THE INDEPENDENT DIRECTOR IN CHINESE CORPORATE GOVERNANCE

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ABSTRACT

*Corporate governance (*gongsi zhili*) is a concept whose time has come in China, and the institution of the independent director is a major part of this concept. Policymakers in several countries such as the United Kingdom and Japan have turned to independent directors as an important element of legal and policy reform in the field of corporate governance. In August 2001, the China Securities Regulatory Commission (CSRC) issued its Guidance Opinion on the Establishment of an Independent Director System in Listed Companies. Covering all companies listed on Chinese stock exchanges (but not Chinese companies listed overseas), it constitutes the most comprehensive measure taken to date by the CSRC—or indeed by any Chinese governmental authority—to regulate internal corporate governance through the institution of the independent director.*

This article discusses the institution of independent directors, and the Independent Director Opinion specifically, as a potential solution to Chinese corporate governance problems. It begins by discussing special features of the Chinese corporate landscape and the most prominent

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A note on references: Authors' surnames and given names are provided in the order appropriate to the language in which the work is published. Where the surname comes first, it is underlined to avoid confusion.

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problems in the area of corporate governance. It then proceeds to identify differing conceptions of what is broadly termed "the independent director"—the outside director, the disinterested director, and the (more narrowly defined) independent director—and discusses the approaches taken in several different jurisdictions.

The article canvasses empirical research on the relationship between independent directors and corporate performance in the United States, as well as in China, and finds that the research yields similar conclusions: there is no strong link. The article concludes by arguing that proponents of the institution of independent directors misconceive the nature of the corporate governance problem in China, as well as the functioning of independent directors in the United States, and have not taken into account specific features of the Chinese institutional environment—particularly the legal environment—that affect the viability of any proposed solution.

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I. INTRODUCTION

Corporate governance (*gongsi zhili*) is a concept whose time seems definitely to have come in China.[1] In part, this is simply a reflection of the increasing attention being paid to the subject in academic, professional, and business circles in the West, and of the increasing integration of Chinese intellectual life with global trends. But the flood of speeches, articles, and conferences on corporate governance in China today would not be occurring if the concept did not seem to promise a way of thinking about, and remedying, a host of perceived flaws in China's legal and economic institutions.

Policymakers in several countries have turned to independent directors as an important element of legal and policy reform in the field of corporate governance. In the United States, insider-dominated boards have been rare for years,[2] and although the New York Stock Exchange (NYSE) has required that independent directors constitute a board majority in domestic companies only since 2004,[3] as of 2001 approximately 75% of

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[1]I searched a database of Chinese periodicals in law, economics, and related subjects (the *Zhongguo Qikan Quanwen Shujuku* [*Chinese Periodicals Full-Text Database*], *at* http://www.cnki.net) to see in how many articles the most common Chinese term for corporate governance, *gongsi zhili*, appeared in the title. In 1994, the year the Company Law came into effect, there were nine such articles. In 1995, there were 14. In 1999, the number was 107; in 2002, 643; and in 2004, 899. As of early March 2006, this database recorded 933 article titles mentioning "corporate governance" in 2005.

[2]*See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921 (1999) ("In the 1960s most [large American companies] had a majority of inside directors; today, almost all have a majority of outside directors and most have a majority of 'independent' directors.").

[3]*See* NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A.01 (2003), *available at* http://www.nyse.com/listed [hereinafter LISTED COMPANY MANUAL]. In the wake of widely-publicized failures of corporate oversight, the chairman of the Securities and Exchange Commission (SEC) issued a public statement in 2002 requesting that the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) review and modify corporate governance standards. *See* Securities and Exchange Commission, Release No. 34-48745, NASD and NYSE Rulemaking: Relating to Corporate Governance (Nov. 4, 2003) (discussing the history of the new NYSE rules and citing Commission Press Release No. 2002-23 (Feb. 13, 2002)). In response, the NYSE generated corporate governance reform proposals now

NYSE-listed companies already had such majorities.[4] With the rise of takeover activity since the 1980s, *disinterested*[5] directors have played an increasingly important role in related state-level litigation, and the modest role for independent directors contemplated in the listing rules of the NYSE[6] has given way, in the wake of Enron and other corporate scandals, to federal mandates for listed companies under the Sarbanes-Oxley Act (SOA).[7] Britain's own set of corporate scandals led to the Cadbury Report, which recommended, along with subsequent similar reports and studies, a greater role for outside and independent directors,[8] and the last decade has seen a number of corporate law reforms in Japan designed to enhance the role of directors and auditors not tied to management.[9]

The increasing worldwide interest in independent directors has not gone unnoticed by Chinese policymakers. Indeed, Chinese interest predated the corporate scandals that led to federal-level corporate governance reforms in the United States, possibly because of the many similar scandals that had already occurred among Chinese companies listed on one of the country's two stock exchanges.[10] In August 2001, the China Securities Regulatory Commission (CSRC) attracted attention with the issuance of its Guidance Opinion on the Establishment of an Independent Director System

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included in Section 303 of the Listed Company Manual. *See id.*

[4]*See* Joann S. Lublin, *NYSE Considers Rules to Boost Power of Boards Fostering the Independence Of Directors Could Improve Governance, Advisers Say*, WALL ST. J., June 3, 2002, at A2 (citing report by Investor Responsibility Research Center). In a 2003 survey of its 150 members, the Business Roundtable, an organization of large American corporations, found that 80% had boards that were at least 75% independent, and that 90% had boards that were at least two-thirds independent. *See* Press Release, The Business Roundtable, The Business Roundtable Releases Corporate Governance Survey (July 15, 2003), *available at* http://www.brt.org/press.cfm/970.

[5]The difference between disinterested, independent, and outside directors is discussed *infra* Part III.B.

[6]*See infra* note 109 and accompanying text.

[7]*See infra* notes 106-07 and accompanying text.

[8]*See infra* notes 120-23, 131 and accompanying text. As of 2001, outside directors were a board majority in 53% of companies on the London Stock Exchange. *See* MOTOMI HASHIMOTO, COMMERCIAL CODE REVISIONS: PROMOTING THE EVOLUTION OF JAPANESE COMPANIES 14 (Nomura Research Institute, NRI Papers, No. 48, May 1, 2002) (citing CORPORATE GOVERNANCE 2001 (PIRC ed., Dec. 2001)). In 2004, however, Pensions Investment Research Consultants reported a board majority of independent directors in well under 15% of LSE-listed companies. *See* Pensions Investment Research Consultants Ltd. (PIRC), Presentation of Corporate Governance Annual Review 2004 (Nov. 18, 2004), *available at* http://www.pirc.com.

[9]*See infra* notes 134-39 and accompanying text.

[10]The two Chinese stock exchanges are in Shanghai and Shenzhen.

in Listed Companies (Independent Director Opinion).[11] Covering all companies listed on Chinese stock exchanges (but not Chinese companies listed overseas), the Opinion constitutes the most comprehensive measure taken to date by the CSRC or any Chinese governmental authority to regulate internal corporate governance through the institution of the independent director. It is also portrayed unapologetically as a borrowing from United States corporate governance law and practice,[12] and as such implicates many issues relevant to legal transplants.[13]

Despite its scope, the Opinion was not the first Chinese regulatory document[14] to call for the appointment of independent directors, and the idea had been under discussion for some time in academic journals and the financial press. Although the institution of independent directors has been mooted largely as part of a solution to governance problems in listed companies, the problems in question are not necessarily unique to listed companies. As Chinese economic reform continues and the government abandons the traditional ways of managing state-owned enterprises, and as individual wealth increasingly makes possible the accumulation of private assets on a scale too large to be managed by an individual owner, there will increasingly exist corporate entities in one form or another that are run by professional managers who do not own the assets, and yet are unconstrained by the disciplines that functioned reasonably well under the system

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[11]China Securities Regulatory Commission, *Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian* [*Guidance Opinion on the Establishment of an Independent Director System in Listed Companies*] § 1(1), issued Aug. 16, 2001 [hereinafter *Independent Director Opinion* or *Opinion*].

[12]*See, e.g.*, Gao Yong, *Duli Dongshi Zhidu yu Shangshi Gongsi Zhili* [*The Independent Director System and Corporate Governance in Listed Companies*], JINGJI TIZHI GAIGE [ECONOMIC SYSTEM REFORM], No. 1, 2002, at 8, 8; Ma Gengxin, *Wanshan Woguo Shangshi Gongsi Duli Dongshi Zhidu Jianshe de Sikao* [*Some Thoughts on Perfecting the Construction of the Independent Director System in China's Listed Companies*], 20 ZHENG-FA LUNTAN [POLITICAL-LEGAL FORUM], No. 6, 2002, at 61, 61; Yan Hai & Chen Liang, *Duli Dongshi Zhidu Yanjiu* [*A Study of the Independent Director System*], HUADONG ZHENG-FA XUEYUAN XUEBAO [JOURNAL OF THE EAST CHINA INSTITUTE OF POLITICS AND LAW], No. 4, 2001, at 23, 24.

[13]On legal transplants in corporate law, with many intriguing parallels to China, see Hideki Kanda & Curtis Milhaupt, *Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law* (Columbia Law School Center for Law and Economic Studies, Working Paper No. 219, 2003), *available at* http://ssrn.com/abstract=391821.

[14]The admittedly clumsy term "regulatory document" includes all rules of a normative character issued by Chinese legislative, governmental, and judicial agencies, as well as quasi-governmental variations thereon. The nature of the Chinese legal system makes such a term necessary, although this article is not the place to demonstrate the point systematically. *See generally* Perry Keller, *Sources of Order in Chinese Law*, 42 AM. J. COMP. L. 711, 711-12 (1994) (characterizing Chinese legislation as being in a state of "chronic disorder").

of state planning.[15] Thus, Chinese scholars and policymakers have been searching for new mechanisms of corporate governance and accountability not just for listed companies, but for all concentrations of assets managed by non-owners.

This article will discuss the institution of independent directors, and the Independent Director Opinion specifically, as a potential solution to Chinese corporate governance problems. I will argue that proponents of the institution misconceive the nature of the corporate governance problem in China, as well as the functioning of independent directors in the United States, and have not taken into account specific features of the Chinese institutional environment, particularly the legal environment that affects the viability of any proposed solution. The discussion of independent directors will, I hope, shed light on a number of broader issues in Chinese corporate governance, including such questions as the basic approach to the regulation of corporate activity.

Part II of this article examines basic issues of corporate governance generally as well as in China. It introduces some basic facts about the system as well as the principal problems seen by commentators. Part III looks at the specific institution of independent directors as a proposed solution, and canvasses regulatory responses, including the Independent Director Opinion. Part IV pulls these strands together, discussing first the empirical evidence regarding the effect of the presence of independent directors on the board of directors, and then the policy implications for corporate governance of what we know about corporate structure and the legal system in China. Part V offers a conclusion.

II. CORPORATE GOVERNANCE IN CHINA

A. *Listed Companies in China*

As this article is concerned primarily with the governance of Chinese companies listed on one of the country's two stock exchanges, an introduction to the relevant features of such companies is essential before turning to issues of corporate governance both in general and in China.

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[15]On constraints on management behavior under the system of state planning, see generally EDWARD S. STEINFELD, FORGING REFORM IN CHINA: THE FATE OF STATE-OWNED INDUSTRY (Cambridge Univ. Press 1998).

1. Who Are They?

Chinese companies may be listed on one of China's two stock exchanges in Shanghai and Shenzhen. They may also be listed on overseas exchanges, typically in Hong Kong or New York. As of the end of 2005, there were 1381 companies listed on China's two domestic markets.[16]

To be listed and thus able to raise money directly from the public, a company must take the corporate form of a joint stock company (*gufen youxian gongsi*) (JSC) under the Company Law[17]—a form intended for large corporations with widely dispersed stock ownership. Thus, a traditional state-owned enterprise (TSOE)[18] must reorganize itself to be listed. The vast majority of listed companies are, in fact, reorganized TSOEs. Of 1088 listed companies on both exchanges at the end of 2000, over 900 were originally TSOEs,[19] and of 1160 listed companies at the end of 2001, approximately 1103 were originally TSOEs.[20] A recent study concluded that approximately 84% of listed companies were, viewed solely from the standpoint of equity ownership and not taking account of informal mechanisms of influence, directly or indirectly under state control.[21]

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[16]English-language statistics are available at the CSRC's Web site at http://www.csrc.gov.cn/en/homepage/index_en.jsp.

