to those reported in our regression analysis. Finally, since the CCL 2006 has just come into effect, many new rules have not yet been implemented in Chinese publicly listed companies. Further research could focus

on the implementation of new regulations, including the effectiveness of the means of enforcement used in China.

REFERENCES

- Agrawal, A. and C. R. Knoeber, 1996. Firm Performance and Mechanisms to Control Agency Problems between Manager and Shareholders, *Journal of Financial and Quantitative Analysis*, Vol. 31. No.3, p377.
- Ahmad, Jamal Uddin, 2000, Corporate Governance for Transparency and Accountability, *The Bangladesh Account*, Vol.29. No.2.
- Alchian, A. A., 1965. *Some Economics of Property Rights*, reprinted in Alchian, A.A. *Economic Force at Work*, Indianapolis: Liberty Press, (1977).
- Alchian, A. A. and H. Demsetz 1972 "Production, Information Costs and Economic Organization. *American Economic Review*, 62(5), 777-95.
- Alchian, A. A. and H. Demsetz, 1973. The property Rights Paradigm, *The Journal of Economic History*, pp173-83.
- Allen, J. and F. Roy, 2001. *Corporate Governance in Greater China: A Comparison between China, Hong Kong and Taiwan*. Asian Corporate Governance Association.
- Andres, P., V. Azofra and F. Lopez, 2005. Corporate Boards in OECD Countries: Size, Composition, Functioning and Effectiveness. *Corporate Governance: An International Review*, Vol. 13, 197-210.
- Armour, J., S. Deakin and S. J. Konzelmann, 2003. *Shareholder Primacy and the Trajectory of UK Corporate Governance*, ESRC Centre for Business Research, University of Cambridge, working paper No.266.
- Baums, T. Shareholder Representation and Proxy Voting in European Union: A Comparative Study, in Hopt et al, 1998, *Comparative Corporate Governance*, Clarendon, p547.
- Baysinger, B.D. and H.N. Butler 1985. Corporate Governance and the Board of Directors: performance effects of changes in board composition. *Journal of Law, Economics and Organisation*, Vol. 1, pp. 101-124.
- Baysinger, B. D. and R.E. Hoskisson, 1990. The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy, *Academy of Management Review*. 15, 72-87.
- Bebchuk, L. A. 1989. Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 *Harvard Law Review*, pp1820-1860.

- Bebchuk, L. A. and M. Roe, 1999. A Theory of Path Dependence in Corporate Governance and Ownership, *52 Stanford Law Review* 127.
- Berglof, E and S. Claessens, 2006, Enforcement and Good Corporate Governance: Governance in Developing Countries and Transition Economies. *The World Bank Research Observer*, 21:123-150.
- Berkowitz, D., K. Pistor and J. Richard, *Economic Development, Legality, and the Transplant Effect*, CID working paper No.39 March 2000, Centre for International Development at Harvard University.
- Berle, A. A. and G. C. Means, 1932. *The Modern Corporation and Private Property*. New York: Macmillan.
- Bhagat, S. and B. Black 1999. The Uncertain Relationship between Board Composition and Firm Performance, *Business Lawyer*. 54: 921-963;
- Bhagat, S. and B. Black, 2001. The non-correlation between board independence and long-term firm performance, *Journal of Corporation Law*. 27: 231-274.
- Borcherding, Thomas E.; Schneider, Friedrich and Pommerehne, Werner. 1982, Comparing the Efficiency Private and Public Production, *Zeitschrift für Nationalökonomie*, Supplement.
- Boyle, A.J. and J. Bird, 2004. *Boyle & Birds' Company Law*, 5th ed. Jordans.
- Black, B. 1994. Institutional Investors and Corporate Governance: The Case of Institutional Voice, *6 Journal of Applied Corporate Finance*, pp19-32.
- Blair, M. and L. A. Stout, 1999. A Team Production Theory of Corporate Law, *85 Virginia Law Review*. 247.
- Blair, M. 1995. *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*, the Book Institution Washington D. C.
- Boubakri, N and Cosset, J. C. 1998. The Financial and Operating Performance of Newly Privatized Firms: Evidence from Developing Countries, *Journal of Finance*, Vol.53, pp1081-1110.
- Boyle, A. J., 1997. The New Derivative Action, *Company Lawyer*. 18: 256.
- Boyle, A. J. 2002, *Minority Shareholders' Remedies*, Cambridge University Press, p29.

Butcher, D. B. 1995. Reform of the General Meetings. In Saleem Sheikh and William Rees ed. *Corporate Governance and Corporate Control*, Cavendish Publishing Ltd.

Cadbury, A. 2002. *Corporate Governance and Chairmanship: A Personal View*, Oxford University Press.

Cadbury Report, 1992. *The Report of Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice*, Gee Publishing, December 1992.

Cai, W. 1999. Privative Securities Litigation in China: Of Prominence and Problems, *13 Columbia Journal of Asian Law*. 135, 146.

Carleton, W. T., J. M. Nelson, and M. S. Weisbach, 1998. The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF, *The Journal of Finance*, Vol. LIII, No.4, 1335-1362, at 1356-1657.
Chambers, A. D. 2005. Audit Committee: Practice, Rules and Enforcement in the UK and China. *Corporate Governance: An International Review*, Vo.13 pp92-100,

Charkham, J. 1994. *Keeping Good Company: A study of Corporate Governance in Five Countries*, Oxford University Press.

Cheffins, B. R. 1997. *Company Law: Theory, Structure and Operation*, Clarendon Press, Oxford.

Chen, Q. 2004. *State Shareholders Should Become an Active Force in Establishment of Effective Corporate Governance*, Shanghai OECD Corporate Governance Forum, 26 February.

Chen, Z. and P. Xiong, 2001. *Discounts on Illiquid Stocks: Evidence from China*. Yale ICF Working Paper No. 00-56, September.

Chen, Y. M. and S. C. Gong, 2000. Ownership Structure and Corporate Performance – Some Chinese Evidence, *Advances in Pacific Basin Financial Markets*, 6, 177-193.

Chen, D. H., J.P.H. Fan and T.J. Wong, 2002. Do Politicians Jeopardize Professionalism? Decentralization and the Structure of Chinese Corporate Boards, Working Paper, Shanghai University of Finance & Economics and Hong Kong University of Science & Technology.

Cheng, Y. 2000. Enterprises Demand Supervision, *China Economic Daily*, Jannaury 10.

Chung, K. H. and S. W. Pruitt, 1994. A Simple Approximation of Tobin's Q, *Financial Management*, 23(3):70-74.

- Claessens, S., S. Djankov and G. Pohl, 1997. *Ownership and Corporate Governance: evidence from the Czech Republic*, World Bank Policy Research Working Paper No. 1737.
- Claessens, S., S. Djankov, J. P. H. Fan, and L. H. P. Lang , 1999. *Expropriation of Minority Shareholders: Evidence from East Asia*, Working Paper No.2088, World Bank.
- Claessens, S. and Djankov, S. 1999, Ownership Concentration and Corporate Performance in the Czech Republic, *Journal of Comparative Economic*, 27: 498-513.
- Claessens, S., S. Djankov and L. H. P. Lang, 2000. The Separation of Ownership and Control in East Asian Corporations, *58 Journal of Financial Economics* 81-122.
- Claessens, Djankov and Lang 2002, Berkowitz, Pistor and Richard, 2002, Economic Development, Legality, and the Transplant Effect, *European Economic Review* 47(1): pp165-195
- Claessens, Stijn and Joseph P.H. Fan, 2003. Corporate Governance in Asia: A Survey, *International Review of Finance* 3(2), pp71-103.
- Clark, R. 1997, *Corporate Law, Aspen Law & Business*, Panel Publisher.
- Clarke, T., 2004. *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, ed. London; New York: Routledge, p1.
- Company Law Review Steering Group, 2001. *Modern Company Law for a Competitive Economy: Final Report* (URN 01/942, vol. 1, 2001).
- Company Law Review Steering Group, 2000. *Modern Company Law for a Competitive Economy: Developing the Framework*. (URN 00/656, March 2000).
- Company Law Review Steering Group, 2000. *Modern Company Law for a Competitive Economy: Completing the Structure* (URN 00/1335 November 2000).
- Company Law Review Steering Group, 1999. *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication*, (URN 99/1144, October 1999).
- Coase, R. H., 1960. The Problem of Social Cost, *Journal of Law and Economics*, vol. 3, pp1-44.
- Coase, R. H. 1937. The Nature of the Firm, *4 Economica* pp386-405

- Coffee, J. C. 1994. The SEC and the Institutional Investor: A Half-Time Report, 15 *Cardozo L. Rev.* 837.
- Coffee, J. C. 1999. Privatisation and Corporate Governance: The Lesson from Securities Market Failure, 25 *J. Corp. L.* 1-37.
- Coffee, John C. 1999, The Future as History: The Prospects of Global Convergence in Corporate Governacne and Its Implications. *Northwestern University Law Review*, 93 (3):639-707.
- Coffee, J. C. 2001. The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, 111 *Yale L. J.* 1
- Coleman, J. 1966. Reward Structures and the Allocation of Effort in P. F. Lazarsfeld and N. W. Henry, eds. *Reading in Mathematical Social Science*. Cambridge: MIT Press, pp.159-73.
- Coles, J.W., V. B. McWilliams and N. Sen, 2001. An Examination of the Relationship of Governance Mechanisms to Performance. *Journal of Management* 27: 23-50;
- Conger, J., D. Finegold and E. Lawler, 1998. Appraising Boardroom Performance, *Harvard Business Review*, 76, 136-148.
- Conyon, M. J. and K. J. Murphy, (2000), The Prince and the Pauper? CEO Pay in the United States and The United Kingdom, *Economic Journal*, Vol.110, No. 467, pp209-226.
- Conyon, M. J. and S. I. Peck, 1998. Board Size and Corporate Performance: Evidence from European Countries, *The European Journal of Finance*, 4, 291-304.
- Conyon, M. J., S. I. Peck, L. E. Read and G. V. Sadler, 2000. *Long Range Planning* 33, pp478-503.
- Cook, L. and K. Leissle, (2002) UK Company Corporate Governance: Comparing the FT-1000 and TechMark-100 Indices, available at http://www.boardroomanalysis.com/gov/UK%20Company%20Research_FY99-00_March%202002.pdf.
- Core, J., R. Holthausen and D. Larcker, 1999. Corporate Governance, Chief Executive Officer compensation and Firm Performance. *Journal of Financial Economics*, 51: 371-406.
- Cox, J. D. 1982. Searching for Corporation's Vote in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, *DUKE L. J.* 962.

