

Research on Models of Corporate Governance Structure under Corporate Law in China

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Abstract: Shareholders tend to grant their power to the board of directors nowadays, namely they want to be investors instead of managers. At the same time, *the Corporate Law of the People's Republic of China (henceforth referred to as Corporate Law)* is amending now, which proposes to change the corporate governance structure model. The second draft of the amendment was promulgated on 30th December 2022. Compared with the first draft, the legislative body has changed its views about the board's authority, a general item before, to provide an enumerated item. In other words, this law sticks to the shareholders' meetings centralism model instead of the board centralism model. This article argues that the limited board centralism model that combines the board centralism model and offensive shareholder activism is more suitable for China. Professional employees must maintain the daily operation of Chinese companies and expand the board's authority to protect shareholders' rights items in the law. This paper will explain the idea of limited board centralism and explain why it could suit China and the effect of applying it in practice by comparing it with foreign laws.

Keywords: corporate governance structure model, shareholders' meetings centric model, offensive shareholder activism, board centralism model, limited board centralism model

1. Introduction

The corporate governance structure has always been the most popular topic in corporate laws, especially in China recently. Although shareholders' meetings are the center of the authorities of a company as provided by law, companies' actual authorities are usually exercised by the board of directors. In other words, shareholders' meetings tend to delegate their power to the board of directors in practice. For example, the Supreme People's Court of China confirmed in "Miss Yuan and Miss Pan Damage the Interests of the Company" that shareholders' meetings may designate their powers under Corporate Law to the board of directors through management policies and investment plans. In this case, Miss Yuan and other shareholders pointed out that the board of directors' decision of investment decisions were a breach of the company bylaw, which requires shareholder meeting resolution should be obtained for significant affairs, including selling, trade-in investing, fair competition developing, mortgaging and other disposing all or part of the company's property (at least 3,000,000 Yuan). They argued that the exception under the company bylaw that shareholder meeting resolution not required for developing the company's own assets deprived the power of shareholders' meeting and conflicted with Corporate Law [1].

Similarly, in “The Effect of the Resolution of the Company between Miss Xu, Anshun Oasis Newspaper Hotel Co., Ltd, and Third Party Guizhou Qianzhong Newspaper Industry Development Co., Ltd.”, the company’s bylaw also designated the power of shareholder meeting, including capital increasing and reducing, merger, split-up, dissolution of the company, to the board of directors. Shareholders argued that the company organ of authority and the organ of the executive should be treated differently, and the lawful power of the shareholders’ meeting should not be designated to the board of directors from a plain reading of the Corporate Law. However, the third party, Guizhou Qianzhong Newspaper Industry Development Co., Ltd., also one of the shareholders, suggested that the Corporate Law did not ban the board of directors from exercising the power of shareholders’ meetings. Therefore such designation under bylaw should be legal [2]. This raised the critical issue of corporate governance in China: Who should be the central managing organ? The shareholders or the board of directors?

2. The Definition of the Shareholder-centric Model, the Board Centralism Model, and the Limited Board Centralism Model

2.1. How to Define the Shareholder-centric Model Board Centralism Model?

There are considerable standards of the definition of the shareholders’ meetings centralism model and the board centralism model. “Exclusivity Management Rights Standard” suggests that if the board of directors could exercise their authority separately without shareholders’ meeting intervening, this model could be the board centralism model; if not, that would be the shareholders’ meetings-centric model. Another standard is the “Remind Power Standard”, which considers powers provided under the law to decide [3]. The differences between these two corporate governance models rest on whether the board of directors or shareholders’ meeting plays the central authoritative role in corporate governance. If the main management power is provided to the shareholders’ meeting, the corporate governance structure is the shareholders’ meeting centralism model; if not, that should be the board centralism model. In practice, on the one hand, under the shareholder-centric model, concerns arise from the suspicion that the board of directors is a mere figurehead of shareholders’ meetings, which raises concerns about the protection over minority shareholders’ interests when the controlling shareholder manipulates the board of directors. To protect minority shareholders’ rights, corporate laws worldwide usually grant share repurchasing rights to dissenting minority shareholders.