[17]See *Zhonghua Renmin Gongheguo Gongsi Fa* [*Company Law of the People's Republic of China*], as amended Oct. 27, 2005, ch. 4 [hereinafter *Company Law*]. Such companies are sometimes referred to as "companies limited by shares." The pre-amendment version of the Company Law, adopted in 1993 and effective from July 1, 1994 through Dec. 31, 2005, is referred to hereinafter as *1993 Company Law*.

[18]By "traditional state-owned enterprise" I mean the kind of state-owned enterprise that existed prior to the Company Law: something like a cost center or a division within the loosely organized firm of China, Inc. There was no formal law governing industrial TSOEs until 1988, and there is still no formal law governing commercial TSOEs. *See generally* Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 496 (2003).

[19]*See* On Kit Tam, *Ethical Issues in the Evolution of Corporate Governance in China*, 37 J. BUS. ETHICS 303, 305 (2002).

[20]*See* STEPHEN GREEN, CHINA'S STOCK MARKET: EIGHT MYTHS AND SOME REASONS TO BE OPTIMISTIC (The China Project, Royal Institute of International Affairs and Cambridge University, Feb. 2003). Jiang Qiangui, the chairman of the State Economic and Trade Commision (SETC), was recently quoted as saying that "the vast majority of listed companies are reorganized state-owned enterprises." *Guojia Jing Mao Wei Fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong* [*SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder*], JINGJI RIBAO [ECONOMIC DAILY], Jan. 30, 2003, *available at* http://www.chinainfobank.com.

[21]*See* Guy S. Liu & Pei Sun, *Identifying Ultimate Controlling Shareholders in Chinese Public Corporations: An Empirical Survey* 2 (Royal Institute of International Affairs, Asia Programme Working Paper No. 2, 2003).

2. Capital Structure

As JSCs, listed companies are allowed under the Company Law to have only one class of shares. It is crucial to understand, however, that there are nevertheless several different types of shares, distinguished by rules about their ownership and trading.[22] First, there are several types of shares known as circulating shares that may be traded freely and publicly on various stock markets. A-shares may be listed on a domestic stock exchange and owned and traded by any domestic individual, entity, or specially approved foreign institutional investor.[23] B-shares are also listed on domestic stock exchanges and until recently could be bought only by foreigners using foreign currency; they may now be purchased by domestic investors as well with foreign currency. Other letter-designated shares include H-shares (listed in Hong Kong), N-shares (represented by American Depositary Receipts listed in New York), L-shares (listed in London), and so on.

Second, there are several types of shares known as non-circulating shares that are subject to more severe trading restrictions. These are state shares (*guojia gu*), which may be owned only by state organs; legal person shares (*faren gu*), which may be owned only by organizations with formal legal personality, such as companies; and employee shares, which generally represent accumulated profits in a state enterprise prior to its public share

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[22]For a fuller account of share types, see CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: THE STOCK MARKETS AND THEIR ROLE IN CORPORATE REFORM 71-87 (John Wiley & Sons 2003).

[23]Some analysts define A-shares broadly as shares available only to domestic investors, and include all the non-circulating shares described in the following paragraph in the text. This seems confusing to me for several reasons and I shall adopt the narrower definition here. First, popular usage of the term "A-shares" almost always refers to tradeable shares listed on stock markets. Second, state shares and employee shares (which have their origin in the corporatization of traditional state-owned enterprises) are by definition domestically held, so giving them a second label seems redundant. Third, legal person shares may, following the lifting of a prohibition lasting from 1995 to 2003, be sold to foreign entities, subject to appropriate approvals. *See* China Securities Regulatory Commission, Ministry of Finance, and State Economic and Trade Commission, *Guanyu Xiang Waishang Zhuanrang Shangshi Gongsi Guoyougu he Farengu Youguan Wenti de Tongzhi* [*Notice Regarding Transfer to Foreign Investors of State-Owned Shares and Legal Person Shares of Listed Companies*], issued Nov. 1, 2002. Circulating shares recently became available to certain foreign entities qualifying as Qualified Foreign Institutional Investors. *See* China Securities Regulatory Commission and People's Bank of China, *Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Zanxing Banfa* [*Provisional Measures on the Administration of Investment in Domestic Securities by Qualified Foreign Institutional Investors*], issued Nov. 5, 2002, effective Dec. 1, 2002. Whether tradeable shares can be owned by foreigners and whether legal person shares can be owned by foreigners are two different policy decisions that will likely be made separately; labeling both types by the same name does not seem to serve any useful purpose.

offering and are deemed formally owned by the collective body of enterprise employees. These shares are not tradeable at the time of listing and are generally managed by either an investment management committee or a staff union.[24]

It should be noted that the state share/legal person share distinction is well established in law and statistics but is conceptually problematic. Legal persons that hold shares can be state-owned and state-controlled, so in some sense many legal person shares should be seen as state shares.[25] That said, it must be added that the various government bodies holding state shares do not act with one mind and may pursue conflicting objectives. Some government bodies may well be purely profit seeking, while others seek to use their share ownership to influence the company to fulfill certain government objectives such as full employment.

By the same token, apparently some shares classified as state shares are in fact held not by government agencies but by companies (e.g., parent companies of corporate groups) that are controlled by the government agency in charge of that industry.[26] These should technically be called legal person shares, but they are called state shares because their voting and use is in some sense directly controlled by government. The principles governing the classification of shares as legal person shares or state shares are neither clear nor uniform.[27] The bottom line of the state share/legal person share distinction, therefore, is that it does not tell us much about the nature of the ultimate controlling shareholder.[28]

3. Who Owns Them?

Until quite recently, the mean shareholding percentages across companies was typically about 30% for each of the state, legal persons, and

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[24]*See* Zhongguo (Hainan) Gaige Fazhan Yanjiu Yuan Keti Zu [China (Hainan) Reform and Development Institute Project Group], *Tiaozheng Zhili Jiegou, Lizu Zhidu Chuangxin: Haikou Guantou Chang Qiye Gaige Anli Diaoyan [Adjust the Governance Structure on the Basis of Institutional Renovation: A Case Study of Enterprise Reform in the Haikou Canning Factory]*, *in* ZHONGGUO GONGSI ZHILI JIEGOU [THE STRUCTURE OF CORPORATE GOVERNANCE IN CHINA] 309, 322-23 (China (Hainan) Reform and Development Institute ed.,Waiwen Chubanshe 1999); Daqing Qi et al., *Shareholding Structure and Corporate Performance of Partially Privatized Firms: Evidence from Listed Chinese Companies*, 8 PACIFIC-BASIN FIN. J. 587, 592-93 (2000).

[25]*See* Yin Wenquan, *Qiye Jituan Shangshi Gongsi de Guquan Jiegou Gaizao [Reform in the Equity Structure of Listed Enterprise Group Companies]*, *in* ZHONGGUO GONGSI ZHILI JIEGOU [THE STRUCTURE OF CORPORATE GOVERNANCE IN CHINA], *supra* note 24, at 98-111.

[26]*See, e.g.*, *id.* at 99-100.

[27]*See id.* at 99.

[28]This point is explored in detail in Liu & Sun, *supra* note 21, at 8.

A-share holders, with 10% going to foreigners and employee shares.[29] Although this rough average seems robust over several studies, one study finds that the standard deviation is large, showing that there are large variations in the formal ownership mix across firms.[30]

A recent study, however, calls this stylized fact into question. Lü and Wu find that as of the end of 2002, state shares represented as much as 47.2% of outstanding shares of listed companies, down from 51.31% at the end of 1992.[31] It seems unlikely that state share ownership dipped to somewhere around 30% in the 1990s and then rose again. Lü and Wu further put legal person shareholdings at 11.31% and circulating shares (including B-shares and H-shares) at 34.67%.[32] Thus, the rough figure for circulating shares seems confirmed by all studies, whereas the figure for state and legal person shares is in question. Since Lü and Wu's figure for legal person shares seems abnormally low, it may be that by "state shares"

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[29]*See* Qi et al., *supra* note 24, at 593. Xu and Wang come to a similar conclusion for ownership as of the end of 1995, *see* Xiaonian Xu & Yan Wang, *Ownership Structure and Corporate Governance in Chinese Stock Companies*, 10 CHINA ECON. REV. 75, 76 (1999), and Yin reports that as of the end of 1997, the mix was 32% state shares, 30% legal person shares, and 35% tradeable shares, *see* Yin, *supra* note 25, at 98. (Note, however, that many legal person shares are held by institutions that are themselves state-owned.) Zhang and Sun report a mix of 34% state shares and 34% circulating shares against 20.9% domestic legal person shares for 1998, with the remainder being held by foreigners, founders, and employees. *See* Zhang Zongxin & Sun Yewei, *Guquan Jiegou Youhua yu Shangshi Gongsi Zhili de Gaijin* [*The Optimization of Share Capital Structure and the Improvement of Corporate Governance in Listed Companies*], JINGJI PINGLUN [ECON. REV.], No. 1, 2001, at 36, 36. Ren Haichi reports a figure of 60% *state-owned* shares (*guoyou gu*) and 35% circulating shares for all listed companies as of the end of June 2002 (note that the term "state-owned" includes both state shares and legal person shares belonging to entities owned by the state). *See* Ren Haichi, *Ruhe Youhua Woguo Shangsi Gongsi Ziben Jiegou* [*How to Improve the Capital Structure of China's Listed Companies*], SHANGHAI JINRONG XUEYUAN XUEBAO [J. SHANGHAI INST. FIN.], No. 2, 2004, at 60, 60.

CSRC statistics as of the end of December 2005 put the value of circulating shares at 1.06 trillion *yuan*, and the value of all shares of listed companies at 3.24 trillion *yuan*. *See* CSRC Web site, http://www.csrc.gov.cn. While it is not economically realistic to value non-listed shares at the same price as listed shares, *see infra* note 51, doing so does permit the conclusion that a reasonable weighted average percentage for circulating shares is about 33%.

Publicly issued (that is, tradeable) shares must account for at least 25% of all shares at the time of a public offering unless the par value of the company's stock exceeds 400 million *yuan*, in which case they must account for at least 10%. *See Zhonghua Renmin Gongheguo Zhengquan Fa* [*Securities Law of the People's Republic of China*], as amended Oct. 27, 2005, art. 50. This rule was, prior to the October 2005 revisions to both the Securities Law and the Company Law, set forth in Article 152 of the Company Law.

[30]*See* Xu & Wang, *supra* note 29, at 80 (table).

[31]*See* Lü Hui & Wu Xingming, *Shangshi Gongsi Guquan Jiegou yu Gongsi Zhili* [*The Stock Ownership Structure and Corporate Governance of Listed Companies*], JINGJI TIZHI GAIGE [REFORM OF THE ECONOMIC SYSTEM], No. 4, 2004, at 88, 88.

[32]*See id.*

(*guojia gu*) they actually mean "state-owned shares" (*guoyou gu*), a term that includes legal person shares owned by state-owned entities.

While individuals, as noted above, are not permitted to hold state shares or legal person shares, institutions are allowed to hold A-shares. It is very difficult, however, to know the degree of institutional ownership of A-shares. According to one source, for example, as of the end of 1998, there were 19.9 million stock accounts at the Shanghai stock exchange. Of these, 99.75% were for individuals, with institutions holding only 0.3%. Individuals held 93.15% of A-shares by value.[33] By the end of 2001, the reported number of A-share accounts on both exchanges was up to an astonishing 60 million,[34] equal to about one in five urban residents between the ages of 15 and 64.[35] Anthony Neoh, the former chairman of Hong Kong Securities and Futures Commission and a prominent advisor to the CSRC, however, was reported in December 2001 to have asserted that because of duplicate registrations and dormant or abandoned accounts, the real number was closer to 10 million.[36] Despite these cautions, media outlets were still reporting, without qualification, account totals of 70 million in January 2005.[37] Walter and Howie, on the basis of a variety of data, put the number

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[33]*See* Hu Ruyin et al., *Zhongguo Shangshi Gongsi Zhili Mianlin de Wenti yu Duice* [*Corporate Governance Problems Confronting Chinese Listed Companies and Measures to Address Them*], *in* GUO FENG & WANG JIAN, GONGSI FA XIUGAI ZONGHENG TAN [AN ALL-AROUND DISCUSSION OF REFORM OF THE COMPANY LAW] 172, 184 (Falü Chubanshe 2000) (citing the Shanghai Stock Exchange as their source). The authors state that the figures for the Shenzhen Stock Exchange are similar. This claim is borne out by SHENZHEN ZHENGQUAN JIAOYISUO SHICHANG TONGJI NIANJIAN 2000 [SHENZHEN SECURITIES EXCHANGE MARKET STATISTICS YEARBOOK 2000] 9 (Shenzhen Securities Exchange ed., Zhongguo Jinrong Chubanshe 2001) (showing 19 million accounts in 1998) and CHINA SECURITIES ASSOCIATION, ZHONGGUO ZHENGQUAN SHICHANG NIANBAO 2000 [CHINA SECURITIES MARKET ANNUAL REPORT 2000] 47 (Zhongguo Jinrong Chubanshe 2000) (showing 39 million accounts for both exchanges in 1998).