CSRC; 2001, Circular of the China Securities Regulatory Commission and the State Administration of Foreign Exchange, Notice on Issues Concerning Individual Domestic Residents' Investment in Foreign Currency Stocks Listed in the Domestic Stock Markets, CSRC No.22.

CSRC, Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, Zhengquanfa [2001] No. 102. Available at <http://www.csrc.gov.cn/en/jsp/detail.jsp?infoid=1061947864100&type=CMS.STD>. [Accessed 25 September 2005]

CSRC, Circular on the Transfer of State Shares and Legal Person Shares to Foreign Investors, ZhengJianFa [2002] No.83, November 2002. Available from: http://www.ec.cn/pubnews/2003_02_16/200616/1000747.jsp [Accessed 15 March 2005].

Cubbin, A. D. and D. Leech, 1983. The Effect of Shareholder Dispersion on the Degree of Control in British Companies: Theory and Measurement, *93 Economic Journal*, p351.

Dahya, J., J.J. McConnell and G.N. Travlos, (2002), The Cadbury Committee, Corporate Performance and Top Management Turnover, *Journal of Finance*, Vol.57, pp461-483.

Dahya, J., Y. Karbhari, J. Z. Xiao and M. Yang, 2003. The Usefulness of the Supervisory Board Report in China, *Corporate Governance: An International Review*, Vol.11, pp 308-321.

Dallas, L. L. 1996. The Relational Boards: Three Theories of Corporate Board of Directors, *The Journal of Corporation Law*, vol.22, pp1-25.

Dalton, D. R., C. M. Daily, A. E. Ellstrand and J. L. Johnson, 1998, Meta-analytic Reviews of Board Composition, Leadership Structure, and Financial Performance, *Strategic Management Journal*, 19, 3: 269-290. at 284.

Dalton, D. R. and I. F. Kesner, 1987. Composition and Duality of Boards of Directors: An International Perspective, *Journal of International Business Studies*, pp33-42, at p35.

Davies, P. L. and D. D. Prentice, 1997. *Gower's Principles of Modern Company Law*, 6th ed. London, Sweet & Maxwell.

Davis, P. L. 1993, Institutional Investors in the United Kingdom. In D.D. Prentice and P.R.J. Holland, ed. *Contemporary Issues in Corporate Governance*, Oxford University Press, pp69-96.

- Deakin, S. and A. Hughes, 1997. Comparative Corporate Governance: An Interdisciplinary Agenda. In Deakin, S. and A. Hughes, ed. *Enterprise and Community: New Directions in Corporate Governance*. Blackwell Publishers: Oxford.
- Dehaene, A., V. De Vuyst, and H. Ooghe, 2001. Corporate Performance and Board Structure in Belgian Companies, *Long Range Planning*, 34, 383-389.
- Deli, D. N. and S. L. Gillan, 2000. On the Demand for Independent and Active Audit Committees, *Journal of Corporate Finance*, Vol.6, Issue 4, pp427-445.
- Demsetz, H. 1988. *Ownership, Control and the Firm*. New York: Basil Blackwell.
- Demsetz, H. 1976. Toward a Theory of Property Rights, *American Economic Review*, 57: 347-359.
- Demsetz, H. 1988. Profit as a Functional Return: Reconsidering Knight's Views, in Harold Demsetz, *Ownership, Control and the Firm: The Organisation of Economic Activity*, vol.1, Oxford and New York: Basil Blackwell, pp236-247.
- Demsetz, H. and K. Lehn, 1985. The Structure of corporate ownership: causes and consequences, *Journal of Political Economy* 93, 1155-1177;
- Deng, J. 2005. Building an Investor-Friendly Shareholder Derivative Lawsuit System in China, *Harvard International Law Journal*, (46), p347.
- Detomasi, D., 2002, International Institutions and the Case for Corporate Governance: Toward a Distributive Governance Framework? *Global Governance*, 8(4), 421-442.
- Dhareadkar, Ravi, Gerard George and Pamela Brandes, 2000, Privatization in Emerging Economies: An Agency Theory Perspective, *The Academy of Management Review*, Vol.25, pp650-669.
- Diane, K. Denis and John J. McConnell, 2003. International Corporate Governance, *Journal of Financial and Quantitative Analysis* 38: 1-36.
- Donaldson L. and J. Davis, 1991. Stewardship Theory or Agency Theory: COE Governance and Shareholder Returns, *Australian Journal of Management*. 16(1): 49.
- Donaldson, T. and L. E. Preston. The Stakeholder Theory of the Corporation, Evidence and Implications. *The Academy of Management Review*, Vol.20, 65-91.

Dou, J. 1999. Research on the History of Corporate Ideology in China, citing in Wei, Y., 2002. The History of the Corporation in China, 66 *University of Western Sydney Law Review*, pp95-122.

Drury, R. and P. Xuere, 1991. *European Company Law: A Comparative Approach*. Dartmouth.

Du, Julian and Yi Dai, 2005. Ultimate Corporate Ownership Structures and Capital Structures: Evidence from East Asian Economies, *Corporate Governance: An International Review*, Vol.13, pp60-71.

Dulewicz, V. and P. Herbert, 2004. Does the composition and practice of boards of directors bear any relationship to the performance of their companies? *Corporate Governance*, Vol.12, No.13, July.

Department of Trade and Industry, Explanatory Notes to the Bill. Available from: <http://www.publications.parliament.uk/pa/ld200506/ldbills/034/2006034.htm> [Accessed 12 March 2006]

Department of Trade and Industry, Company Law Reform White Paper, March 2005, Ch3, available from: <http://www.dti.gov.uk/cld/WhitePaper.htm> [Accessed 25 September 2005]

Department of Trade and Industry, Transparency of Voting by Institutional Investors, Available from: <http://www.dti.gov.uk/cld/votingrightsexpl.doc> . [Accessed 25 September 2005]

Easterbrook, F. H. and D. R. Fischel, 1983. Voting in Corporate Law, 26, *Journal of Law & Economics*, 395: 401-02.

Easterbrook, F.H. and D. R. Fischel, 1989. The Corporate Contract', 89 *Columbia Law Review*. 1416.

Easterbrook F. H. and D. R. Fischel, 1996. *The Economic Structure of Corporate Law*, Harvard University Press;

Edkins, M., and T. Bush, 2002. Encouraging Shareholder Activism: An Consultation Document, 17 May. Hermes, at p1. The document is available from: http://www.hermes.co.uk/pdf/corporate_governance/commentary/encouraging_shareholder_activism_170502.pdf [Accessed 22 February 2005].

Eisenberg, T., S. Sundgren and M.T. Wells, 1998. Large Board Size and Decreasing Firm Value in Small Firms, *Journal of Financial Economics*, 48, 35-54

Ellingson, D. A. H. 1996, *Board Composition and the Use of Accounting Measures: The effects of the Relationship Between CEO Compensation and Firm Performance*, PhD. Dissertation, Virginia Polytechnic Institute of and State University.

Ezzamel, M. and R. Watson, 2005. Boards of Directors and the Role of Non-executive Directors in the Governance of Corporations. In K.Keasey, S. Thompson and M. Wright ed. *Corporate Governance: Accountability, Enterprise and International Comparisons*. John Wiley & Son Ltd.

Fama, E. F. and M. C. Jensen, 1983, Agency Problem and Residual Claims, *Journal of Law and Economics*, Vol. XXVI, pp327-349.

Fang, L. 1995. China's Corporatization Experiment, 5 *Duke Journal of Comparative and International Law*. 149.

Farrar, J. et al, 1998. *Farrar's Company Law*, 4th ed. Butterworths.

Faure, D. 1996. Company Law and the Emergence of the Modern Firm. In: R.A. Brown, *Chinese Business Enterprise* (Routledge, London, 1996), Vol. IV, chapter II.

Fisch, J. E., 1994, Relationship Investing: Will It Happen? Will It Work? *Ohio State Law Journal*, Vol.55, No5, 1009.

Fischel, R. Daniel and M. Bradley, 1986. The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 *Cornell Law Review*, 261.

Florence, P. S., 1961. *Ownership, control and success of large companies: an analysis of English industrial structure and policy 1936-1951*, Sweet & Maxwell, p85.

Forbes, W and R. Watson, 1993. Managerial Remuneration and Corporate Governance: A Review of the Issues, Evidence and Cadbury Committee Proposals. *Accounting and Business Research*, 23: 331-8.

Franks, J and C, Mayer, 1995. Ownership and Control. In H. Siebert (ed.), *Trends in Business Organisation: Do Participation and Cooperation Increase Competitiveness?* Tübingen: Mohr (Siebeck).

Freeman, R. E. 1984, *Strategic Management: A Stakeholder Approach*, Ballinger, Boston, MA.

Freeman, R. E. 1984. *Strategic Planning: A Stakeholder Approach*, Pitman.

Forjan, J. M. 1999. The Wealth effects of shareholder-sponsored proposals, *Review of Financial Economics*. 8:61-72.