On the other hand, under the Board Centralism Model, directors, usually professionals, could injure shareholders’ and creditors’ rights. So, to solve this problem, generally, corporate law of many countries enacted the fiduciary duties of directors to regulate their acts. The different model means different approaches when addressing conflicts between shareholders and the board of directors. Under the shareholders-centric model, shareholders' powers are exclusive to shareholders’ meetings and not designable to the board by the bylaw. Under the board centralism model, the designation of powers could be legal and effective. China has long adopted the shareholder-centric model. In “Guangxi Nanning Hongbailan Investment Co., Ltd. v. Mr Liu about the dissolved company”, the Supreme People’s Court of the People’s Republic of China interprets the Corporate Law of China as adopting the shareholder-centric model because in a previous guiding case, a company is ordered to dissolution because of a non-functioning shareholders’ meeting [4]. The fate of a non-functioning shareholder meeting would be different under the board centralism model. First, a company may not be ordered to dissolve solely based on a non-functioning shareholder meeting. Second, the board of directors could still operate a company directly and resolve shareholders’ conflicts. Based on the corporate governance structure of China, this article argues that the Corporate Law of China should adopt a limited board centralism model.

2.2. What is the Limited Board Centralism Model?

The limited board centralism model features a corporate governance model combining the board centralism model as the dominator and offensive shareholders activism. Offensive shareholder activism includes acts by shareholders or shareholders' meetings who are unwilling to control companies and replace the board of directors [5]. Meanwhile, it allows shareholders to query acts of the board of directors and resolutions in which shareholders are confused or distrusted.

The limited board centralism model means that the board of directors' authority is limited. Unlike the board centralism model, under the limited board centralism model, the directors, when the board makes some essential decisions, including decisions on capital increasing and reducing, merger, split-up, or dissolution of the company, should report their resolutions to the shareholders' meetings for voting. In other words, the board of directors enjoys full management powers except for some vital affairs rather than the shareholders' meeting being the authoritative organ and the board of directors being the executive organ of the shareholders' meetings.

3. Analysis of the Corporate Governance Structure in China

3.1. Limited Liability Companies' structures and Problems

Based on current Chinese Corporate Law, a limited liability company should have such organs at least:

- a) the shareholders' meeting.
- b) the board of directors.
- c) the board of supervisors.
- d) the managers.

First, under the Chinese Laws system, the shareholders' meetings are the center of the companies' authority. The board of directors executes shareholders' meetings resolutions effectively and undoubtedly. Second, the functions of the board of supervision supervises the acts of managers when carrying out the board's designated tasks and the board of directors, and reports to the shareholders' meetings if necessary. Quite a few questions arise under this corporate governance structure. First, owing to its lack of supervision by the public or government, the shareholders' meetings control the board of directors, sometimes in practice shareholders even employ themselves being the directors in their companies, resulting in the corporation had lost its independent personality. Meanwhile, in practice, the board of supervision usually becomes a figurehead of the shareholders' meetings because a supervisor will be fired by the shareholders' meetings if a supervisor cannot follow the shareholders' meetings' instructions.

In addition, some shareholders, especially the promoters, are not willing to grant more power to the board of directors and restrict directors' power via bylaws. Distrust is the main reason for this, especially when directors are elected as result of competition and compromises in the shareholders' meetings.

3.2. Public Companies' structures and Problems

Compared with limited liability companies, public corporations are usually operating with more regularity. That is mainly because there are considerable legal documents to regular those companies in that they are related to public properties.