[34]*See Woguo Zhen Gumin Buguo Yiqian Wan* [*True Shareholders in China Not More than Ten Million*], TIANJIN RIBAO [TIANJIN DAILY], Dec. 13, 2001, at 3.

[35]I have calculated this figure from the numbers provided in ZHONGGUO TONGJI ZHAIYAO 2001 [CHINA STATISTICAL ABSTRACT 2001] 36-37 (State Statistics Bureau ed., Zhongguo Tongji Chubanshe, 2001).

[36]*See Woguo Zhen Gumin Buguo Yiqian Wan* [*True Shareholders in China Not More than Ten Million*], *supra* note 34.

[37]*See 7000 Wan Gumin Qunian Meihu Junping Kuisun 2045 Yuan* [*70 Million Stock Investors Lost 2045 RMB Per Person on Average Last Year*], BEIJING XIANDAI SHANGBAO [BEIJING MODERN BUSINESS NEWS], Jan. 5, 2005, *available at* http://finance.sina.com.cn/stock/y/20050105/00011270285.shtml. One reason for the persistence of this grossly inaccurate number may be the interests of the securities industry. It has attempted to resist regulation by frightening the government with an argument amounting in effect to the claim that regulation would pierce a bubble of (unwarranted) public confidence, cause market prices to plummet, and send 70 million investors on to the streets in protest. A senior official in the Shanghai Stock Exchange cited this number at a meeting attended by the author in 2004; his subordinates readily admitted in subsequent conversations that everyone (including the official and others in the

of actual holders of shares at five to ten million, and estimate the number of active traders to be only about one million.[38]

The presence of official and unofficial investment funds complicates the picture further. Recent research suggests that as much as 40% to 50% of the value of circulating shares is controlled by official and unofficial investment funds;[39] when one then adds in the value of A-shares controlled by other institutions, the amount in the hands of individuals appears to be far less.

Overall and within the non-circulating share block, ownership concentration is high in Chinese listed companies. Xu and Wang found that as of 1995, the five largest shareholders in their sample (all firms listed on the Shanghai and Shenzhen stock exchanges) accounted for 58% of outstanding shares, as compared with 57.8% in the Czech Republic, 79% in Germany, 33% in Japan, and 25% in the United States.[40] Chen found that the largest single shareholders held on average 48% of outstanding shares, and that the largest ten shareholders held on average nearly 64% of the outstanding shares.[41] Moreover, of the 12 largest companies on the Shenzhen stock exchange, 11 had a single shareholder owning over 50%, and in four of the largest companies, a single shareholder owned over 70%.[42] Perhaps the best overall picture is that of Lou and Yuan, who report that as of May 10, 2001, 177 out of 1206 listed companies (15%) were more than 66% owned by a single shareholder; 510 (42%) were more than 50% owned; 742 (62%) were more than 37.5% owned; and 888 (74%) were more than 30% owned.[43]

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audience) knew the real number was nowhere near this.

[38]*See* WALTER & HOWIE, *supra* note 22, at 140.

[39]*See id.* at 150; Barry Naughton, *The Politics of the Chinese Stock Market*, CHINA LEADERSHIP MONITOR, No. 3, 2002, *available at* http://www.chinaleadershipmonitor.org.

[40]*See* Xu & Wang, *supra* note 29, at 76. The authors state cryptically that their figures for China were calculated by themselves and are not "directly comparable" with the figures for other countries, but they do not specify how their method of calculation differed from that used in the studies from which they source their figures for other countries, and in any case they specifically make the comparison in several places.

[41]*See* Jian Chen, *Ownership Structure as Corporate Governance Mechanism: Evidence from Chinese Listed Companies*, 34 ECONOMICS OF PLANNING 53, 61 (2001).

[42]*See* Ning Ao et al., *Guanyu Wanshan Shangshi Gongsi Zhili Jiegou de Ruogan Cuoshi* [*On Several Measures to Improve the Governance Structure in Listed Companies*], *in* GUO & WANG, *supra* note 33, at 235. The authors do not indicate how size was measured (i.e., whether by gross assets, some measure of market capitalization, or something else).

[43]*See* Lou Fang & Yuan Hongqi, *Duli Dongshi Zhidu: Xifang de Yanjiu he Zhongguo Shijian Zhong de Wenti* [*The Independent Director System: Western Research and Problems in Chinese Practice*], GAIGE [REFORM], No. 2, 2002, at 51, 55. The authors' figure for the proportion of companies more than 50% owned by the largest shareholder is difficult to reconcile with the figure of 890 out of 1190 listed companies provided for the previous month in Wang

Within the A-share (circulating shares) block, the pattern is similar. In companies listed on the Shezhen Stock Exchange, for example, about 9% of the shareholders own about 58% of the A-shares.[44] Few large shareholders are individuals. In a 1997 sample of 300 companies listed on the Shenzhen Stock Exchange, only 42 companies listed individuals among their five largest shareholders.[45] Individual investors among the ten largest shareholders still controlled only a small amount of stock: individual holdings rarely exceeded 0.5% of the total, and the aggregate holdings of such individuals constituted about 3.4% of total outstanding shares of the sample companies.

Where state share ownership exists it appears to be concentrated. Out of 541 listed companies with some state share ownership in 1999, in 312 the state shareholder was the only shareholder with a stake exceeding 5%. In over 87% of the 541 companies, the state held a controlling interest either through a majority holding or a dominant holding.[46] Lin provides a different angle on the issue, finding that in 1997, 97% of all listed companies were state-owned, state-controlled, or had significant state share ownership, and that 75% of the outstanding (not necessarily all listed) shares of listed companies were directly or indirectly owned by the state (indirect ownership presumably including ownership through state-owned or state-controlled companies of legal person shares).[47] Such direct or indirect ownership continued in subsequent years. By the end of June 2002, state-owned shares (i.e., state shares and legal person shares owned by state-owned entities) accounted for at least 70% of the outstanding shares of over half of the largest 112 listed companies.[48]

There are several problems with the studies on share ownership that must be taken into account before attempting to read any significance into the results. First, political authorities retain many channels of control, both lawful and customary, through which internal corporate matters (for

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Changbo & Feng Hualan, *Lun Duli Dongshi Zhidu yu Jianshihui Zhidu Xiang Jiehe de Jian Guan Moshi* [*On the Monitoring Model Combining the Independent Director System and the System of the Board of Supervisors*], SHENGCHANLI YANJIU [RESEARCH IN PRODUCTIVE FORCES], No. 1, 2002, at 119, 121. Liu also provides the figure of 890 out of 1124 listed companies for the same period. Liu Zhongwen, *Shangshi Gongsi Yigu Duda Hai Yao Chixu Duojiu?* [*How Long Will the Situation of "One Big Stockholder" Last for Listed Companies?*], MEITAN QIYE GUANLI [COAL ENTERPRISE MGMT.], No. 7, 2004, at 13, 13. None of the authors provides a source for these numbers; I do not know who is right.

[44] *See* WALTER & HOWIE, *supra* note 22, at 133-34.

[45] *See* Xu & Wang, *supra* note 29.

[46] *See* Zhang & Sun, *supra* note 29, at 36.

[47] *See* Cyril Lin, *Corporatisation and Corporate Governance in China's Economic Transition*, 34 ECONOMICS OF PLANNING 5, 24 (2001).

[48] *See* Ren, *supra* note 29, at 60.

example, the selection of the chief executive officer) may be influenced even in the absence of a controlling share ownership.

Second, and on the other hand, a high proportion of state shares does not necessarily mean highly concentrated ownership in a practical sense. A given proportion of state shares would mean a given concentration of ownership only if the state shares were all held by the same body and subject to the same will. In fact, state shares can be held by different bodies formally representing the state but pursuing very different agendas.[49] At the same time, however, effective concentration of ownership in the hands of a single state body could be higher than the statistics show, because as discussed above, the line between state shares and legal person shares is often difficult to draw in terms of the motivations and objectives of the shareholder. A governmental body could exercise influence both through directly held state shares and through legal person shares held by a controlled entity.[50]

Third, the averaging of ownership concentration across companies can create severe distortions, depending upon how it is done. A simple averaging technique will yield an average ownership concentration of 50% from a tiny company that is 90% owned by its largest single shareholder and a huge corporation that is 10% owned by its largest single shareholder. Clearly, this averaging is not very helpful. Weighting by numbers of shares is equally unsatisfactory, because there is no reason why both companies could not, for example, have the same number of shares outstanding (although they would of course have different values). Finally, the most obvious technique, weighting by the value of the company, has some serious problems when applied to China because it is not clear how such value should be measured. A simple market capitalization measure—multiplying the market value of one share by the number of outstanding shares—will certainly yield a number, but the meaningfulness of that number is questionable. As noted earlier, only a small proportion of

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[49]This point is specifically made in Zheng Changde & Chen Zhe, *Sichuan Shangshi Gongsi Zhili Jiegou de Shizheng Fenxi* [*An Empirical Analysis of the Corporate Governance Structure of Sichuan Listed Companies*], XINAN MINZU XUEYUAN XUEBAO: ZHEXUE SHEHUI KEXUE BAN [BULLETIN OF THE XINAN MINORITIES INSTITUTE: PHILOSOPHY AND SOCIAL SCIENCE EDITION], No. 12, 2001, at 176, 180.

[50] Zhang and Sun, for example, speak of shares that are state-owned "in nature" but have been transferred from a state asset management organ to a state-owned group company. *See* Zhang & Sun, *supra* note 29, at 38. Chinese government agencies themselves use inconsistent (but not irrational, given their particular policy missions) definitions of share types. When legal person shares are owned by a state-owned enterprise or other institution owned or controlled by the state, they are called "state-owned legal person shares"; they are counted as state shares by the State Assets Administration Bureau (such term to include its successor organizations) but as legal person shares by the CSRC. *See* Lin, *supra* note 47, at 23.

corporate shares—roughly one third—is tradeable on the public markets, and it is by no means clear that the non-circulating shares should be valued at the same price. Chen and his colleagues suggest that the market value of non-circulating shares is far below that of circulating shares, sometimes by as much as 90%.[51] The true discount may be even steeper, because the price of non-circulating shares should reflect in many cases a control premium; in general, a controlling block of shares simply cannot be purchased on the stock market, and therefore control over a listed company is transferred through the sale of non-circulating shares.

Despite all these issues, the bottom line is that concentrated ownership, and therefore control, by a single state shareholder is quite common in Chinese listed companies. A study of corporate governance conducted in 2002 by the CSRC and the State Economic and Trade Commission (SETC) found that of 1015 controlling shareholders in the 1175 listed companies studied, 77% could be considered state organs (*guojia xingzhi*), while in 390 companies a single state shareholder held over half of the shares.[52] Using a different approach that traced the ultimate ownership of both state shares and legal person shares, a recent study found that 84% of listed companies were ultimately under state control.[53]

4. Relationship Between Ownership Structure and Performance

Some studies of Chinese listed companies have attempted to correlate ownership structure with performance, measured in various ways. In general, performance seems to be positively correlated with concentrated ownership, at least to some point, and negatively correlated with dispersed ownership.[54] ("Concentrated ownership" must be understood here to mean concentrated ownership by state agencies or legal persons because concentrated ownership by individuals is virtually unknown.) The explanation typically offered is that large shareholders reduce the free rider

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[51]*See* Chen Zhiwu et al., Faren Gu Paimai Shizheng Yanjiu [Empirical Research into Auctions of Legal Person Shares] (2000), *at* http://www.fsi.com.cn/fsi900/fsinews902/902011212.pdf.