Furubotn, E. and S. Pejovich, 1974. *The Economic of Property Rights*, Cambridge, Mass: Ballinger Publishing.

Gan, Z.P. 1998, *The Law of Enterprise and Companies*. Beijing University Publishing House.

Gao, X. (Ed.), 2001. *Secrets of Listed Companies*. World Publication Press.

Carlin, W. and C. Mayer, 1999. How do Financial Systems Affect Economic Performance? Available from:
[http://www.finance.ox.ac.uk/file links/finecon_papers/1999fe08.pdf](http://www.finance.ox.ac.uk/file_links/finecon_papers/1999fe08.pdf) [Accessed 12 September 2005].

Gaved, M. 1998. The Role of Disclosure in Strengthening Corporate Governance and Accountability: Corporate Governance in the United Kingdom. OECD, February. Available FEOM: <http://www.oecd.org/dataoecd/63/14/1932499.pdf> [Accessed 12 March 2006]

Giffiths, A. 1995. Shareholding and the governance of public companies. In Saleem Sheikh & William Rees, ed. *Corporate Governance & Corporate Control*. Cavendish Publishing. p61.

Gillian, S. and L. Starks, 1998. A Survey of Shareholder Activism: Motivation and Empirical Evidence, *Contemporary Finance Digest* 2(3), 10-34.

Gillian, S. and L. Starks, 2000. Corporate Governance Proposals and Shareholder Activism: the Role of Institutional Investors. *Journal of Financial Economic* 57: 275-305.

Goergen, M. 1998. *Corporate Governance and Financial Performance: A Study of German and UK initial public offerings*, Cheltenham: Edward Elgar.

Goetzmann, William and Elisabeth Köll, 2003, *The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control*, Yale ICF Working Paper No.04-29. June 2004.

Goswami, Omkar, 2000, *The Tides Rises, Gradually: Corporate Governance in India*, (CII/OECD), Informal Workshop on Corporate Governance in Developing Countries and Emerging Economies, April.

Goyal, V. and C. Park, 2002. Board Leadership Structure and CEO Turnover, *Journal of Corporate Finance*, 8:49-66.

Green, S. 2003. 'Two-third Privatisation': How China's Listed Companies are – Finally – Privatising, Chatham House Briefing Note, The Royal Institute of International Affairs, Asia Programme.

Greenbury Report, 1995. Directors' Remuneration, Report of a Study Group Chaired by Sir Richard Greenbury. Gee Professional Publishing, London.

Gregory, H. J. *The Globalisation of Corporate Governance*, Weil, Gotshal & Manges LLP: New York 2003, Law Firm Publication.

Griffiths, A. 1995. Shareholding and the Governance of Public Companies, in Saleem Sheikh and William Rees ed. *Corporate Governance and Corporate Control*, Cavendish Publishing Ltd.

Grossman, S. J. and O. Hart, 1986. The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, *Journal of Political Economy*, 94, 691-719.

Gu, M. 2003. Will an Independent Director Institution Perform Better than a Supervisor? Comments on the Newly Created Independent Director System in the People's Republic of China, 6 *Journal of Chinese and Comparative Law*, 59.

Gugler, K. 2001. *Corporate Governance and Economic Performance*. Oxford University Press.

Guo, R. 2002. Disinterested or Uninterested? Some Thoughts on the CSRC's Independent Directors Guiding. *Perspectives*, Vol.3. No 5. available at http://www.oycf.org/Perspectives/17_063002/Disinterested_Uninterested.htm [Accessed 25 September 2005]

Hampel Report: *Committee on Corporate Governance, Final Report*, January 1998, Gee Publishing Ltd.

Han, A. M. 1996. China's Company Law: practicing capitalism in transitional economy, 5 *Pacific Rim Law & Policy Journal*, 457.

Hanazaki, Masaharu and Qun Liu, 2003. The Asian Crisis and Corporate Governance: Ownership Structure, Debt Financing, and Corporate Diversification, CEI Working Paper Series, No. 2003-18.

Hannigan, B. 2003. *Company Law*, LexisNexis UK.

Hart, O. and J. Moore, 1990. Property Rights and the Nature of the Firm, *Journal of Political Economy*, 98, 1119-1158.

Hart, O. 1989, An Economist's Perspective on the Theory of the Firm, *Columbia Law Review*, 89: 1757-74.

Hart, O. 1995, *Firms Contracts and Financial Structure*, Clarendon Press, Oxford.

Hart, O. 1995. Corporate Governance: Some Theory and Implications. *The Economic Journal*, Vol.105, pp678-89.

Hermalin, B. E. and M. S. Weisbach, 1991. The Effects of Board Composition and Direct Incentives on Firm Performance, *Financial Management* 20(4) 101-112.

Herman, E. S. 1981. *Corporate Control, Corporate Power: A Twentieth Century Fund Study*, Cambridge University Press.

Higgs, D. 2003. Review of the Effectiveness of Non-Executive Directors, London, Department of Trade and Industry. s.6.4. Available from: <http://www.ecgi.org/codes/documents/higgsreport.pdf> [Accessed 12 March 2006].

Hillman, A. J. and T. Dalziel, 2003. Board of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives. *Academy of Management Review*, 28: pp383-396.

Ho, S. M. 2003. *Corporate Governance in China: Key Problems and Prospects*, Centre for Accounting Disclosure and Corporate Governance, School of Accountancy, The Chinese University of Hong Kong

Hoang, L. H. 2003. *The Effects of Judicial Efficiency on Credit Market Development*, IEE Working Paper, Volume 174, Institute of Development Research and Development Policy, RUHR University Bochum.

Holderness, C. G. and D. P. Sheehan, 1988. The Role of Majority Shareholders in Publicly Held Corporations: an Exploratory Analysis, *Journal of Financial Economics*, 20, 317-346.

Hong, T. L. 2000. Corporate Governance Issues in PRC Companies, *International Company and Commercial Law Review*, 11(3), 87-95, at89-90.

Hopt, K. J. 1997. The German Two-tier Board (Aufsichtsrat): A German View on Corporate Governance. In Hopt, K J and Wymeersch E (ed.), *Comparative Corporate Governance, Essays and Materials*, Walter de Gruyter, New York.

Hovey, M., L. Li and T. Naughton, 2003. The Relationship between Valuation and Ownership of Listed Firms in China. *Corporate Governance* 11(2), 112-122.

Hu, R., 2002. *The Recent Development of Corporate Governance in Great China Area, Shareholder Rights and the Equitable Treatment of Shareholders*, the Fourth Asian Roundtable on Corporate Governance.

Hutchens, W. 2003. Private Securities Litigation in China: Material Disclosure about China's Legal System, 24, *University of Pennsylvania Journal of International Economic Law*, pp599-689.

Institute International Finance (IIF) Equity Advisory Group, 2004. *Corporate Governance in China: An Investor Perspective*. Task Force Report, April 2004. Available from: http://www.iif.com/data/public/china_task_force_final.pdf [Accessed 12 February 2006].

IIF Task Force Report, 2004. *Corporate Governance in Brazil: An Investor Perspective*, June.

Jensen, M. C. 1993. The Modern Industrial Revolution, Exit, and the Failure of Internal Control Mechanisms, *Journal of Finance*, XL VIII, 831-880, at 865.

Jensen, M. and W. Meckling, 1976. Theory of the firm: Managerial behaviour, agency costs and ownership structure, *The Journal of Financial Economics*, 3:305-60.

Jesover, F. 2001, Corporate Governance in the Russian Federation: The Relevance of the OECD Principles on Shareholder Rights and Equitable Treatment, *Corporate Governance*: 9, pp79-88.

Jiang, D. 2003. *Company Law Report (II)*, Citic Publishing House.

Jiang, Q. 2002. Standardizing Behavior and Deepening Reform, to be Creditworthy and Responsible Shareholders of Listed Companies, Speech at the Meeting on Summarising the Experience of Establishing Modern Enterprise System in Listed Companies, December 27.

Johnson, S., F. Lopez-de-Silanes, R. La Porta, and A. Shleifer, 2000. Tunneling, *The American Economic Review Papers and Proceedings* 90: 22-27

John, K and L. W. Senbet, 1998. Corporate Governance and Board Effectiveness, *Journal of Banking & Finance*, 22, 372-403.

Kackenzie, C. 1993. *The Shareholder Action Handbook: Using Shares to Make Companies More Accountable*, Newcastle: New Consumer Ltd.

Karpoff, J. 1998. *The Impact of Shareholder Activism on Target Companies: Survey of Empirical Findings*, University of Washington, School of Business, Seattle, Washington.

Kawashima, S. and Susumu Sakurai, 1997. Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms; 33 *Stanford Journal of International Law*. 9-60.

Keasey, K, S. Thompson and M. Wright, 2005. Introduction, in K. Keasey, S. Thompson and M. Wright. *Corporate Governance: Accountability, Enterprise and International Comparison*, eds. John Wiley & Sons, Ltd. p1.

Kirby, W. C., 1995. China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China, *Journal of Asian Studies*. 54: 43-63.

Kirkbride, J., S. Letza and X. Xun, 2005. Corporate Governance: Towards a Theory of Regulatory Shift. *European Journal of Law and Economics*. 20:57-70.

Klausner, M. 2003. Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage, 152 *University of Pennsylvania Law Review*. 755.

Klein, A. 1998. Firm Performance and Board Committee Structure, *Journal of Law and Economics*, 41: 275-303.

Knowles, G. 1996. Shareholder Communication: Proposed Changes to the Companies Act, *Company Lawyer*, 17(6), 188-189.

Koontz, H., 1967, *The Board of Directors and Effective Management*, New York, McGraw-Hill Book Company. p121.