However, the essential problem with public companies in China is that public companies are controlled by the controlling stockholders with the most shares. First, given that minority shareholders' equities are usually not enough to decide important affairs about the companies, the companies are controlled by majority shareholders, who tend to ignore rights of the minority

shareholders and prioritize personal profits or escaping from personal debt over the companies' overall interest. The concerns arising from controlling shareholders' manipulation of the board of directors and ignoring minority shareholders' interest grew after LeTV defaulted on its debts and its Chairman and controlling shareholder Yueting Jia fled in 2017. In addition, some minority shareholders, lacking the professional knowledge to understand and analyze companies' disclosed data and development strategies, just vote on some essential affairs following resolutions reported by the board of directors or managers. Such shareholders are, in fact, figurehead of the directors or controlling shareholders, and could easily be misguided by a superstar shareholder or manager.

4. Which Model is Suitable for Chinese Companies?

4.1. Historical Situations of Corporate Law of the People's Republic of China

The first corporate law was promulgated in 1993 by the government of the People's Republic of China, which is the original model of the current corporate law. However, this law's function was to provide a firm legal basis for the State-owned companies which planned to transform into business companies [6]. If those companies transformed into business companies, it means that those companies would have the whole independent status of legal person, which could get out of the country's hands. Thus, in order to enhance the rights of the country as a shareholder, this law enacted the shareholders meetings centralism. Furthermore, owing to the structure of the combination of civil and commercial codes, the Civil Code of China also enacted some rules about corporations, for example, it enacts the governing body---the shareholders meetings, and the executive body---the board of directors. The Civil Code has the same point as Corporate Law in a certain way.

Meanwhile, the other reasons for enacting the shareholders' meeting centralism are that, in the same period, China was experiencing a transfer from the planned economy to the market economy and to rule the company's operation. Market development requires investments, thus the first Corporate Law was promulgated during the period of Economic Reform and the Opening up of China, adopting the shareholder-centric model [7]. The Corporate Law was then amended in 2005 to further develop the capital and financial market of China.

4.2. Based on Two Chinese Cases about Shareholder Meeting Authorities and The Board of Directors' powers.

As mentioned above in the two cases, Miss Yuan and Miss Pan Damage the Interests of the Company, and "The Effect of the Resolution of the Company between Miss Xu, Anshun Oasis Newspaper Hotel Co., Ltd, and Third Party Guizhou Qianzhong Newspaper Industry Development Co., Ltd.". In the first case, the Supreme People's Court's judge adopted a limited board centralism approach. The judges reasoned that, the power of deciding managing policies and investing plans is not the exclusive power of the shareholders' meetings, although this item had been enacted the power of shareholders' meetings [1]. Meanwhile, on the law does not ban the board's decision on items of the shareholders' meetings if such the power to decide on such items are effectively designated to the board of directors. According to the principle "Absence of Legal Prohibition Means Freedom", such designation of power should be legitimate and positive.

Yet the judges of the Higher People's Court of Guizhou Province gave a different final award in the second case. The reason is that the powers granted by shareholders' meetings to the board of directors are exclusive powers to the shareholders' meetings in that those powers need stockholders to vote [2]. The decision conflicts with the prominent practice in China that shareholders' meetings tend to designate more power of management to the board of directors. The decision also brings up new issues: What if the controlling shareholder slacks with its duties in the shareholder's meeting? Is the board of supervisors functioning? How should the board of directors best apply their professional

knowledge to the management of companies? The current Corporate Law of China fails to address practical issues nowadays, and it needs to be amended to return to board centralism.

Owing to Chinese corporate governance, which is a two-tier structure, the experience of the United States or British cannot be directly suited to China. However, given the limited function of the board of supervisors, the Chinese companies' structure could turn into the one-tier structure.