[52]The study is reported in *Guojia Jing Mao Wei Fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong* [*SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder*], *supra* note 20.

[53]*See* Liu & Sun, *supra* note 21, at 2-3. Legal person shares counted toward state control if the controller of the legal person shareholder was, directly or indirectly, a state institution.

[54]*See, e.g.*, Lü & Wu, *supra* note 31, at 89-90 (reviewing various studies); Chen, *supra* note 41, at 69; Qi et al., *supra* note 24, at 594; Sun Yongxiang & Huang Zuhui, *Shangshi Gongsi de Guquan Jiegou yu Jixiao* [*Shareholding Structure and Performance in Listed Companies*], JINGJI YANJIU [ECON. RESEARCH], No. 12, 1999, at 23-30; Xu & Wang, *supra* note 29, at 86-87.

problem of small, dispersed shareholders and make better monitors of management.[55] The same studies, however, find that performance is negatively related to the proportion of state shares and positively related to the proportion of legal person shares in the total capital stock.[56] Thus, it is not simply any large shareholder that will do. The large shareholder must be an institutional shareholder that is separate enough from the state so as not to be counted as a holder of state shares.

Several theories have been proffered to explain why companies with a high percentage of legal person shares perform better than companies with a high percentage of state shares. Generally, the explanation is that state control causes poor performance—first, because

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[55]The poorer performance may also be the result of institutional deficiencies. Individual dispersed shareholders are more dependent on institutional support such as a well functioning legal system and an active and well informed financial press, whereas large blockholders can rely on their own strength. Djankov and Murrell show that the performance of state-owned enterprises after privatization is worse in those whose owners are less concentrated. *See* Simeon Djankov & Peter Murrell, *Enterprise Restructuring in Transition: A Quantitative Survey*, 11 J. ECON. LITERATURE 739, 741, 759 (2002).

[56]*See, e.g.*, Chen, *supra* note 41, at 68; Qi et al., *supra* note 24, at 604-05; Xu Xiaonian, *Gongsi Zhili Jiegou: Zhongguo de Shijian yu Meiguo de Jingyan* [*The Structure of Corporate Governance: China's Practice and America's Experience*] (Zhongguo Renmin Daxue Chubanshe 2000); Xu & Wang, *supra* note 29, at 88. Lin and Dong have a similar result although they do not label it as such. They note that performance is better when the leading shareholder is a company limited by shares or a limited liability company (two corporate forms under China's Company Law), and find worse performance in companies whose dominant shareholder is a so-called "group company" (*jituan gongsi*) or "general company" (*zong gongsi*). *See* Lin Ling & Dong Hong, *Faren Zhili Jiegou yu Jingying Jixiao: Lai Zi Gao Keji Shangshi Gongsi de Shizheng Fenxi* [*Legal Person Governance Structure and Operational Results: An Empirical Analysis of High Technology Listed Companies*], *in* GUO & WANG, *supra* note 33, at 204-34. The latter two entities are typically not organized under the Company Law, but are instead commercial-sounding names for what are essentially government agencies. Thus, they should be considered state shareholders. Indeed, entities with such names are frequently listed as the holders of shares designated "state shares" (*guojia gu*) in company reports. See, for example, the report for Guangdong Baolihua Industry Co. Ltd. in ZHONGUO SHANGSHI GONGSI JIBEN FENXI [CHINA LISTED COMPANY REPORTS] 282 (Zhongguo Faxue Jishu Chubanshe 1999) (naming Guangdong Baolihua Group Company as holder of 71.8 million state shares (*guojia gu*)) or for Wenergy Co. Ltd. in SHANGSHI GONGSI JIBEN FENXI [CHINA LISTED COMPANY REPORTS] 194 (Zhongguo Faxue Jishu Chubanshe 1999) (naming Anhui Provincial Energy Investment General Company as holder of 468 million state shares).

Interestingly, Lin and Dong report that there is no apparent relationship between performance and the proportion of shares publicly listed. *See* Lin & Dong, *supra*, at 208. This necessarily implies, however, that there is no relationship between performance and the proportion of shares *not* publicly listed: state shares and legal person shares (with some very small exceptions). Therefore, their analysis would suggest that the key variable is not the proportion of state or legal person shares overall, but their proportions relative to each other.

the state is necessarily an ineffective monitor of management,[57] and second, because the state pursues goals other than profit maximization.[58]

The second explanation seems more plausible than the first. It is no secret that one of the very purposes of state ownership of enterprises is to enable the state to use its ownership, and thereby control, to cause the enterprise to engage in activities that a profit-maximizing firm would avoid, such as the sale of essential products at below-market prices, enforcement of state birth control policies among employees, or pursuit of an urban full-employment policy.

It is not clear, on the other hand, why the state must be a more ineffective monitor than a non-state institutional share owner. Certainly, the state official that performs the actual monitoring gets no personal benefit from doing the job well, but the same could be said of a CalPERS employee charged with monitoring the fund's holdings in a particular company.[59] In practice, of course, there are many reasons why the state may do worse. First, the monitoring individuals may well be locally employed and salaried, while the formal ownership of the shares is lodged in a higher level of government. A monitor responsible to local government will not object to corporate policies such as high employment that are beneficial to local government at the expense of the central state shareholder. Second, a monitor working in a government agency may be less able to distinguish good from bad corporate policy than a monitor in a business-oriented institutional shareholder.[60] Third, an individual monitoring on behalf of the state is much less likely to have someone at some point above him in the chain of command making a strong demand for good corporate performance in companies held by the state.

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[57]*See* Zhang & Sun, *supra* note 29, at 37; X.L. Ding, *The Illicit Asset Stripping of Chinese State Firms*, CHINA J., No. 43, 2000, at 1; Yingyi Qian, *Enterprise Reform in China: Agency Problems and Political Control*, 4 ECON. OF TRANSITION 427, 428 (1996).

[58]Qi and his colleagues note that correlation does not equal causation: it may be that the state invests in poorly-performing firms, while non-state institutional shareholders invest in well-managed ones. They test for causality by looking at changes in ownership proportions in a given firm over time, and find that as legal person shareholding increases, so does performance. *See* Qi et al., *supra* note 24, at 607-09.

[59]For a discussion of the incentives facing human money managers employed by institutional investors, see Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 876-83 (1992).

[60]For a fuller discussion, see Qi et al., *supra* note 24, at 594-95. *See also* Pamela Mar & Michael N. Young, *Corporate Governance in Transition Economies: a Case Study of Two Chinese Airlines*, 36 J. OF WORLD BUS. 280, 282 (2001) ("[A]lthough Chinese SOEs [(state-owned enterprises)] have concentrated ownership (i.e., the state) the potential positive effect of such an arrangement is absent because of the dispersal of state representation .... In short, many SOEs are simply monitored inadequately or ineffectively.").

Putting aside the question of the difference between legal person shareholders and state shareholders, it remains to be discussed why concentration of ownership in the hands of legal person shareholders might be positively correlated with performance. As noted above, the usual argument is that concentration of shareholdings gives the shareholder an incentive to monitor management that is absent in a small shareholder, since the benefit of monitoring is too attenuated to be worth the cost.[61] On the other hand, it is also reasonable to be concerned that as a shareholder's influence over the corporation rises, the reduced risk of expropriation of shareholders by management is replaced by the increased risk of expropriation of minority shareholders by majority shareholders. As Shleifer and Vishny note, "[I]n large corporations of most countries, the fundamental agency problem is not the Berle and Means conflict between outside investors and managers, but rather than between outside investors and controlling shareholders who have nearly full control over the managers."[62]

The prospect of dominant shareholders exploiting minority shareholders, rather than that of Berle-and-Means managers enjoying on-the-job consumption at the expense of all shareholders, is certainly the one that seems most worrisome to Chinese commentators (except where the state is the dominant shareholder, where the concern is of ineffective monitoring leading to mismanagement and asset-stripping).

Research on U.S. firms indicates that the relationship between firm performance and ownership concentration is an inverted V: as concentration rises, performance rises at first, but then declines as concentration rises still further.[63] The explanation, according to Shleifer and Vishny, is that "as ownership gets beyond a certain point, the large owners gain nearly

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[61]As will be discussed below, the usual substitutes for shareholder monitoring as a means of disciplining managers—shareholder litigation, the managerial labor market, the input and product market, and the market for corporate control—do not, with the exception of the input and product market, function at all well in China. Indeed, even the Wall Street Rule is hard to apply in the case of legal person shareholders because their shares are so illiquid.

[62]Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. OF FIN. 737 (1997). Others make a similar finding in a detailed study of several East Asian economies: "[T]he salient agency problem in [East Asian] economies is expropriation of outside shareholders by the controlling shareholder." Mara Faccio et al., *Dividends and Expropriation*, 91 AM. ECON. REV. 54, 55 (2001).

[63]*See, e.g.*, John McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595 (1990); Karen Wruck, *Equity Ownership Concentration and Firm Value*, 23 J. FIN. ECON. 3 (1989). *But see* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985) (finding no significant correlation between ownership concentration and profit rates for 511 large corporations).

full control and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders."[64]

This pattern has not been observed in Chinese firms—possibly because virtually all listed firms have at least 30% public shareholding, making it hard to find examples of highly concentrated ownership, and possibly because the studies simply have not yet been done. If anything, the opposite pattern has been observed. One study found that performance, as measured by the ratio of market value to book value, followed a U-shaped curve as ownership concentration by legal person shareholders increased. The study's authors hypothesized that individual investors at first feared expropriation by such shareholders—that they would use their influence to expropriate—but believed that as their stake rose, the interests of the legal person shareholders would become more congruent with theirs.[65] In other words, a controlling shareholder's ability to expropriate would remain constant whether it owned 51% or 91%, but its incentive to do so would decline as its financial interest in the corporation increased. Another study found that performance peaked when the largest shareholder held 30% to 50% of the stock, and was worst when no shareholder held more than 30%.[66]

Until further research is done, probably the most that can be safely said is that concentrated ownership by non-state shareholders is probably by and large a good thing that should not be discouraged by the law—there is some evidence that it is valued by the market[67]—and that public shareholders are probably capable of taking the possibility of dominant-shareholder expropriation into account.

B. *Corporate Governance in General*

The concept of corporate governance is extremely broad, and a number of definitions of varying degrees of complexity and scope are possible. Perhaps the simplest definition—in words, if not in scope—is found in the report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Report), which defines corporate governance as

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[64]Shleifer & Vishny, *supra* note 62, at 759.

[65]*See* Xu & Wang, *supra* note 29, at 91.

[66]*See* Lin & Dong, *supra* note 56, at 205.

[67]*See* Qi et al., *supra* note 24, at 609; Xu & Wang, *supra* note 29, at 95. A problem with both of these studies is that they appear to assume that a given proportion of legal person shareholding is more concentrated than the same proportion of individual shareholding. This is probably true as an empirical matter, but it is not a necessary characteristic of legal person ownership.

"the system by which companies are directed and controlled."[68] Margaret Blair supplies a very broad definition, calling it "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated."[69]

A slightly narrower definition is used by institutional economists such as Oliver Williamson, who in his chapter on corporate governance sets out to examine the relationship between the firm and each of what he calls its constituencies: labor, capital (equity and debt), suppliers, customers, the community, and management.[70] This conception of corporate governance essentially attempts to cover everyone who participates in some way in the process by which a firm's product is produced and sold. It sees these parties (with the exception of "the community") as engaging in voluntary interactions with the firm, and the question it poses is: What are the terms on which they interact, and why do those terms look the way they do? "Governance," in the work of Williamson and others writing in a similar vein, refers to the institutional structure parties set up to deal with the inevitable incompleteness of their contracting, and attempts to explain voluntary relationships in those terms.

Finally, the narrowest definition—and the one adopted in this article—centers around the relationship between stockholders, the board of directors, and senior management,[71] and deals with "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[72]

One of the key tensions within any system of corporate governance is the necessary tradeoff between authority and accountability. On the one hand, managers must be allowed a certain amount of leeway to make decisions and even to make mistakes; this is why they are hired to manage in the first place. Protection for minority shareholders cannot go too far because they may use their power to block the majority from undertaking reasonable and justified measures unless they are paid off. Unlimited

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[68]FINANCIAL REPORTING COUNCIL, LONDON STOCK EXCHANGE, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE ¶ 2.5 (Gee & Co., Ltd. 1992), *available at* http://www.ecgi.org/codes/code.php?code_id=132 [hereinafter CADBURY REPORT].