Kornhauser, L., 2006, Legal Philosophy: The Economic Analysis of Law, in Edward N. Zalta (ed.), *The Stanford Encyclopedia of Philosophy (Spring 2006 Edition)*, available from: <http://plato.stanford.edu/archives/spr2006/entries/legal-econanalysis/> [Accessed 20 April 2006].

Levin, S. G. and S. L. Levin, 1982. Ownership and Control of Large Industrial Firms: Some New Evidence, *Review of Business and Economic Research*, Spring, 37-49;

La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny. 1997. Legal Determinants of External Finance, *Journal of Finance* 52:1131.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny, 1998. Law and Finance, *Journal of Political Economy* 106: 1113–1155.

La Porta, R., F. Lopez-de-Silanes, and A. Shleifer, 1999. Corporate Ownership around the World, *Journal of Finance* 54: 471–517.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny. 2000. Agency Problems and Dividend Policies around the World, *Journal of Finance*, 55: 1-33.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny. 2002, Investor protection and corporate valuation, *Journal of Finance* 57:1147–1170

Lane, Christel, 2003. Changes in Corporate Governance of German Corporations: Convergence to the Anglo-American Model? ESRC Centre for Business Research, University of Cambridge, Working Paper No.259,

Lerner, Robert J., 1966. Ownership and Control in the 200 Largest Non-Financial Corporations, 1929 and 1963. *American Economic Review*, 56:777-87.

Law Commission Report, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*, Law Com. No.153, (London: Stationery Office, 1999).

Law Commission, *Shareholder Remedies* (Law Commission Report No.246, Cm 3769, Stationary Office, 1997)

Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (1998, Law Com No 153, Scot Law Com No 105).

Lee, S. M., 2001. The Development of China's Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law, *New York International Law Review*, 14:1.

Leech, D. and J. Leahy, 1991. Ownership Structure, Control Type Classifications and the Performance of Large British Companies, *Economic Journal*, 101: 1418-1437.

Lemmon, M. L. and K. V. Lins, 2003. Ownership Structure, Corporate Governance and Firm Value: Evidence from the East Asian Financial Crisis. *The Journal of Finance*, Vol. LVIII, 1445-1468.

Li, C., 2002. Independent Directors Quit as CSRC Gets Tough, *South China Morning Post* (Hong Kong), August 21.

Li, H. 2004. China – Measurement Problems, *Corporate Governance Watch*. p39. Available from:
http://www.empea.net/docs/research/thirdparty/CLSA_ACGA_CGWatch2004.pdf. [Accessed 26 May 2006].

Li, N. 2004. Civil Litigation against China's Listed Firms: Much ado about nothing?" Asia Programme Working Paper, No.13, February;

Li, Y. 2001, CSRC: Yinguangxia Fabricated 745m Yuan Profits, *People's Daily*, 06 September 2001, available from:

http://blog.issproxy.com/2006/02/china_enacts_new_governance_ru_1.html.

[Accessed 25 April 2005]

Licht, A. N., C. Goldschmidt, and S. H. Schwartz, 2001. *Culture, Law, and Finance: Culture Dimensions of Corporate Governance Laws*. Available from:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=267190 [Accessed 12 September 2005].

Lin, C. 2001. *Private vices public place: Challenges in corporate governance development in China*. Working paper for the OECD Development Centre Research Project on Corporate Governance in Developing and Emerging Economies.

Lin, T. W. 2004. *Corporate Governance in China: Recent Developments, Key Problems and Solutions*, USC Marshall Research, University of Southern California, Marshall Business School.

Lipton, M. and J. W. Lorsch, 1992. A Modest Proposal for Improved Corporate Governance, *The Business Lawyer* 48: 59-77.

Liu, D., 2000. *Corporate Governance of the State-owned Enterprises in China*. Available from: <http://www.oecd.org/dataoecd/47/59/1929582.pdf>. [Accessed 25 February 2005].

Liu, G. S. and P. Sun, 2005. Ownership and Control of Chinese Public Corporations: A State-dominated Corporate Governance System, in Kevin Keasey, Steve Thompson and Mike Wright, ed. *Corporate Governance: Accountability, Enterprise and International Comparisons*. John Wiley & Sons Ltd.

Liu, G. S. and S. P. Sun, 2003. *The Class of Shareholdings and its impacts on Corporate Performance – A case of State Shareholding Composition in Chinese Publicly Listed Companies*, The Royal Institute of International Affairs, Asia Programme Working Paper No.2.

Liu, J. 2003. EGM Disputes Need Judicial Intervention, *Zhongguo Zhenquanbao* (China Securities Daily) March 18, Available from http://www.fsi.com.cn/policy200/explain203/203_0303/203_03031801.htm (in Chinese).[Accessed 12 February 2006].

Liu, J. 1999. *Legal Reforms in China*, ZEF Discussion Papers on Development Policy 13, Centre of Development of Research, Bonn, August.

Lo, B. T. 1993. Improving Corporate Governance: Lessons from the European Community, *Indiana Journal of Global Legal Studies*, Vol.1, Issue (1), p219.

Lojpuer, Andelko 2004, Corporate Governance in the Transition Process, South-East Europe Review, Vol.3, pp.107-118

Long, X. 2003. Stock Option Dream Hardly Becomes True (Gupiao Qiquan de Nanyuan Zhimeng), *International Finance News*. (Guoji Jinrong Bao), 28 April.

Loose, P., M. Griffiths and D. Impey, 2000. *Company Director: Power, Duties and Liabilities*, 8th ed. Jordans.

Lord Sainsbury of Turville, Second Reading debate, Hansard Col.245, 11 January 2006.

Lorsch, J. W. and E. MacIver, 1989, *Pawns or Potentates: The Reality of America's Corporate Boards*. Harvard Business School Press, Boston, Massachusetts.

Lu, G. 2003. Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme Peoples' Court 2003 Provisions Concerning Private Securities Litigation, 12, *Pacific Rim Law and Policy Journal*, 718

Lu, Justin and Jonathan Batten, 2001, The Implementation of OECD Corporate Governance Principles in Post-Crisis Asia, *Journal of Corporate Citizenship*, 4: 47-62.

Lu, T. et al, Corporate Governance Correspondence, Vol.1, 2004, available at http://www.iwep.org.cn/cccg/pdf/tongxun_2003-5.pdf [Accessed 28 September 2005].

Lu, T., 2001. *Corporate Governance in China*, Institute of World Economics and Politics, Chinese Academy of Social Science. Available from: <http://www.iwep.org.cn/cccg/pdf/Corporate%20Governance%20in%20China%20%20Prof.pdf>. [Accessed 12 March 2006]

MacAvoy, P. W. and I. M. Millstein, 2003. *The Recurrent Crisis in Corporate Governance*, Palgrave Macmillan.

Macey, J. R., and G. P. Miller. 1993. Corporate Stakeholders: A Contractual Perspective. 43 *University of Toronto Law Journal*, 401.

- Mak, Y. T. and M. Roush, 2000. Factors Affecting the Characteristics of Boards of Directors: An Empirical Study of New Zealand Initial Public Offering Firms, *Journal of Business Research*, 47, 147-159.
- Mallin, C., A. Mullineux and C. Wihlborg, 2004. *The Financial Sector and Corporate Governance – Lessons from the UK*. LEFIC Working Paper.
- Margolis, S. J. and S.J. Leibowitz, 1998. Path Dependence. In Peter Newman ed. *New Palgrave Dictionary of Law and Economics*. MacMillan, London.
- Marinov, B. Z. and B. A. Heiman, 1998, Company Law and Corporate Governance Renewal in Transition Economies: The Bulgarian Dilemma. *European Journal of Law and Economics*, 6:231-261.
- Marks, A. L. and W. M. Rees, 1991. Shareholders' Actions, *International Company and Commercial Law Review*. 2(2): 39-46.
- Maskin, E. and J. Tirole, 1999. Unforeseen Contingencies and Incomplete Contracts, *Review of Economic Studies*, 66, pp89-114.
- Mattei, U., 1995. The Comparative Law and Economics of Penalty Clauses in Contracts, 43 *American Journal of Comparative Law*. 427-45, at 430.
- Mattei, U. 1997. *Comparative Law and Economics*, the University of Michigan Press.
- Maughan, C. W. and S. F. Copp, 1999. The Law Commission and Economic Methodology: Values, Efficiency and Directors' Duties, *Company Lawyer*. 20(4):109-116.
- Mayer, C. 1994. Stock-markets, Financial Institutions and Corporate Performance, in N. Dimsdale and M. Prevezer (eds.), *Capital Markets and Corporate Governance*, Oxford: Clarendon Press.
- Mayson, S., D. French and C. Ryan, 2005, *Mayson, French & Ryan on Company Law*. London: Oxford University Express.
- McConnell, J.J. and Servaes, H., 1990, Additional Evidence on Equity Ownership and Corporate Value, *Journal of Financial Economics* 27: 595-612.
- Mehran, H. 1995. Executive Compensation Structure, Ownership, and Firm Performance, *Journal of Financial Economics*, 38:163-184.
- Minow, N. 1995. *Putting Shareholders Back into Shareholder Litigation*. Available from: <http://www.lens-library.com/info/cgadvis.html>. [Accessed 11 December 2005]

Minow, N. 1994. Money Managers, If Not Them, Who? In Robert A.G. Monks and Nell Minow, *Corporate Governance*, Blackwell.

Monks, R. and N. Minow, 2004. To Sell or Not to Sell: the Prisoner's Dilemma, in R. Monks and N. Minow, *Corporate Governance*, Blackwell Publishing.

Morck, R., A. Shleifer and R. Vishny, 1988. Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics* 20: 293-316.