4.3. The Foreign Corporate Laws about the Corporate Governance Structure and Its Historical Background

Different from Chinese Corporate Law, each state of the United began to promulgate their own corporate law to attract investment from other states and attract already-established companies. Such corporate laws reduced restrictions on companies' governance and gave more space and room to companies to manage and operate [8]. Board centralism is widely adopted by different states and Delaware Corporate Law stands out due to the flexibility it granted in corporate establishment and governance. Due to the one-tier corporate governance structure, companies in the United States do not set a board of supervision, so those companies only have shareholders' meetings and a board of directors. Typically, the powers of the board of directors promulgated by the law are that: a) Act as the company; b) Manage the corporation; c) Select and manager officers; d) Declare and pay dividends; e) Fiduciary duties. Conversely, shareholders' powers are less than the board of directors. They only enjoy voting, selling, suing, electing the board of directors, and information rights.

Likewise, British corporate law enacts the power of directors, such as the power of management, appointment of agent out of company and so on. But this law does not enact the power of the board of directors, and it gives room and spares to the company, which allow shareholders' meeting and bylaws to grant some powers to the board except some exclusivity power or rights which belongs to shareholders or shareholders' meeting [9]. The corporate governance structure of companies in the UK is as same as it in America, and they are both one-tier structure.

The difference between the one-tier company's structure and the two-tier company's structure is whether a separate board of supervisors is required by law. In a one-tier structure company, outside directors or independent directors serves to supervise and manage the company. In China, given the futile board of supervisors, Corporate Law should first allow companies to decide whether to keep a board of supervisors to prevent controlling shareholders from intervening board of directors' decisions.

Therefore, the limited board centralism model could be a transition corporate governance structure model, which can help the Chinese companies' governance structure to the board centralism model.

4.4. The Reason and Effect of Applying the Limited Board Centralism Model and Some Other Related Provisions.

As has been noted, the current Corporate Law is unadopted the society's practice which is that shareholders just want to be investors and earn profits in short-termism instead of being governors in companies. The board of directors, however, put their eyes on the long-term profits of the companies, which could conflict with shareholders' profits. Therefore, giving the management power to the board of directors would play a vital role during the development of the companies.

However, owing to the Chinese legal system, which is the combination of Civil and Commercial codes, the Civil Code enacted that shareholders' meeting is the governing body of a company, so the corporate governance structure could be reformed under this background to avoid frequently amending laws. In other words, the best way to reform this structure is to maintain the necessary power of the shareholders' meetings and expand the power of the board of directors (incredibly independent directors) as a transitional way to the board centralism model, for instance, allowing

shareholders' meetings to grant their non-exclusive powers to the board of directors or promulgating those powers belonged to the board of directors by the law. Moreover, the governance structure shall be chosen by the companies, namely allowing companies whether set the board of supervision or audit committee to exercise supervise power.

In addition, more powers mean more obligations. First, the fiduciary duties and diligence obligations of directors should be enhanced; for example, directors should assume responsibilities to creditors directly when their acts would infringe upon creditors' lawful rights and interests (including intentionally or gross negligence), which is called directors' liability to creditors in the law of The United States [10]. Second, some protected items should be enacted to protect directors from unreasonable fire by resolutions of the shareholders' meetings.

In addition, offensive shareholders activism does not mean that shareholders could intervene in the management power of directors. Although shareholders could affect directors' resolutions, that should be restricted to a little room, like an emergency. Otherwise, it may cause equity abuse and return to the shareholders' meetings centralism. In other words, shareholders can exercise their information rights to learn about the operation situations of companies, and directors should also disclose their resolutions to shareholders to protect shareholders' profits. Besides, if necessary, shareholders could also protect companies' interests via the shareholder representative litigation system.

5. Conclusion

In conclusion, based on the Chinese situation, it is impossible that turn to board centralism in a short period, and the next step is that take a moderate method to transform the shareholder-centric model to the board centralism model, which is called limited board centralism. It has a part of characters with board centralism and shareholders activism. And this theory could not only help companies maintain a good operation situation but also protect shareholders from the distortion of the board of directors, such as managerial corruption. But limited board centralism is a new theory, for now, that has yet to be tested by practice. Furthermore, it is a whole ideal theory. To improve that, legislation could rule the board of directors' power as a general cause and then give the opinion to the company self to confirm how far the board could go.

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