[69]MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 3 (The Brookings Inst. 1996).

[70]*See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 298 (The Free Press 1985).

[71]*See* Mark J. Roe, *Path Dependence, Political Options, and Governance Systems*, *in* COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS 165, 168 (Klaus J. Hopt & Eddy Wymeersch eds., Walter de Gruyter 1997).

[72]Shleifer & Vishny, *supra* note 62, at 737.

protection for minority shareholders simply erases the distinction between small stakes and large stakes, and subjects all corporate decisionmaking to second-guessing by the body—perhaps a court—charged by the law with providing the protection.

On the other hand, it is equally clear that managers cannot be left wholly unaccountable. If they were, they would have no incentive to maximize anyone's interests but their own, and others would therefore have no incentive to commit resources to their management, leading to the collapse of the enterprise. Dooley sums up the paradox by positing two models of corporate governance: the Authority Model, which is concerned with giving directors and officers sufficient power to manage the corporation, given that the shareholders cannot and do not expect to do so, and the Responsibility Model, which is concerned with ensuring the accountability of directors and officers to shareholders and perhaps others.[73] As he points out, "[N]either Model exists in pristine form in the real world."[74] Elements of both are needed in a functioning regime of corporate governance.[75] But as he also points out, "Authority and Responsibility are both essential values because each responds to one of the two principal kinds of costs incurred in operating as a firm. Unfortunately, these values are also antithetical, and more of one means less of the other."[76]

C. *Corporate Governance in China*

Any one of the definitions of "corporate governance" canvassed above could be serviceable depending on its intended purpose. For the purposes of this article, however, I will define corporate governance as the set of rules and practices regulating relationships among participants in a post-traditional Chinese business enterprise and governing decisionmaking within that enterprise. By "post-traditional" enterprise I mean any enterprise that is no longer bound tightly within the traditional state planning system and operated by its administrative superior agency essentially as a division within a larger enterprise.[77] It is an enterprise in

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[73]*See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 (1992).

[74]*Id.*

[75]*See id.* at 463-64.

[76]*Id.* at 464.

[77]Most such enterprises are governed by China's Law on Industrial Enterprises Owned by the Whole People (Quanmin Suoyouzhi Gongye Qiye Fa), adopted Dec. 2, 1986 [hereinafter the *State-Owned Enterprise Law*].

which voluntary, contractual relationships are important and top-down commands from government are less important.

This definition makes clear my understanding that current discussions in China do not focus on the state-owned enterprise in its traditional form. Instead, these discussions take for granted that this form is on the way out.[78] They do deal with state ownership of industrial and commercial enterprises, but in the capacity of a stockholder or equity owner of a company organized under the Company Law, not in the capacity of controller of a traditional state-owned enterprise governed (at least formally) by the State-Owned Enterprise Law.

Corporate governance in the post-traditional enterprise has caught the attention of policymakers and academics for a good reason. At the macroeconomic level, the focus of state economic reform policy has been to move from a system of regulation by direct command to a system of regulation by government adjustment of market signals. By the same token, the focus of reform policy at the microeconomic level has been to move from a system of governance of firms through direct administrative commands to a system of governance that works by establishing institutions that operate in relation to each other to produce the desired result. Thus, for example, the state ideally seeks to make enterprises more efficient no longer by ordering state-owned enterprise managers to reach certain profit targets, but by putting the power to select managers in the hands of directors who represent profit-oriented shareholders.[79]

At least in form, state-owned enterprise reform has seen significant progress. Over 80% of small and medium state-owned enterprises have been transformed from a traditionally structured enterprise into a corporate entity under the Company Law or some other organizational law or regulation, and over 1200 large enterprises have restructured themselves

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[78]This does not mean that state ownership of enterprises is on the way out. The government has explicitly declared its firm commitment to retaining control over enterprises in several sectors: national security-related industries, natural monopolies, sectors providing important goods and services to the public, and important enterprises in pillar industries and the high-technology sector. *See Heli Buju Tiaozheng Jiegou, Fazhan Zhuangda Guoyou Jingji—Fang Guowuyuan Guoyou Zichan Jiandu Guanli Weiyuanhui Zhuren Li Rongrong* [*Rationally Lay out Structural Adjustment, Develop a Great State-Owned Economy: A Visit with the Chairman of the State Council's State Asset Supervision and Management Commission, Li Rongrong*], JINGJI RIBAO [ECON. DAILY], Internet ed., June 13, 2003.

[79]On the policies behind reform in the state-owned enterprise sector, see generally Clarke, *supra* note 18.

into joint stock companies and raised funds through a public issue of shares and subsequent listing on one of China's two stock exchanges.[80]

The operation of the board of directors of such companies presents complex problems. Chinese discussions of the board typically focus on two areas of concern. It is important to understand the distinction between them in order to assess the potential effectiveness of independent directors in addressing them.

One prominent complaint about the current regime governing the powers and responsibilities of enterprise managers is that there is too much "insider control" (*neibu ren kongzhi*).[81] Because control of the firm must rest with some person or persons, and those persons are virtually insiders by definition, it is necessary to unpack this complaint a little. What is usually meant is insider control unfettered by effective accountability mechanisms, with the result that assets belonging to the corporation are converted through various subterfuges into the personal property of management. This asset-stripping, a familiar phenomenon in transition economies, is made possible by the devolution of considerable managerial authority to the enterprise level coupled with the legalization of new forms of trade and new privately-controlled entities to which the stripped assets can, by means of controlled transactions, be transferred. The complexity of property relations and ownership forms has outstripped the state's capacity to monitor, which remains designed for the simple structures of an earlier day, when private ownership of significant property was not allowed, and transfers between enterprises were physical and not financial.[82] The result is the phenomenon of the "absent owner" (*suoyouzhe quewei*): it is not collective action problems that prevent effective shareholder monitoring, since there is a large and possibly sole shareholder, but rather organizational problems internal to that shareholder.[83]

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[80]*See* STOYAN TENEV & CHUNLIN ZHANG, CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS, at xi (World Bank and the International Finance Corporation 2002).

[81]*See, e.g.*, Liu Yunpeng, *Cong Xiandai Qiye Lilun yu Chanquan Lilun Kan Zhongguo de Gongsi Zhili Wenti* [*Looking at Chinese Corporate Governance Issues from the Standpoint of the Theory of the Modern Firm and the Theory of Property Rights*], *in* ZHONGGUO GONGSI ZHILI JIEGOU [THE STRUCTURE OF CORPORATE GOVERNANCE IN CHINA] 119, 129 (China (Hainan) Reform and Development Institute ed., Waiwen Chubanshe 1999); Xu Meizheng, *Qiye Chongzu yu Gongsi Zhili Jiegou* [*Enterprise Reorganization and Corporate Governance Structure*], *in id.* at 83, 83.

[82]*See* Ding, *supra* note 57.

[83]The same phenomenon has been noted among institutional investors in Western countries, who are often criticized for being unduly passive even when "they have strong reservations about strategy, personnel, or other potential causes of underperformance." DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS ¶ 15.22 (The Stationery Office 2003), *available at* http://www.dti.gov.uk/cld/non_exec_review.

If management commits waste and fraud at the expense of shareholders, this is obviously of direct concern to the state because of its large stake in the enterprises being looted. But it is also a government concern where the state is not a significant shareholder because in addition to damaging individual (and institutional) shareholders, mismanagement and asset-stripping will, by discouraging investment in corporations, raise the cost of capital in the economy generally and hinder growth.

A second complaint is that management may respond all too well to a board under the control of a dominant shareholder (*yigu duda*), which will use its power to exploit minority shareholders through such devices as manipulating prices in transactions with controlled entities.[84] Indeed, when corporate governance failings are specifically studied, they typically relate to abuse by the dominant shareholder of its position, not to the depredations of management at the expense of shareholders as a whole.[85] For example, a 2002 study of corporate governance by the CSRC and the SETC revealed, on the basis of self-reporting alone, that 40% of listed companies engaged in related-party transactions with their top ten shareholders.[86] A related-party transaction is not, of course, necessarily a transaction on unfair terms to the company, but given the lack of institutional safeguards that might ensure fair terms, there are legitimate grounds for concern. The CSRC/SETC study further found that 676 listed companies had had their funds misused by their parent company (the controlling shareholder) in the amount of almost US$12 billion.[87]

The concern of the government in this case is once again that the public may lose faith in corporate stock as an investment, raising the cost

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[84]*See, e.g.*, Gu Gongyun, *Gongsi Fa Xiugai Ying Jiejue de Ruogan Shiji Wenti* [*Several Practical Problems that Should Be Solved in a Revision of the Company Law*], *in* GUO & WANG, *supra* note 33, at 57, 60.

[85]At least one article laments at the same time the overconcentration of stock in the hands of large shareholders and the inability of shareholders to monitor management because of the dispersion of voting power brought about by the many varieties of share types. *See* Zheng & Chen, *supra* note 49, at 180.

[86]*See Guojia Jing Mao Wei Fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong* [*SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder*], *supra* note 20. Other empirical studies of related-party transactions include Meng Hui et al., *Shangshi Gongsi Guanlian Jiaoyi Xingwei Jianguan de Shizheng Yanjiu* [*An Empirical Study of the Monitoring of Related-Party Transactions in Listed Companies*], JINGJI YU GUANLI YANJIU [ECONOMICS AND MANAGEMENT RESEARCH], No. 1, 2004, at 61, and Wang Ruiying et al., *Woguo Shangshi Gongsi Guanlian Jiaoyi de Shizheng Yanjiu* [*An Empirical Study of Related-Party Transactions in Listed Companies*], CAIMAO JINGJI [FINANCE & TRADE ECONOMICS], No. 12, 2003, at 29.

[87]*See Guojia Jing Mao Wei fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong* [*SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder*], *supra* note 20.

of capital throughout the economy.[88] Thus, policymakers are concerned with the consequences of both underconcentration and overconcentration of share ownership.

The picture is further complicated by the fact that although the state has an interest in preventing dominant shareholder exploitation of minority shareholders when it is a passive shareholder, it may itself be guilty of such exploitation when it is the dominant shareholder.[89] Indeed, the entire project of retaining majority state ownership, and therefore control, in

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[88]The view of the government and most Chinese commentators—that public confidence in corporate governance procedures and the honest functioning of the securities markets is essential to the ability of firms to raise money from public investors, and therefore essential to the economy as a whole—is shared by most foreign commentators, but appears to rest more on intuition and common sense than on solid evidence. First, considerable funds have in fact been raised from public investors—US$86 billion by the end of 2002, *see* Li Qing, *Chu Du Shang Fulin* [*A Preliminary Reading of Shang Fulin*], CAIJING [FIN. & ECON,], Nos. 3-4, 2003, at 36, 36, and US$141 billion by the end of January 2005, *see* China Securities Regulatory Commission, *Tongji Xinxi* [*Statistical Information*], *Biao 2-2: Zhengquan Shichang Chouzi Tongji Biao* [*Table 2-2: Table of Capital Raising in the Securities Market*], *available at* http://www.crsc.gov.cn—even in the probable absence of substantial public confidence in corporate governance procedures. Of course, perhaps this amount would have been much higher had the public had more confidence, but the relatively high price-to-earnings ratio prevailing on the Chinese stock market (on average ranging from 40 to 50, *see* WALTER & HOWIE, *supra* note 22, at 136, considerably higher than the low-20s average prevailing on the New York Stock Exchange) suggests that public investment is being limited by supply, not by demand. Second, it is not clear that well-functioning securities markets really are, at least at present, essential to the economy as a whole. In 2001, for example, enterprises raised US$14 billion from share issues, but borrowed more than ten times that amount—US$157 billion—from banks. Figures from 2002 suggest that the stock market is actually in decline as a source of capital: IPOs and share rights issues raised only US$8.9 billion from January to September 2002, down 30% from the same period in the previous year, while bank financing rose 55% (well above the rate of growth) to $170 billion (over the same period). Overall, the stock market provided about 5% of official corporate financing. *See* GREEN, *supra* note 20. Listed companies themselves are of significant but not overwhelming importance in the economy, accounting for 8% of GDP and 17% of enterprise income tax receipts in 2001. *See Zhongguo Shangshi Gongsi de Zonghe Jixiao Zhengzai Fashengzhe Zhi de Bianhua* [*Overall Results of Chinese Listed Companies Undergoing Qualitative Change*], ZHONGGUO ZHENGQUAN BAO [CHINA SEC. NEWS], Nov. 1, 2002.