Monks, R. A.G., 1995. *Sleeping Giants: Expectations of Institutional Investors and Their Voting Behaviour, Corporate Governance - Structural Reforms in the American and German Corporation Law*, Heidelberg, Available from: http://www.ragm.com/archpub/ragm/sleeping_giants.html [Accessed 13 November 2005].

Mueller, Dennis C 2006, The Anglo-Saxon Approach to Corporate Governance and Its Applicability to Emerging Markets, *Corporate Governance: An International Review*, Vol.14, pp207-219.

Myners, P. 2005. Review of the Impediments to Voting UK Shares, Report by Paul Myners to the Shareholder Voting Working Group, January, available at http://www.manifest.co.uk/links_search/votingUKshares.pdf [Accessed 25 April 2006]

Nanfang Weekend, *Jinan Motorcycle: Replay of Monkey King Fiasco*, Nanfang Weekend, 17 June 2001.

Nesbitt, G. 2006. Directors' Duties under Common Law and Statute, *The Tax Journal*, 825, pp13-14.

Newman, H. A. and D. W. Wright, 1995. *Compensation Committee Compensation and its Influence on CEO Compensation Practices*, Working Paper, School of Business, University of Michigan.

Nolan, R. C. 2006. The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report. *Theoretical Inquiries in Law*, Vol. 6, pp363-412.

Nyman, S. and A. Sillberston, 1978. The Ownership and Control of Industry, 30 *Oxford Economic Papers* p74.

OECD Principles of Corporate Governance (2004), p11. Available from: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>. [Accessed 22 February 2006]

Ong, K. T. W. and C. R. Baxter, A. 1999. Comparative Study of the Fundamental Elements of Chinese and English Company Law. *International and Comparative Law Quarterly* Vol.48, pp88-127.

Osgathorpe, J. D. 1996. A Critical Survey the People's Republic of China's New Company Law, 6 *Indiana International and Comparative Law Review* 493.

Palmiter, A. R. 2003. *Corporations: Examples & Explanations*, 4ed. CITIC Publishing House.

Parkinson, J. 1997. *Reforming Directors' Duties*. Policy Paper No. 12. University of Sheffield: Political Economy Research Centre.

Parkinson, J. E. 2000. *Corporate Power and Responsibility: Issues in the Theory of Company Law*, Oxford University Press, p237.

Peev, E. 2001. *Corporate Governance Transformation in Transition Economics: Evidence from Bulgaria*. *Quarterly Journal of Economic Research*, Vol.1, pp.290-301.

Pennington, R. R. 2001, *Pennington's Company Law*, 8th ed. Butterworths,

Perrow, C. 1986. *Complex Organizations: A Critical Essay*, New York: McGraw-Hill.

Pettet, B. 2005. *Company Law*, 2ed. Harlow: Pearson Longman.

Pettigrew, A. and T. McNulty, 1998. Sources and Uses of Power in the Boardroom, *European Journal of Work and Organisational Psychology*, 7(2):197-214.

Pfeffer, J. and G. Salancik, 1978, *The External Control of Organisations: A Resource-dependence Perspective*, New York: Harper & Row.

PIRC, The AGM: A Focus for Shareholder Involvement, PIRC's Response to the Consultation Document from Company Law Review Steering Group on Shareholder General Meetings and Shareholder Communications, January 2000.

PIRC, 1999. New Survey Reveals Increase in Proxy Voting but System "ramshackle", PIRC Press Release, 7 November.

PIRC, 2004, *Growing Opposition*, Proxy Voting Annual Review 2004.

PIRC, 2004, *Institutional Investment in the United Kingdom*, Proxy Voting Annual Review 2004.

PIRC, 1999. *Making Votes Count: PIRC Proposes Proxy Reform*, PIRC Intelligence, February.

PIRC, 2002. *Modernising Company Law: PIRC's Response the White Paper*, December.

PIRC, 2003. *Upward Voting Trend Halted Says PIRC: PIRC's Annual Voting Survey Highlights "Shareholders Continued Failure to Vote at UK Listed Companies"*. Available from: <http://www.thecorporatelibrary.com/special/PR/PIRCvoting2003.pdf> [Accessed 12 March 2006].

Pistor, K., M. Raiser and S. Gelfer, 2000. *Law and Finance in Transition Economic*, CID Working Paper No.49, Centre for International Development at Harvard University,

Pistor, K. 2000. *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies*, European Bank for Reconstruction and Development, Working Paper No.49, May.

Pistor, K., Y. Keinan, J. Kleinheisterkamp, Mark D. West, 2002. The Evolution of Corporate Law: A Cross-Country Comparison, 23 *University of Pennsylvania Journal of International Economic Law* 791.

Pistor, K. and C. Xu, 2002. Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory. Law Working Paper No. 01/2002. European Corporate Governance Institute. Available at http://econ.lse.ac.uk/staff/cxu/pub/Pistor-Xu_FiduciaryDuty_02.pdf [Accessed on 25 April 2005].

Pistor, K. and C. Xu, 2003. Deterrence and Regulatory Failure in Emerging Financial Markets: Comparing China and Russia, April, 2003, working paper available from: http://www.wcfia.harvard.edu/conferences/piep/piep05172003/px_failure_04-03.pdf [Accessed 25 September 2005].

Posner, R. A. 1973. The Economic Approach to Law, 53 *Texas Law Review*, pp757-761.

Putterman, L. and R. S. Keoszner, 1996. The Economic Nature of the Firm: a New Introduction. In Putterman, Louis and Randall S. Keoszner eds. *The Economic Nature of the Firm: A Reader*. 2nd. Cambridge University Press.

Rebeiz, K. S. 2002. Strategies for Corporate Governance in Engineering Corporations, *IEEE Transactions on Engineering Management*, Vol.49, No.4, pp398-408.

Rehman, S. S. and F. V. Perry, 2005. *Global Convergence of Corporate Governance Systems and Competitiveness*, Occasional Paper Series, the GW Centre for the Study of Globalization. Available from:

<http://gstudynet.com/gwccsg/publications/OPS/papers/CSGOP-05-35.pdf>. [Accessed 26 January 2006].

Reitz, J. C, 1998. How to Do Comparative Law, 46 *American Journal of Comparative Law*. pp617-636.

Richard S. 2003. Directors' Duties. In Glen James, Slaughter and May ed. *A Practitioners Guide to Directors' Duties and Responsibilities*, City & Financial Publishing.

Riles, A. 1999. Wigmore's Treasure Box: Comparative Law in the Era of Information, 40 *Harvard International Law Journal*, 221-283.

Riley, C. A., 1994, Controlling Corporate Governance Management: UK and US Initiatives, *Legal Studies* V.14, 244-256.

Riley, C.A., 1999. The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard, *Modern Law Review*, Vol.62, pp697-724, at 698.

Roe, M. 1994. *Strong Manager and Weak Owners: The Political Roots of American Corporate Finance*, Princeton University Press.

Roe, M. 1996. Chaos and Evolution in Law and Economics, 109 *Harvard Law Review* 641.

Rose, C. 2004. Stakeholder Orientation vs. Shareholder Value – A Matter of Contractual Failures, *European Journal of Law and Economics*, 18: 77-97.

Rosenstein, S. and J.H. Wyatt, 1990. Outside Directors, Board Independence, and Shareholder Wealth, *Journal of Financial Economics*, 26, 175-191.

Rubach, M.J. and T. C. Sebor, 1998, Comparative Corporate Governance: Competitive Implications of an Emerging Convergence, 33. *Journal of World Business*, 167.

Ruskola, T. 2000. Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective. *Stanford Law Review* 52: 1599.

Russell, M. E. 2004. *The People's Republic of China-Visit Report: Banking on Reform*. Available at http://www.citlon.co.uk/pdf/features/China_Report2.04.pdf [Accessed 23 March 2005].

Schipani, C. A. and J. Liu, Corporate Governance in China: Then and Now, *Columbia Business Law Review*, 1

Shanghai Stock Exchange, 2003. *China Corporate Governance Report*, Shanghai: Fudan University Press.

Share Ownership-- Share Register Survey Report 2002. Available from: http://www.statistics.gov.uk/downloads/theme_economy/ShareOwnership2002.pdf. [Accessed 13 November 2005].

Sharon M. L. 2001. The Development of China's Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law, (14) *New York International Law Review*, 1.

Sheikh, S. and S. K. Chatterjee, 1995. Perspective on Corporate Governance. In Saleem Sheikh and William Rees, ed. *Corporate Governance & Corporate Control*, Ch1. London : Cavendish.

Sheikh, S. 2002. Non-Executive Directors: Self-Regulation or Codification, *Company Lawyer*, 23 (10), 296-307.

Shi, S. and D. Weisert, 2002. Corporate Governance with Chinese Characteristics, *China Business Review*, Vol. 28, No.5.

Shirley, M. and Patrick Walsh, "Public versus Private Ownership: The current State of the Debate", available at http://econ.worldbank.org/files/1175_wps2420.pdf.

Shivdasani, A. and D. Yermack, 1999, CEO involvement in the selection of New Board Members: An Empirical Analysis, *Journal of Finance* 54: 1829-54.

Shivdasani, A. and Marc Zenner, 2002, *Best Practice in Corporate Governance: What Two Decades of Research Reveals*, Salomon Smith Barney (SSB).

Shleifer, A., and R.W. Vishny, 1986. Large Shareholders and Corporate Control. *Journal of Political Economy* 95, 461-488.

Shleifer, A. and R. W. Vishny, 1997. A Survey of Corporate Governance, 52 *Journal of Finance* 737.

Shen, S. and J. Jia, 2004. Will the Independent Directors Institution Work in China? *Loyola of Los Angeles International & Comparative Law Review*. Vol.27:223-48

Short, H. and K., Keasey, 1997, Institutional shareholders and Corporate Governance in the United Kingdom, in: K. Keasy, S. Thompson and M. Wright, eds., *Corporate Governance: Economic and Financial Issues*, Oxford University Press, Oxford, pp18–53.

Shun, Z. 1982. The Speech at Farewell Party for the members of Tongmeng Society, in Complete works of Shun zhongshen, Vol.2, 322.

Sigh, H. and F. Harianto, 1989. Management-Board Relationships, Takeover Risk, and the Adoption of Golden Parachutes. *Academy of Management Journal* 32: 7-24.

Slynn, R. 2003. Directors' Duties. In Glen James, Slaughter and May ed. *A Practitioners Guide to Directors' Duties and Responsibilities*, City & Financial Publishing,

Smerdon, R. 2004. *A Practical Guide to Corporate Governance*, 2ed. Sweet & Maxwell Ltd.

Smith, D.G. 1996. Corporate Governance and Managerial Incompetence: Lessons from Kmart, *74 North Carolina Law Review*, pp1037-1139, at 1138.

Smith, A. 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations*, edited by Edwin Cannan, New York: Modern Library edition, 1937.

Smith, M. 1996. Shareholder Activism by Institutional Investors: Evidence from CalPERS, *Journal of Finance* 51: 227-252.

Soederberg, S, 2003. The Promotion of 'Anglo- American' Corporate Governance in the South: Who Benefits from the New International Standard? *Third World Quarterly*, 24, pp7-28.

Solomon, J. and A. Solomon, 2004. *Corporate Governance and Accountability*. John Wiley & Sons Ltd.

Solomon, J. F., A. Solomon, N. Joseph, and S. Norton (2000), Institutional Investors' View on Corporate Governance Reform: Policy Recommendations for the 21st Century, *Corporate Governance: An International Review*, Vol.8 215-226.

Stapledon, G. P., 1995, Exercise of Voting Rights by Institutional Shareholders in the UK, *Corporate Governance: An International Review*, Vol.3, pp144-155.

Stiglitz, J. E. 1985. Credit Markets and the Control of Capital, *Journal of Money, Credit and Banking*, 17(2):133-152.

Stiles, P. and B. Taylor, 2001. *Boards at Work: How Directors View Their Roles and Responsibilities*, Oxford University Press.

Stock, M and J. Watson, 2003, *Introduction to Econometrics, International Edition*, Addison Wesley.

Sundaramurthy, C., J. M. Mahoney and J.T. Mahoney, Board Structure, 1997. Antitakeover Provisions, and Stockholder Wealth, *Strategic Management Journal*, Vol.18(3), pp 231-245.

Supreme People's Court, Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Guiding (Yi) (Zhengqiu Yijian Gao), [The Regulations on Some Issues Concerning Trails for Corporate Dispute Case (Part 1) of the Supreme People's Court. November 04, 2003. Available from: http://www.chinacourt.org/public/detail.php?id=88551&show_all_img=1 [Accessed 15 October 2005].

Tam, O. K. 1999. *The Development of Corporate Governance in China*. London, Edward Elgar.

Tam, O. K. 2000. Models of Corporate Governance for Chinese Companies, *Corporate Governance: An International Review*, Vol.8 pp52-64.

Tenev, S. and C. Zhang, 2002. *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*. World Bank and the International Finance Corporation Washington, D.C.

The Encyclopaedia about Corporate Governance. Available from: <http://www.encycogov.com> [Accessed 5 January 2006].

Thomsen, S. and T. Pedersen. 2000. Ownership Structure and Economic Performance in the Largest European Companies, *Strategic Management Journal*, 21: 689-705.

Tian, G. L. 2000. State Shareholding and the Value of Chinese Firms. Working paper London Business School.

Tirole, J. 1999, Incomplete Contracts: Where Do We Stand? 67 *Econometrica*, pp741-81.

Tong, D. 2001. Current Conditions, Problem of Listed companies and How to Exercise Regulation: Positioning of the Responsibilities of Regulatory Department and Regulatory Measures, in *Corporate Governance Reform: China and the World*. Available from: http://www.cipe.org/china/cg_book_toc.htm. [Accessed 12 March 2005].

Torbert, P.M., 1993. China's Evolving Company Legislation: A Status Report, 14, *Northwestern Journal of International Law & Business*, 1.

Tricker, R. I., 1994. *International Corporate Governance: Text Readings and Cases*, Prentice Hall, Sydney.

TUC Fund Manager Voting System 2003 available from:
<http://www.tuc.org.uk/pensions/tuc-6839-f0.cfm> [Accessed 12 March 2006].

Ueda, R. 2002. *Corporate Governance and Reform of Japan's Commercial Code*. J-IRIS Research Newsletter, Issues No.2, October.

UKLA, Listing Rules, December 2003.

UK Shareholder Associations, UKSA's Response to Modern Company Law for a Competitive Economy: Company General Meeting & Shareholder Communications, 9 January 2000.

Vafeas, N. 1999. Board Meeting Frequency and Firm Performance, *Journal of Financial Economics*, 53: 113-42.

Van den Berghe, L. and A. Levrau, 2004. Evaluating Boards of Directors: What constitute a good corporate board? *Corporate Governance*, Vol.12, 461-478.

Wang, L. 2003. Another First Case Arose in Stock Market – Shareholder Sue Chairman of the Board on Behalf of Company, *Shanghai Securities News*, 9 April.

Wang, L. 2003. The First Derivative Action was not Accepted, *Shanghai Securities News*, 22 April.

Wedderburn, K. W. 1957. Shareholders' Rights and the Rule in Foss v Harbottle, *Cambridge Law Journal*, 194.

Weisbach, M. S. 1988 Outside Directors and CEO Turnover, 20 *Journal of Financial Economics*, Vol.20, pp431-460.

Wei, Y. 2003. *Comparative Corporate Governance: A Chinese Perspective*. Kluwer Law International.

Wei, Y. 2003. An overview of corporate governance in China. *Syracuse Journal of International Law and Commerce*, Vol.30 23-48

Wei, Y. 2002. The History of the Corporation in China, 6 *University of Western Sydney Law Review*, pp95-122.

- Wei, Y. 2001. Seeking a Practical Chinese Model of Corporate Governance, 10 *Michigan State University – DCL Journal of International Law*, 393.
- Wei, Y. 1998. A Chinese perspective on corporate governance. 10 *Bond Law Review*. 363-76.
- Whitehead, C. 1988. Introduction, Theory and Practice, in Whitehead, ed., *Reshaping the Nationalised Industries*. New Brunswick: Transaction Books.
- Williamson, O. E. 1995. *The Economic Institutions of Capitalisms*, the Free Press: New York.
- Xiangcai Security Research Group, 2000. *Corporate Governance Research*. Chinese Security Association, Research on Advanced issues of Chinese Securities Market Development, China Finance Publishing Company.
- Xiao, Jason Zezhong Jay Dahya and Zhijun Lin, 2004, A Ground Theory Exposition of the Role of the Supervisory Board in China. *British Journal of Management*, Vol.15, pp39-55.
- Xinhua, 2006. Delong Mansion in Shanghai Put for auctions in Late January, *People's Daily Online*, available at http://english.people.com.cn/200601/07/eng20060107_233521.html. [Accessed 26 May 2006].
- Xu, X. and Y. Wang, 1999. Ownership Structure and Corporate Governance in Chinese Stock Companies, *China Economic Review* 10:75-98,
- Xu, Y. 1997. *The Principles of Company Law*, Law Publishing House, Beijing.
- Yang, J. 2005, Comparative Corporate Governance: Reforming Chinese Corporate Governance. *International Company and Commercial Law Review*. 16(1), 8-17.
- Yang, X. 2005. *The Proposed Amendments to Company Law and the Development of China's Capital Market*. KING&WOOD PRC LAWYERS.
- Yang, Y. Ex-Baiwen Independent Directors Case Rejected, Shenzhen Daily, August 15, 2002, available from: http://pdf.sznews.com/GB/content/2002-08/15/content_1225103.htm, [Accessed September 25, 2005].
- Ying, Z. 1993, Lun Qing Mo De Jingji Fagui, *Historical Research*, 1993:5, 92-109.
- Yermack, D. 1996. High Valuation of Companies with a Small Boards of Directors, *Journal of Financial Economics*, 40: 185-212.

Yu, G. and A. Wong, A new Listed Company Law: CSRC Guideline on Article of Association for Listed Companies in China. July 1998. Available from: <http://www.omm.com/webcode/navigate.asp?nodeHandle=817> [Accessed 12 March 2006]

Yuan, A. 2000. Foreign Direct Investments in China – Practical Problems of Coping with China's Company Law and Laws for Foreign-invested Enterprises. *Northwestern Journal of International Law and Business*, 20: 475-508

Zahra, S. A. and J. A. Pearce II, 1989. Boards of directors and Corporate Financial Performance: A Review and Integrative Model, *Journal of Management*, Vol. 15, No.2, 291-334.

Zhang, X. 1998. Practical demands to update the Company law, *Hong Kong Law Journal* 28: 248

Zhang, W., 1999. Development in Chinese Corporate Finance and its Implication for Ownership Reform, *Asia Pacific Financial Development*, Routledge, London.

Zhao, T. 2004. Comparison between Industrial Classification in Chinese National Accounts and International Standard Industrial Classification for All Economic Activities (ISIC), (Nov. 30, 2004). Available at <http://www.oecd.org/dataoecd/32/25/33982328.pdf> (last visited Sep. 28, 2005).

Zheng, J. 2001. Agency Conflict, Equity Value and Path Dependence in Reducing State-held Shares. Available from: http://www.cipe.org/china/p4_JiangHuai.htm [Accessed 12 March 2005].

Zhong, J. 2002. Chairman and General Manager (Zongjingli) Who is the CEO of the Chinese Companies? *Chinese Securities*, 31 January.