For an argument that weak corporate governance, insofar as it saps the confidence of investors in their ability to forestall managerial expropriation, can exacerbate financial crises, see Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141, 142 (2000).

[89]Mar and Young, for example, report that China Southern Airlines and China Eastern Airlines, both of which are publicly listed but in which the dominant shareholder is a state agency, can be forced to purchase aircraft they may not want from the state: "[W]hen [the Civil Aviation Authority of China] buys too much [aircraft], they have to put them somewhere." Mar & Young, *supra* note 60, at 297 (quoting a Hong Kong industry analyst). The potential for a conflict of interest is explicitly recognized by one commentator, who proposes that dominant state shareholders voluntarily refrain from policies that hurt minority shareholders so as not to discourage investment in the securities markets. *See* Jiang Qiangui, *Gongsi Zhili yu Guoyou Qiye Gaige*, ZHONGGUO ZHENGQUAN BAO [CHINA SEC. NEWS], Internet ed., June 12, 2001. See, however, the remarks of Xiang Bing *infra* at text accompanying note 167.

particular firms or sectors has as its purpose the use of that control to achieve objectives other than profit maximization—for example, full employment or strategic control of a particular industry that for some reason cannot be achieved through regulation.[90] The ideological justification for retaining state majority ownership cannot lie in simple profit maximization for the state, since there is no *a priori* way of knowing whether profits would be maximized by keeping the state's holdings in a particular firm or by selling them, and indeed firms without dominant state ownership have been shown in several studies[91] to outperform firms with dominant state ownership. Thus, as long as state policy requires the state to stay as an active investor in firms of which it is not the sole shareholder, meaningful legal protection for minority shareholders is going to mean either constraints on the state's ability to do precisely those things for which it retained majority ownership, or else a *de facto* separate legal regime for enterprises in which the state is the dominant shareholder.

III. INDEPENDENT DIRECTORS AS A SOLUTION TO CORPORATE GOVERNANCE PROBLEMS

One institution of corporate governance that has recently come to prominence as a potential solution to many of the problems of Chinese corporate governance is the independent director. Like many legal borrowings, the independent director is viewed by different parties as a solution to different specific concerns. Those problems may or may not be related to the problems that led to the development of a concept of independent director in the jurisdiction from which the borrowing takes place.

A. *Functions of the Non-Management Director*

To understand more fully the functions and potential of the independent director in China, it is useful to canvass other conceptions of the independent director. To do so, we must first seek a more general term, for not all jurisdictions place a great deal of importance on directors who

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[90]The notion that state control will be maintained in particular sectors with the specific intent of "influencing and guiding" the use of social capital—i.e., causing it to be used in ways that serve the state's interests, which are not necessarily those of small investors—was expressed in an interview by Jiang Qiangui, vice chairman of the SETC. *See Guojia Jing Mao Wei Fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong* [*SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder*], *supra* note 20.

[91]*See, e.g.*, Chen, *supra* note 41; Qi et al., *supra* note 24; Xu & Wang, *supra* note 29.

might plausibly be called "independent." Different jurisdictions and corporate governance norms speak variously of directors who are "non-interested,"[92] "independent,"[93] "outside,"[94] "non-executive,"[95] "non-employee,"[96] and "disinterested."[97] Each of these terms is defined differently and implies a different role for the director it describes, yet they are frequently discussed together as if they were all describing the same thing, and conclusions about directors of one type are applied to directors of another.[98]

The generic term I shall use here is "non-management" director (NMD), because it captures the one element all of the above terms have in common: the director in question is not a member of the current senior

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[92]*See* Investment Company Act (ICA) (codified in relevant part at 15 U.S.C. § 80a-2(a)(19) (2000)).

[93]*See* Securities Exchange Act of 1934 (SEA) § 10A (codified at 15 U.S.C. § 78f(m)(3)(B) (2000)). The provision in question comes from Section 301 of the Sarbanes-Oxley Act of 2002 (SOA). Sarbanes-Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78f (2002)).

[94]*See* SHŌHŌ [COMMERCIAL CODE OF JAPAN], art. 188(2)(7.2) (2002) (using the term *shagai torishimariyaku*—literally, "director from outside the company").

[95]*See* CADBURY REPORT, *supra* note 68, at 22.

[96]See Rule 16b-3 under the Securities Exchange Act promulgated by the Securities and Exchange Commission (SEC). 17 C.F.R. § 240.16b-3(b)(3)(i) (2005).

[97]*See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2001); MODEL BUS. CORP. ACT § 8.31 (2005).

[98]Miwa and Ramseyer, for example, use data on *outside* directors in Japan to refute what they take to be the conventional wisdom about the role of *independent* directors. For statistical convenience, however, they follow what they say is the Japanese custom of defining as an "outsider" anyone who has a past or concurrent career outside the firm. This would include, for example, partners at law firms whose major client was the firm in question, who would not qualify under most definitions of "independent." Indeed, they explicitly note that the vast majority of outside directors take such directorships as full-time jobs with the firm on whose board they sit. *See* Yoshiro Miwa & J. Mark Ramseyer, *Who Appoints Them, What Do They Do? Evidence on Outside Directors from Japan* 11-14 (Harvard Univ., John M. Olin Center for Law, Economics and Business, Discussion Paper No. 374, 2002), *available at* http://papers.ssrn.com/abstract_id=326460. The conventional wisdom about independent directors may indeed be wrong, but no conclusion derived from a study of this kind of outside director can rigorously demonstrate it. The definition of "outside director" (*shagai torishimariyaku*) in Japanese law is somewhat stricter than the Miwa-Ramseyer definition (*see infra* text accompanying note 134), and the distinction between outside directors and independent directors is well understood. *See Shagai Torishimariyaku to Dokuritsu Torishimariyaku* [*The Outside Director and the Independent Director*], YASASHII KEIZAI YŌGO NO KAISETSU [EASY EXPLANATIONS OF ECONOMIC TERMS], *at* http://www.nikkei4946.com/today/0305/11.html (Japan Economic News website).

Two prominent Delaware judges, Chancellor William Chandler and Vice Chancellor Leo Strine of the Delaware Court of Chancery, specifically warn against the danger in adjudication of confusing independence (or the lack of it) with disinterestedness (or the lack of it). *See* WILLIAM B. CHANDLER III & LEO E. STRINE, JR., THE NEW FEDERALISM OF THE AMERICAN CORPORATE GOVERNANCE SYSTEM: PRELIMINARY REFLECTIONS OF TWO RESIDENTS OF ONE SMALL STATE 62 (New York University Center for Law and Business, Working Paper No. CLB 03-01, 2003), *available at* http://papers.ssrn.com/abstract=367720.

management team.[99] This negative feature is, however, consistent with several different positive features, some of which are mutually inconsistent, and each of which contemplates a different conception of the role of the non-management director.

Before canvassing these conceptions, however, it will be useful to set forth some general ideas about the possible functions of NMDs in a corporate governance system. The particular conceptions of different jurisdictions can then be analysed in terms of which function or functions they seem to value, and whether those functions are in fact likely to be fulfilled.

The role of NMD can be analyzed according to whether the NMD is perceived as a substitute for external regulation or as an implementer of it. In American corporate law, for example, the NMD primarily functions as a substitute for external regulation. Courts and legislatures are wary of becoming too involved with the business decisions of corporate management. Thus, even the apparently fundamental and unobjectionable idea that transactions between a corporation and a director should be on terms that are fair to the corporation is not imposed on corporations as a substantive rule of law in Delaware or in the Model Business Corporation Act (MBCA) if the corporation's board has disinterested directors and a majority of them have, after full disclosure, approved the transaction.[100]

One could also imagine NMDs as implementers of external regulation. In such a case, the relevant standard of behavior would be set externally, not by the NMDs themselves, and they would be expected to help implement those standards. This could be done in a number of ways: through exercising their voting power on the board to induce the company to act in compliance with the standards, through using their access to information to alert the authorities to non-compliance, or through using their access to information to certify compliance.

Each of these methods, however, poses difficulties. If one is to rely on NMDs to exercise their voting power in favor of compliance with external standards, then there needs to be some reason for believing that NMDs will be more likely to do so than non-NMDs. Both kinds of directors can be subject to sanctions for voting to violate clear legal obligations. If the purpose is to encourage corporations to act in accordance with principles that do not constitute legal obligations (for example, "maximize local employment"), then it is unlikely that NMDs

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[99]This is, of course, what is usually meant by "non-executive" director. On the other hand, some people say "non-executive" when they really mean "independent" or "outside." I am deliberately creating a new term here so that what I mean by it can be kept clear.

[100]*See infra* discussion at text accompanying notes 143-46.

elected by, and owing fiduciary duties to, profit-maximizing shareholders will produce this result. An entirely different constituency would have to be given the power to elect NMDs.

If the state relies on NMDs to use their access to information to alert it to corporate non-compliance with legal standards, then once again we face the problem of selecting directors who will internalize this duty. Moreover, directors whose job it is to inform on the company will find their access to information considerably decreased. Again, it is perfectly conceivable to have a rule that requires directors and others with knowledge of certain types of violations to report them to the authorities,[101] but there does not seem to be any reason to distinguish NMDs from non-NMDs in this respect.

Finally, it is possible to use NMDs to certify that certain standards have been complied with—for example, that the annual report is accurate, or that the balance sheets have been prepared in accordance with proper accounting standards. In the United States, this job is generally left to independent professionals, and their duty of care is enforced, among other ways, by allowing persons to rely on the certification and to sue if that reliance results in damages. There is no particular reason why NMDs could not perform this function, but there is no particular reason why they should. If NMDs are required to back up their certification with their personal wealth, few may be willing to take on the job. If they are not, then they have little incentive to be responsible. A separate firm that specializes in the information in question—an accounting firm or a law firm, for example—can get access to the same information if the company is willing to grant it (and it would have to do so), and can better bear the risk of the occasional error leading to liability. Moreover, certification of information by a large organization with a reputation to consider is more likely to be reassuring to users of that information than certification by an unknown person of unknown resources.

B. *Conceptions of the Non-Management Director*

Differing conceptions of the NMD's role are not usually mere abstract ideas. Different conceptions imply different structures within which such directors are to fulfill their contemplated role. The following discussion will not, therefore, simply canvass different definitions of the

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[101]See, for example, 12 C.F.R. § 208.62 (2005), which requires U.S. banks to file reports of suspected criminal activity with the Federal Reserve Bank and subjects directors and officers, among others, to disciplinary action if the bank fails to do so.

NMD.[102] It will also bring out how those different definitions relate to the different functions of the director. By understanding the broad range of possible roles for non-management directors, we can understand more fully the actual institution of the independent director in China.

1. The "Independent" Director

A major theme in corporate governance writing is the need for non-management directors on the board to serve as a check on management in the interests of shareholders. In other words, non-management directors are there to help shareholders solve the agency problem. If such directors are to monitor management effectively, they must be independent of management. From this contemplated role stems the typical definition of independent director: one who has no need or inclination to stay in the good graces of management, and who will be able to speak out, inside and outside the boardroom, in the face of management misdeeds in order to protect the interests of shareholders.

A competing conception of the director who is independent of management holds that the director's duty is to protect the interests of a number of different groups, not just shareholders, and indeed sometimes to act against the interests of shareholders in order to protect, for example, employees.[103] The latter view of the role of the independent director—one who is independent of profit-seeking shareholders as well as independent of management—has not, however, found fertile soil in American corporate law scholarship or practice. The dominant view has been that directors

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[102]For a convenient table showing different conceptions of what I call the NMD, see CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CALPERS), CORPORATE GOVERNANCE CORE PRINCIPLES AND GUIDELINES: THE UNITED STATES, app. B-2 ("Variations on a Theme—'Independent Director'") (1998), *available at* http://www.calpers-governance.org/principles/domestic/us/page01.asp.