Zhou, D. 2000. Shareholders May also Convene Shareholder Meeting, *Zhongguo Zhenquanbao (China Securities Daily)* September 28.

Zhuang, J. 1999. *Some Conceptual Issue of Corporate Governance*, Economics and Development Resource Centre Brief Notes 13 and 14.

Zweigert, K. and H. Kötz, 1998. *An Introduction to Comparative Law*, 3rd ed. Oxford: Clarendon Press.

APPENDIX

Survey Samples

China

1	Anhui Huamao Textile Company
2	Baida Group Company
3	Baiyin Copper City Commercial
4	Baoshan Iron & Steel A
5	Beijing Gehua Catv Network
6	Beijing Zhongke Sanhuan
7	BJ Jingxi Tour
8	Bohai Group Company
9	Centennial Brilliance
10	Century Zhongtian Invest
11	Chengdu Qianfeng Electronics
12	Chengdu Yangzhiguang
13	China Jialing Industrial
14	China Liaoning International
15	China Railway Erju
16	China Spacestat Technology 'A
17	China WLD TRD Centre
18	Chinasoft Network Technology Company
19	Chongqing Department Store
20	Citic Guoan Information Ind
21	Cntic Trading Co
22	Dalian Daxian Company
23	Dalian Feifei Aojia
24	Dalian Shengya Ocean
25	Dashang Group Company
26	Dong Feng Automobile Company
27	Dongfeng Motor Electronic Instrument A
28	Dongguan Winnerway Indl
29	Fujian Longking Company
30	Fujian Newland Computer
31	Fujian Shishi Xinfu
32	Fujian Start Computer GP
33	Fujian Tianxiang Industry
34	Guangdong Golden Dragon
35	Guangdong Goworld Company
36	Guangdong Kaiping Company
37	Guangdong Mingzhu Ball
38	Guangzhou Nanhuaxi
39	Guangzhou Pearl River
40	Guilin Tourism Corp.
41	Guizhou Panjiang Coal
42	Handan Iron And Steel Company
43	Hefei Department Store Group 'A'
44	Heilongjiang Black
45	Henan Lianhua
46	Hengda Real Estate Company
47	Hengyang Jinli Technology Company
48	Hit Shouchuang Technology Company
49	Huandong Medicine Company

50	Hubei Guangji Pharmaceutical
51	Hubei Wuchangyu Company
52	Hubei Yihua Chemical
53	Inner Mongolia Prairie
54	Irico Display Devices
55	Jiangsu Hongdou Industry
56	Jiangsu Huaxicun Company
57	Jiangsu Jianghuai Engine
58	Jiangsu Yueda
59	Jilin Chemical Fibre
60	Langchao Electronics Information
61	Advanced Technology & Materials Company
62	Anhui Ankai Automobile
63	Anhui Fangxing Science
64	Anhui Feicai Vehicle
65	Anhui Golden Cattle
66	Anhui Guofeng Plas
67	Anhui Jianghuai
68	Anhui Wenergy Company Limited
69	Anhui Xinke New Material
70	Anyang Iron & Steel Company
71	Auhui Bbca Biochemical
72	Baoding Swan
73	Baoji Titanium Company
74	Baotou Huazi Indl Company
75	Baotou Tomorrow Technology Company
76	Beihai Gofar Marine 'A'
77	Beihai Xinli Industrial
78	Beijing Capital Tourism
79	Beijing Centregate Technology
80	Beijing Shougang Company Limited
81	Beijing Xidan MKT
82	Beiya Industrial Limited
83	Bit Technology Holding Company
84	Blue Star New Chemical Materials
85	Bright Oceans Int-Teleco
86	Canal Scientific & Tech
87	Changchun Department Store Company
88	Changchun Eurasia Group
89	Changchun Goldenstar
90	Chengdu Brilliant Development
91	Chengdu DR Peng Tech 'A'
92	Chengdu Taikang Network Company
93	Chengdu Yinhe Innovations
94	Chengzhi 'A'
95	Chifeng Fulong Company
96	China Sichuan
97	China Sports Group Industry
98	Chongqing Brewery Company Limited
99	Chongqing Holley Share
100	Chongqing Tongjunge
101	Cosco Shipping Company
102	Cosun
103	Dalian Beeda Technology Group
104	Dalian Merro Pharmaceutical Company
105	Dalian Yicheng Group
106	Daqing Huake Company Limited
107	Dongtong Cement Company

108	Emei Shan Tourism Company
109	FAW Car Company Ltd
110	Fiberhome Telecommunications Technology
111	Foshan Plastics Group Company
112	Fujian Cement 'A'
113	Fujian Changyuan Investment Company
114	Fujian Expressway Development
115	Fujian Furi Electronics Company
116	Fujian Qingshan Paper A
117	Fujian Sanmu Group
118	Fujian Shenlong Development Company
119	Gansu Languang Sciencet
120	GD Midea Holding Company
121	Gemdale 'A'
122	Gezhouba Company
123	Guangcai Construction Group
124	Guangdong Golden Horse
125	Guangdong Rongtai Industry
126	Guangdong Shaoneng
127	Guangdong Shengyi Technology
128	Guangxi Guitang
129	Guangzhou Friendship Company
130	Guangzhou Hengyun
131	Hafei Aviation Industry
132	Hainan Expressway Company
133	Hainan First Investment Merchant Company
134	Hainan Pearl River Holdings
135	Hainan Yedao Company
136	Haitong Food Group
137	Hangzhou Iron & Steel Company
138	Harbin Air Conditioning
139	Harbin Churin Group
140	Harbin Swan Industry Company Ltd
141	Hebei Jinniu Energy
142	Heilongjiang Beidahuang
143	Henan Joline & Joysun
144	Henan Shen HUO Coal Industry
145	Henan Topfond Pharmaceutical
146	Henan Yinge Industrial Investment
147	Henan Yuguang Gold & Lead
148	Hualian Supermarket
149	Hubei Changyuan Electric
150	Hubei Jingshan Light Industry
151	Hubei Qianjiang Pharmaceutical
152	Hubei Tlanyi Technologies Company
153	Hudong Heavey Machinery
154	Hunan Dongting
155	Hunan Ansu Company
156	Hunan Computer Company
157	Inner Mongolia Baotou Steel Rare
158	Inner Mongolia Lantai
159	Jiangnan Mould & Plastic
160	Inner Mongolia Mengdian
161	Inner Mongolia Xishui
162	Inner Mongolian Baotou
163	Jiangsu Fasten Company
164	Jiangsu Hengrui Medcinie
165	Jiangsu Kanion Pharmaceuticals

166	Jiangsu Sainty Corp.
167	Hunan Valin Steel Tube
168	Jiaozuo Wangfang Aluminium
169	Jilin Paper Manufacturing Company
170	Jilin Power Company
171	Jilin Yatai Group
172	Jinzhou Petrochemicals Company
173	Joincare Pharmaceutical Group
174	Jonjee High & New Technology Company
175	Kunming Pharmaceutical
176	Kunming Yunnei Power Co
177	Kweichow Moutai Company Limited
178	Lanzhou Huanghe Enterprise
179	Leshan Electric Power
180	Liaoning Chengda Company
181	Liaoning Guoneng Group
182	Liaoning Times Garments
183	Luzhoulaojiao Company
184	Mindong Electric Group
185	Mudanjiang Hengfeng Papr
186	Nanfang Motorcycle
187	Nanjing Central Emporium
188	Nanjing Xinjiekou
189	Ningbo Bird Company Limited
190	Ningbo Success Information Industry
191	Ningxia Hengli Steel
192	North China Pharmaceutical 'A'
193	Phenix Optical Company
194	Qinchuan MCH Development Co
195	Qingdao Jiande Biologica
196	Sanjiu Medicines Pharmaceutical Company
197	Sdic Yuanyi Phosphorus
198	Shandong Huatai Paper A
199	Shandong Lukang
200	Shandong Shanda Company
201	Shanghai Aerospace Automobiles Electric
202	Shanghai Automotive
203	Shanghai Construction Company Limited
204	Shanghai Electric Apparatus
205	Shanghai Hainiao Enterprise
206	Shanghai Industrial United Holdings Comp
207	Shanghai Jiaoda Onlly Company Ltd
208	Shanghai Port Container
209	Shanghai RAW Water Supply Company
210	Shanghai Shenda Textile & Garments
211	Shanghai Shimao Company Limited
212	Shanghai Tongji Science & Technology
213	Shanghai Xingye Housing Company Limited
214	Shanghai Xinmei Real
215	Shanghai Yatong Company
216	Shanxi Lanhua SCI-Tech
217	Shanxi Xishan
218	Shenergy Company
219	Shenyang Dawn Garments Company
220	Shenyang Environmental Protection Equipm
221	Shenyang Jinshan
222	Shenzhen Huaqiang Industry
223	Shenzhen SED Industry Company

224	Shenzhen Shenxin Taifeng Group
225	Shenzhen Tonge Group Company
226	Shenzhen Worldsun Enterprises
227	Shenzhen Zhenye Properties Company Limit
228	Shenzhen Zhongjin Linnan Nonf
339	Sichuan Linfeng Holding
230	Sichuan Hejia Company
231	Sichuan Hushan Electronic
232	Sichuan Meiya Silk Company
233	Sichuan Minjiang
234	Sichuan New Hope Agri
235	Sichuan Quanxing Company Limited
236	Sichuan Tianyi SCI & Technology
237	Sinopec Qilu Petrochemicals
238	Sinopec Wuhan Petroleum Group Company
239	SINOPEC WUHAN PHOENIX CO LTD
240	Sinotrans Air Transportation Development
241	Suntek Technology Company Limited
242	Taiyuan Lion-Head Cement
243	Tianjin Binhai Energy
244	Tianjin Reality Development
245	Tianjin Tasly Pharmaceutical Company
246	Tibet Jinzhu
237	United Travel Company
248	Wuhan Linuo Industry
249	Wuxi Commercial Mansion Corp.
250	Xiamen Tungsten Company
251	Xian Minsheng Group Company
252	Xian Typical Industries
253	Xinjiang Tianfu Company Limited
254	Xinjiang Tianshan Textiles A
255	Xizang Rhodiola Pharmaceutical
256	Yantai Xinchao Industry
257	Yibin Wuliangye
258	Yintai Holdings 'A'
259	Youngor GRP Company
260	Yunan Malong Chemical
261	Zhangjiajie Tourism
262	Zhejiang Zhenyuan Company
263	Zhejiang China Textile
264	Zhejiang Furun Company
265	Zhejiang Orient Holdings Company
266	Zhejiang Xinlian Company
267	Zhongyan Textile 'A'