[103]For a discussion of these competing concepts, see Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 602 (1982). The "shareholder versus stakeholder" debate has been going on for over seventy years. *See* Adolph A. Berle, *Corporate Powers as Powers in Trust*, 45 HARV. L. REV. 1049, 1049 (1932) (arguing that directors should serve shareholder interests) *and* E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (1932) (arguing directors should serve other groups including employees, managers, and society in general). For recent contributions, see William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 276-77 (1992) (discussing for whose benefit directors hold power); William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1067 (2002) (discussing the debate); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003) (arguing for director primacy); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253-54 (1999) (arguing that directors should take non-shareholder interests into account).

who are responsible to many constituencies are in effect responsible to none, and that while many of those who deal with the firm, such as customers, workers, and suppliers, can protect themselves through contract and the threat of terminating their association with the firm, the shareholders are uniquely unable to do so because their investment is sunk and cannot be withdrawn.[104]

Both conceptions share the idea that the directors expected to perform their designated function cannot do so unless they are systematically independent of management. This idea is familiar to corporate law practitioners and scholars in the United States, but interestingly, its reach is limited almost exclusively to federal law as applied to corporations whose stock is listed on a national exchange.[105] Section 301 of the SOA requires that all members of a listed company's audit committee be independent directors,[106] and states:

> In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a

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[104]*See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 56 (Harvard Univ. Press 1996); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001). Gilson and Kraakman go beyond emphasizing the independence of the non-management director in order to stress the desirability of her *lack of independence* from shareholders: "[W]hile most recent efforts addressing the governance role of the board have urged increasing the independence of outside directors from management, we advocate increasing the dependence of outside directors on shareholders. In our view, corporate boards need directors who are not merely independent, but who are *accountable* as well." Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865 (1991). A recent World Bank publication makes the same point, *see* TENEV & ZHANG, *supra* note 80, as does (rarely among Chinese commentary) He Yiping & Yu Yin, *Zhongguo Tuixing Waibu Dongshi Jizhi Zhiyi* [*Doubts About China's Promotion of the Outside Director Mechanism*], ZHEJIANG SHENG ZHENG-FA GUANLI GANBU XUEYUAN XUEBAO [BULLETIN OF THE ZHEJIANG PROVINCE POLITICAL-LEGAL ADMINISTRATIVE CADRES ACADEMY], No. 5, 2001, at 25, 29. The Higgs Report points up the need for such accountability: a majority (52%) of the non-executive directors surveyed *never* discussed company business with investors, and only one in five non-executive directors in FTSE 100 companies did so at least once a year. *See* HIGGS, *supra* note 83, ¶ 15.5. This seems to be taking independence a bit too far.

[105]I deal below with state corporate law and its different concept of "disinterested director." The Investment Company Act, a federal statute, also contains what is essentially a requirement for independent directors in investment companies, whether or not they happen to be listed. The relevant section is discussed briefly below. Finally, note that because this is an article about comparative corporate law and is not intended to be an exhaustive discussion of post-SOA reforms in American corporate governance, I discuss such reforms in general terms only and do not note the numerous exceptions and qualifications to the general rules set forth here.

[106]Strictly speaking, the SOA requires that the SEC adopt rules requiring national securities exchanges and national securities associations to prohibit the listing of the securities of any issuer that does not comply with the standards for independence of audit committee members set forth in Section 301.

member of the audit committee, the board of directors, or any other board committee—

(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii) be an affiliated person of the issuer or any subsidiary thereof.[107]

Stock exchange rules must also, of course, be considered. For the sake of brevity I will look only at the NYSE's rules.[108] The NYSE's former (that is, prior to SOA-associated reforms) and current rules on independent directors make an informative contrast. Under the former rules, independent directors were required only for audit committees, and were those who had "no relationship to the company that may interfere with the exercise of their independence from management and the company."[109] Certain per se disqualifications[110] could be waived by a board determination that the director's exercise of independent judgment would not be affected.

These rules were more flexible than those of the SOA. It was not so critical to maintain a strict distribution between independent and non-independent, possibly because independent directors were not required to play so important a role. For example, the audit committee had to be composed entirely of independent directors, but it did *not* need to have the exclusive authority to hire, monitor, or terminate the outside directors.

In response to the requirements of the SOA, the NYSE adopted rules that mirror the SOA's independence requirements for audit committee members, but that retain some flexibility with respect to other independent directors.[111]

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[107]Sarbanes-Oxley Act of 2002 § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(B) (2005)).

[108]For pre-SOA Nasdaq rules on independent directors, see NASDAQ, NASDAQ MARKETPLACE RULES § 4200(a)(15) (2002). For the post-SOA rules, see Securities Exchange Act Release No. 34-47516, 68 FED. REG. 14451, 14451-56 (Mar. 25, 2003).

[109]NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303.01(B)(2)(a) (1999).

[110]Specifically, independence was foreclosed if the director (1) had been employed by the issuer or its affiliates in the past three years, (2) was an immediate family member of a person employed as an executive officer of the issuer or its affiliates in the last three years, (3) was employed as an executive of another company where any of the issuer's executives sat on the compensation committee, (4) had a direct business relationship with, or was a partner, shareholder, or executive officer of an organization that had a direct business relationship with, the issuer, unless the issuer's board made an affirmative determination that the relationship would not interfere with the director's exercise of independent judgment. *See id.* § 303.01(B)(3)(b)-(d).

[111]*See* LISTED COMPANY MANUAL, *supra* note 3, § 303A.00.

Unlike the SOA, the NYSE rules (except where they mirror SOA requirements) do not contemplate specific mandatory powers for independent directors. Their duties may be limited simply to making recommendations to the board as a whole. Independent directors must, however, constitute a majority of the board as a whole.[112] The theory behind the NYSE rules seems to be that corporate decisionmaking will be improved if a majority of the board can be structured so that a particular motivation, that of pleasing management, is *absent*. The rules do not attempt to ensure that a particular motivation is *present*.

While "independence" has generally proven fairly easy to conceptualize, if more difficult to define in precise legislative language, one area in which substantial disagreement exists even in principle is that of the significance to be given to stock ownership by the putatively independent director. Those who see the independent director primarily as a defender of shareholder interests against management will naturally see more share ownership as better, because it will more closely align the interests of the director with the shareholders as against management.[113] Those who view the independent director as someone whose judgment should be untainted by any financial interest in the company are suspicious of share ownership.[114]

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[112]The requirement for independent directors is subject to an exception for controlled companies, except with respect to the audit committee. *See* LISTED COMPANY MANUAL, *supra* note 3, § 303A.00. Controlled companies are those in which more than 50% of the voting power is controlled by a single individual, group, or company.

[113]In general, ownership of stock by directors, and by independent directors in particular, appears to be positively correlated with company performance. *See* Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885, 885 (May 1999); Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229 (2005); and the review of several studies in R. Franklin Balotti et al., *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution*, 55 BUS. LAW. 661, 672 (2000). For a contrary view, see Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance 8 (Dec. 7, 2004), *at* http://ssrn.com/ abstract=586423 (finding "no evidence that operating performance or firm valuation is positively related either to stock option expensing or to directors receiving some or all of their fees in stock").

[114]As will be discussed below, Chinese legislation and academic commentary generally adopts the suspicious approach and disfavors stock ownership by independent directors. *See, e.g.*, *Independent Director Opinion*, *supra* note 11, § 1(1) (forbidding any relationship with a large shareholder that would impair independence); *id.* § 3(2) (denying independent status to holder of 1% of company's shares or one of top ten shareholders or relative of the latter); People's Bank of China, *Guanyu Gufenzhi Shangye Yinhang Duli Dongshi he Waibu Jianshi Zhidu Zhiyin* [*Guidelines on the System of Independent Directors and Outside Supervisors for Commercial Banks Under the Shareholding System*], issued and effective June 4, 2002 [hereinafter *Commercial Bank Independent Director Guidelines*], art. 2 (denying independent status to holder of 1% of company's shares or employee of shareholder); Ma, *supra* note 12, at 62; Yan & Chen, *supra* note 12, at 26.

It is not altogether clear which view Congress took in the SOA. As we have seen, Section 301 of the SOA amends Section 10A of the Securities Exchange Act (SEA) by providing that an independent director on the audit committee may not be an "affiliated person" of the company.[115] The SEA, for its part, states that "affiliated person" in the SEA shall have the meaning given to it by the Investment Company Act (ICA).[116] Finally, the ICA defines "affiliated person" in part as anyone owning 5% or more of the securities of the company. Thus, Congress—assuming it was aware of this definitional chain—could be seen as viewing substantial ownership of securities as undesirable in independent directors.

The SEC, however, while retaining the ICA stock ownership threshold for independent directors of investment companies, has been much friendlier to shareholding by independent directors in other circumstances, and has created an explicit safe harbor for shareholding under 10%. Moreover, it has stated that shareholding of 10% or more will not automatically be construed to constitute an "affiliation" sufficient to prevent a director from being found "independent."

Some commentators appear to take both positions at once. Derek Higgs, in his recent report on non-executive directors commissioned by the British Department of Trade and Industry, agrees in Para. 12.26 that "shares could be helpful in aligning the interests of the director with the long-term interests of shareholders," but opposes in Para. 12.27 the holding of options by directors "because of the risk of undesirable focus on share price rather than underlying company performance." HIGGS, *supra* note 83, ¶¶ 12.26-12.27. It is not clear why directors who own shares will be less focused on share price than directors who own options, or why shareholders would not want a director to be focused on share price. The notion of a generally knowable distinction between long-term share price and short-term share price is illusory, because the share price at any given time reflects the market's best guess as to the discounted present value of all income (not just income over the short term) that can be earned by the share, whether through dividends or ultimate sale, and thus incorporates all long-term share prices to the extent they can be estimated. A director privy to inside information might well have reason to believe that the current share price does not reflect the valuation the market would place on the stock were the information public, but any undesirable incentives created by this information asymmetry do not depend on whether the director holds stock or options. In any case, while recognizing the beneficial effect of share ownership by directors, the Higgs Report views *significant* share ownership as disqualifying a director from being considered independent. *See id.* at 37.

Two Chinese commentators take the opposite position from Higgs: independent directors should not be allowed to own stock, but *should* be allowed to have stock options. For reasons that are not clear, the authors believe that the independent directors' stock-based incentive structure should not match that of management, and so add the proviso that the stock options should operate differently from those held by management. *See* Yan & Chen, *supra* note 12, at 28. Other commentators oppose stock options as well. *See* Zhao Yu, *Wanshan Duli Dongshi Zhidu Dde Ruogan Sikao* [*How to Improve The System of Independent Director*], Feb. 7, 2005, *reprinted from* CAIKUAI TONGXUN [FIN. & ACCT. BULL.], *available at* http://doc.esnai.com/showdoc.asp?docid=7093&uchecked=true.

[115]Sarbanes-Oxley Act of 2002 § 301, *amending* Securities Exchange Act §10A (codified at 15 U.S.C. § 78j-1(m)(3)(B)(ii) (2005)).

[116]*See* Securities Exchange Act § 3(a)(19).

The NYSE is also friendly to shareholding by independent directors. Where audit committee members are concerned, it simply incorporates by reference the requirements of federal law. But where its own requirement for a majority of independent directors is concerned—a requirement not imposed by federal law—it imposes no limits on shareholding whatsoever. Indeed, in proposing its rule change, the NYSE specifically noted the views of commentators that share ownership should be viewed as desirable, and stated that "as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding."[117]

Although the SEC's rulemaking has not been actively hostile to shareholding by independent directors, it is important to note a fundamental difference in approach between the SEC and both the exchanges in their proposed rules. Both the exchanges require company boards to have a majority of independent directors *except* when the company is a "controlled company," i.e., when a single person, group, or company controls more than 50% of the voting power.[118] In other words, they see independent directors as a protection for shareholders *specifically against management*, not against other shareholders. A shareholder who controls a company does not need an external rulemaker to protect him from a management team that he himself has the power to appoint. Minority shareholders may well need protection from controlling shareholders, but the exchanges are apparently willing to leave this task to other bodies of law, such as federal securities law requiring disclosures and state corporate law mandating certain fiduciary duties.