United Kingdom

1	4IMPRINT GROUP PLC
2	A & J MUCKLOW GROUP P L C
3	ABACUS GROUP PLC.
4	ABBEYCREST PLC
5	ABERDEEN ASIAN SMALLER COMPANIES INVESTMENT TRUST PLC
6	AEGIS GROUP PLC
7	AFA SYSTEMS PLC
8	AGA FOODSERVICE GROUP PLC
9	ALEXANDRA PLC
10	ALTERIAN PLC
11	ALUMASC GROUP PLC
12	ALVIS PLC
13	AMLIN PLC
14	ASSOCIATED BRITISH PORTS HOLDINGS P.L.C.
15	AURORA INVESTMENT TRUST PLC
16	AUTOLOGIC HOLDINGS PLC
17	AVON RUBBER P.L.C.
18	BABCOCK INTERNATIONAL GROUP PLC
19	BALFOUR BEATTY PLC
20	BERTAM HOLDINGS PLC
21	BIOFOCUS PLC
22	BOND INTERNATIONAL SOFTWARE PLC
23	BOOTS GROUP PLC
24	BPB PUBLIC LIMITED COMPANY
25	BRAMMER PLC
26	BRIT INSURANCE HOLDINGS PLC
27	BRITANNIC SMALLER COMPANIES TRUST PLC
28	CAFFYNS PUBLIC LIMITED COMPANY
29	CAIRN ENERGY PLC
30	CAMBRIDGE ANTIBODY TECHNOLOGY GROUP PLC
31	CANARY WHARF GROUP PLC
32	CAPITAL RADIO PLC
33	CARE UK PLC
34	CARILLION PLC
35	CASSIDY BROTHERS PUBLIC LIMITED COMPANY
36	CHAUCER HOLDINGS PLC
37	CHIME COMMUNICATIONS PLC
38	CHRYSALIS GROUP PLC.
39	COE GROUP PLC
40	COMPASS GROUP PLC
41	COMPEL GROUP PLC
42	COOKSON GROUP PLC
43	COSTAIN GROUP PLC
44	COUNTRYWIDE ASSURED GROUP PLC
45	CRODA INTERNATIONAL PUBLIC LIMITED COMPANY
46	DAWSON HOLDINGS PLC
47	DE VERE GROUP PLC
48	DERWENT VALLEY HOLDINGS PUBLIC LIMITED COMPANY.
49	DEWHURST PLC
50	DIAGONAL PLC
51	DIPLOMA PLC
52	DIXONS GROUP PLC
53	DOMINO PRINTING SCIENCES PUBLIC LIMITED COMPANY
54	DTZ HOLDINGS PLC.

55	DUNEDIN ENTERPRISE INVESTMENT TRUST PLC
56	EASYJET PLC
57	EDINBURGH OIL & GAS PLC
58	ELEMENTIS PLC
59	EMI GROUP PLC
60	ENNSTONE PLC
61	ENODIS PLC
62	EURODIS ELECTRON PLC
63	EUROPEAN MOTOR HOLDINGS PLC
64	EXPRO INTERNATIONAL GROUP PLC
65	FIRST CHOICE HOLIDAYS PLC
66	FORTH PORTS PUBLIC LIMITED COMPANY
67	FOUNTAINS PLC
68	FRAMLINGTON INNOVATIVE GROWTH TRUST PLC
69	GAMINGKING PLC
70	GEEST PLC
71	GLOBAL NATURAL ENERGY PLC
72	GLOTEL PLC
73	GOVETT EUROPEAN ENHANCED INVESTMENT TRUST PLC
74	GOWRINGS PLC
75	GRANADA PLC
76	GYRUS GROUP PLC
77	H C SLINGSBY P L C
78	HARVEY NASH GROUP PLC
79	HAVELOCK EUROPA PLC
80	HEADLAM GROUP PLC
81	HELICAL BAR PLC
82	HGCAPITAL TRUST PLC
83	HIGHBURY HOUSE COMMUNICATIONS PLC
84	HOLIDAYBREAK PLC.
85	HONEYSUCKLE GROUP PLC
86	HORNBY PLC
87	HOWLE HOLDINGS PLC
88	HUNTING PLC
89	INCISIVE MEDIA PLC
90	INTELEK PLC
91	INTERCARE GROUP OLC
92	INTERIOR SERVICES GROUP PLC
93	INTERSERVE PLC
94	INVESCO RECOVERY TRUST 2005 PLC
95	INVESCO TECHMARK ENTERPRISE TRUST PLC
96	ITNET PLC
97	J D WETHERSPOON PLC
98	J SAINSBURY PLC
99	JOHN SWAN & SONS P.L.C.
100	JOHNSON MATTHEY PLC
101	JOHNSON SERVICE GROUP PLC
102	JPMORGAN FLEMING EUROPEAN FLEDGELING INVESTMENT TRUST PLC
103	KBC ADVANCED TECHNOLOGIES PLC
104	KELLER GROUP PLC
105	KIDDE PLC
106	KIER GROUP PLC
107	LATCHWAYS PLC
108	LEGGMASON INVESTORS INCOME & GROWTH TRUST PLC
109	LIONTRUST ASSET MANAGEMENT PLC
110	LONDON & ASSOCIATED PROPERTIES PLC
111	LONMIN PUBLIC LIMITED COMPANY
112	LPA GROUP PLC

113	LUMINAR PLC
114	MACFARLANE GROUP PLC
115	MALLET PUBLIC LIMITED COMPANY
116	MARTIN INTERNATIONAL HOLDINGS PLC
117	MCBRIDE PLC
118	MCINERNEY HOLDINGS PUBLIC LIMITED COMPANY
119	MCLEOD RUSSEL HOLDINGS PLC
120	MEARS GROUP PLC
121	MERRYDOWN PLC
122	METALRAX GROUP PLC
123	MSB INTERNATIONAL PLC
124	NICHOLS PLC
125	NORTH ATLANTIC SMALLER COMPANIES INVESTMENT TRUST PLC
126	NORTHGATE PLC
127	OLD MUTUAL SOUTH AFRICA TRUST PLC
128	OVERNET DATA PLC
129	OXFORD INSTRUMENTS PLC
130	PALADIN RESOURCES PLC
131	PHS GROUP PLC
132	PITTARDS PLC
133	PLANESTATION GROUP PLC
134	PNC TELECOM PLC
135	PORVAIR PLC
136	PPL THERAPEUTICS PLC
137	PREMIER FARNELL PLC
138	PROVIDENT FINANCIAL PLC
139	QUAYLE MUNRO HOLDINGS PLC
140	R P S GROUP PLC
141	REDBUS INTERHOUSE PLC
142	REGENT INNS PLC
143	RM PLC
144	ROBERT WALTERS PLC
145	ROYAL & SUN ALLIANCE INSURANCE GROUP PLC
146	ROYAL DOULTON PLC
147	RPC GROUP PLC
148	SABMILLER PLC
149	SAFEWAY PLC
150	SCAPA GROUP PUBLIC LIMITED COMPANY
151	SCOTTISH & NEWCASTLE PLC
152	SEVERFIELD-ROWEN PLC
153	SHANKS GROUP PLC
154	SIMON GROUP PUBLIC LIMITED COMPANY
155	SOMERFIELD PLC
156	SOUTHAMPTON LEISURE HOLDINGS PLC
157	SOUTHERN VECTIS PLC
158	SPIRENT PLC
159	SPRING GROUP PLC
160	SPRINGBOARD PLC
161	STAGECOACH GROUP PLC
162	STODDARD INTERNATIONAL PUBLIC LIMITED COMPANY
163	STYLO PLC
164	SVB HOLDINGS PLC
165	SYLTONE PUBLIC LIMITED COMPANY
166	TBI PLC
167	TDG PLC
168	TESCO PLC
169	THE CAPITA GROUP PLC
170	THE CITY OF OXFORD GEARED INCOME TRUST PLC

171	THE DAVIS SERVICE GROUP PLC
172	THE GAME GROUP PLC
173	THE GO-AHEAD GROUP PLC
174	THE MAIDEN GROUP PLC
175	THE MTL INSTRUMENTS GROUP PUBLIC LIMITED COMPANY
176	THE ROXBORO GROUP PLC
177	TIBBETT & BRITTEN GROUP PLC
178	TRIFAST PLC
179	TRIPLE PLATE JUNCTION PLC
180	TT ELECTRONICS PLC
181	UCM GROUP PLC
182	ULTRAFRAME PLC
183	VI GROUP PLC
184	VOLEX GROUP P.L.C.
185	VT GROUP PLC
186	WEMBLEY PLC
187	WESTBURY PLC
188	WHITBREAD PLC
189	WILMINGTON GROUP PLC
190	WINCANTON PLC
191	WOOLWORTHS GROUP PLC
192	WORKSPACE GROUP PLC
193	XAAR PLC
194	XANSA PLC
195	ZINCOX RESOURCES PLC
196	ZOTEFOAMS PLC