The SEC's approach, however, is different. As we have seen, an "affiliated person" cannot be "independent," and the SEC defines affiliation, among other things, in terms of control. Under the SEC's principle, when stock ownership is enough to lead to control, affiliation exists and independence disappears. The NYSE's approach might be characterized as finding that when stock ownership is enough to lead to control, the director is *super*-independent of management—so much so that the need for paternalistic protection by a rule disappears. Thus, the SEC's view of the proper role of independent directors seems consistent with the second view canvassed earlier: that they should have ties neither with

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[117]Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc., Exchange Act Release No. 34-47672, 68 FED. REG. 19051, 19053 (Apr. 17, 2003), *available at* http://www.sec.gov/rules/sro/34-47672.htm.

[118]*See* NASD MANUAL: MARKETPLACE RULES 4350(c)(5), *available at* www.nasdaq.com; LISTED COMPANY MANUAL, *supra* note 3, § 303.00A.

management nor with the fortunes of the company itself. Yet this view of independent directors seems to see them as ideally having no consistent incentives whatsoever. While clearing away visible ties to management interests, it fails to substitute a tie to the interests of any other constituency. Consequently, it is hard to see how such directors can be expected to act in any predictable way other than in avoiding obvious (and punishable) illegalities; the purpose of having them on the board suddenly seems obscure. The lack of any serious underlying theory of independent director motivation is startlingly manifest.[119]

Independent director requirements in other major jurisdictions have been considerably less exacting, although still important. In the United Kingdom, for example, there does not exist, strictly speaking, any independent director requirement at all. Instead, companies listed on the London Stock Exchange are required by its listing rules to disclose, in their annual report and accounts, a statement of how they have applied the

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[119]For an excellent discussion of the implicit or explicit attitude toward equity ownership by independent directors in the various statutes and regulations discussed above, which takes a somewhat different view on some issues, see CHANDLER & STRINE, *supra* note 98. As is well known, Fama and Jensen argued that independent directors automatically have an incentive to protect shareholder interests, because those who are executives in other businesses and participants in the managerial labor market have an incentive to develop reputations as experts in decision control. *See* E.F. Fama & M.C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983). This view has been challenged, in my view convincingly, by Bebchuk and his colleagues, here in the context of CEO compensation:

> First, the signal provided by independent directorships is likely to be quite noisy, particularly when the board is large and responsibilities are diffuse. Second, and relatedly, the managerial labor market is more likely to focus on the manager's performance in his primary role rather than in his independent directorships. Third, there are likely to be a considerable number of independent directors who are interested less in establishing reputations as "expert decisionmakers" than in keeping their current board seats and perhaps joining other boards. . . . CEOs have considerable influence in the choice of independent directors and will tend to prefer candidates who are unlikely to challenge their compensation. Thus, for a director aspiring to additional board positions, the "market" for directors creates incentives not to challenge the CEO on the issue of his compensation but rather to accommodate the CEO's wishes.

Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 771 (2002) (footnotes omitted). Needless to say, these doubts about incentives become even stronger when there is a deliberate attempt to *remove* any incentive to act in the interests of shareholders.

For an interesting theory of director motivation that makes a good case for considering altruistic behavior, see Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite* Homo Economicus *to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003).

principles in Section 1 of the Combined Code.[120] A company that has not complied must specify the provisions of the code with which it has not complied. Section 1 of the Combined Code's Code of Best Practice provides that non-executive directors should constitute not less than one third of the board,[121] but these are not the same as *independent* directors, who should constitute a majority of the non-executive directors. The Combined Code clearly distinguishes them (without rigorously defining them) by stating:

> The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Non-executive directors considered by the board to be independent in this sense should be identified in the annual report.[122]

Whereas the SOA contemplates a specific role for independent directors only on the board's audit committee, the Combined Code contemplates a role for them on the remuneration committee as well, which is to be composed solely of independent directors.[123] Both committees are to make recommendations to the board, but the board is not obliged to follow their recommendations.

Before leaving the subject of independent directors, it is worth examining their role in the German corporate governance system in order to show that independence from management does not necessarily lead to protection of shareholder interests. German law mandates a dual-board system for large publicly-held corporations. Each corporation has an elected supervisory board (*Aufsichtsrat*), which appoints a managing board

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[120]*See* FINANCIAL SERVICES AUTHORITY (UNITED KINGDOM), THE LISTING RULES ¶ 12.43A, *available at* http://www.fsa.gov.uk. The "Combined Code" refers to the "Principles of Good Governance and Code of Best Practice," a document compiled by the Committee on Corporate Governance and derived from its own final report (the Hampel Report), the Greenbury Report, and the Cadbury Report. FINANCIAL SERVICES AUTHORITY (UK), PRINCIPLES OF GOOD GOVERNANCE AND CODE OF BEST PRACTICE, *available at* http://www.fsa.gov.uk [hereinafter COMBINED CODE]. On the relationship between mandatory state regulation and self-regulation in the United Kingdom, see generally BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION 364-420 (Clarendon Press 1997).

[121]COMBINED CODE, *supra* note 120, Code of Best Practices § 1.A.3.1.

[122]*Id.* § 1.A.3.2.

[123]*See id.* § 1.B.2.2. As I am strictly distinguishing here between *independent* directors and non-executive directors, who may or may not be independent, I save for the following section a discussion of the nominating committee under the Combined Code, which is to be composed of *non-executive* directors.

(*Vorstand*) composed of senior corporate managers. The role of the supervisory board is that of overseeing the management of the company,[124] but its role is limited to just that. Its major powers are the power to appoint and dismiss members of the managing board and the power to represent the company in its dealings with members of the management board.[125] The law explicitly allocates managerial power to the managing board.[126] Shareholders can even overrule supervisory board decisions through a three-fourths majority vote.[127]

Since the managing board is, by definition, composed of corporate managers, an examination of independent directors in German corporations must focus on the supervisory board. German corporate law aims to ensure the independence of its members from company management by excluding both legal representatives of enterprises controlled by the company in question and legal representatives of other corporations whose supervisory boards include members of the management board of the company in question.[128]

It is by no means intended, however, that supervisors should be independent of *all* outside influence and should exercise their judgment in pristine isolation from the world around them. On the contrary, as many as one half may, under the German system of co-determination, be employee representatives whose explicit remit is to protect the interests of employees. Others may be representatives of banks and other businesses who are "chosen for the very reason that they are not independent; that is, because they or the particular constituency they represent has an existing financial or similar relationship to the company."[129] German corporate law in this sense seems clearer about the functions of independent directors (or their equivalent) than U.S. federal law, which mainly seeks to ensure that a certain number of directors *not* be beholden to management.

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[124]*See* AKTIENGESSELSCHAFTEN [LAW ON STOCK CORPORATIONS] § 111(1), *translated in* COMMERCIAL LAWS OF THE WORLD: GERMANY (rev. ed. 1995).

[125]*See* Walter Oppenhoff & Thomas O. Verhoeven, *Stock Corporations*, *in* BUSINESS TRANSACTIONS IN GERMANY ch. 24, § 24.03 (Bernd Rüster ed., Matthew Bender 2003).

[126]*See* AKTIENGESSELSCHAFTEN [LAW ON STOCK CORPORATIONS], *supra* note 124, § 76(1).

[127]*See id.* § 111(4).

[128]*See id.* § 100(2).

[129]Thomas J. André, Jr., *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 TUL. L. REV. 69, 152 (1998) (emphasis omitted).

2. The "Outside" Director

The concept of outside director is often confused with that of independent director, but it makes sense to distinguish the two, because they can play different roles. By "outside director" I mean any director who is not a company employee,[130] without regard to whether she meets a standard of independence. The Cadbury Report envisages "a board made up of a combination of executive directors, with their intimate knowledge of the business, and of outside, non-executive directors, who can bring a broader view to the company's activities."[131] Cheffins notes in a similar vein that one function of outside directors is that of "providing full-time executives with support and assistance as they carry out their managerial tasks, which entails offering specialized advice and fostering links with other organizations."[132]

While outside directors *as defined above* are not part of the American corporate law scene, at least in terms of mandatory requirements, they do have a role to play in British corporate governance. As noted above, the Combined Code, the degree of compliance with which must be disclosed by companies listed on the London Stock Exchange, calls for one third of the board to be composed of outside directors.[133]

Japanese corporate law also uses the concept of "outsideness" for directors and auditors (*kansayaku*). An outside director is defined as

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[130]"Outside director" and "non-executive director" are often used interchangeably. I do not use the term "non-executive" director here because on its face such a term could include directors who were employees, but not executives—for example, worker representatives. Such directors would be neither outside directors, in the sense of being able to bring some special expertise to the board not otherwise available to the company, nor independent directors, in the sense of feeling free to oppose management. Because the role of such employee directors is very different from the role of non-employee non-executive directors, I do not favor using a term that on its face encompasses them both.

[131]CADBURY REPORT, *supra* note 68, ¶ 4.1.

[132]CHEFFINS, *supra* note 120, at 96.

[133]The Combined Code calls them "non-executive directors," but specifically contemplates that some will not meet a criterion of independence. *See* COMBINED CODE, *supra* note 120. Although the Combined Code does not specifically exclude employees from the scope of non-executive directors, such seems to be the intention. Something akin to a legislative history of these provisions of the Combined Code can be found in the Cadbury Report, from which they are largely taken. Dahya and McConnell, in their study of outside directors in British companies, state that they consider a director an outsider "if he/she is listed as a 'non-executive' director, he/she is not related to the company's controlling family, and he/she was not employed by the company historically." Jay Dahya & John J. McConnell, Outside Directors and Corporate Board Decisions 9 (Aug. 29, 2003), *available at* http://www.mgmt.purdue.edu/centers/ciber/publications/pdf/2003-008%20McConnell.pdf.

> [a] person who is currently a director but who is not executing any company business, who has not in the past been a director, manager or other employee executing any business of the company or its subsidiaries, and who currently is neither executing any business of a subsidiary nor is a manager or any other employee of the company or its subsidiaries.[134]

Note that this concept of outsideness does not exclude persons such as lawyers, suppliers, and others who may do large amounts of business with the company.[135]

The distinction between independence and outsideness seems to be well understood in Japan. The Revised Corporate Governance Principles of the Japan Corporate Governance Forum differentiate the two,[136] and a website operated by the *Nihon Keizai Shimbun* (the *Wall Street Journal* of Japan) contains a list of definitions of economic terms where the distinction is spelled out clearly.[137] Prior to recent corporate law reforms, the concept of outsideness might, however, have been more appropriate than one of independence. The only purpose it served was to define what sort of director could be subject to a more forgiving standard of care[138] and, therefore, it is reasonable to focus on those who are not intimately acquainted with the affairs of the company as opposed to those who are not

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[134]SHŌHŌ [COMMERCIAL CODE OF JAPAN], art. 188(2)(7.2) (2002), as adapted from translation in HASHIMOTO, *supra* note 8, at 9.

[135]Note also that this definition is *not* the definition of outsideness used in Miwa and Ramseyer's study of outside directors and corporate performance in Japan. Their definition includes anyone with past or concurrent careers at other institutions, apparently notwithstanding past employment at the company in question. *See* Miwa & Ramseyer, *supra* note 98, at 11.

[136]*See* JAPAN CORPORATE GOVERNANCE FORUM, REVISED CORPORATE GOVERNANCE PRINCIPLES (Oct. 26, 2001), *available at* http://www.ecgi.org/codes/code.php?code_id=70. Principle 6.3 states: "The majority of directors on the nominating committee and the compensation committee should be outside directors, and there should be one or more independent directors. The majority of audit committee members should be independent directors." Principle 4 states:

> 1. An outside director is someone who is not and has never been a full-time director, executive, or employee of the company or its parent company, subsidiaries or affiliates (collectively, the "Company etc.").
>
> 2. An independent director is someone who can make decisions completely independently from the managers of the Company etc., and therefore necessarily does not hold any interest with respect to the company.

[137]*See Shagai Torishimariyaku to Dokuritsu Torishimariyaku* [*The Outside Director and the Independent Director*], *supra* note 98.

[138]*See* SHŌHŌ [COMMERCIAL CODE OF JAPAN], art. 266(18) (2002) (providing that shareholders may by resolution reduce an outside director's maximum liability to the company to twice her annual director's income, as opposed to four times the annual income for ordinary directors and six times the annual income for representative directors (*daihyōtorishimariyaku*)).

dependent in some way upon management's favor. In the 2002 corporate governance reforms that became effective in April 2003, however, outside directors are expected to play a role more akin to that expected of independent directors in U.S. federal securities law: companies may opt into a U.S.-style corporate governance structure in which outside directors are required to be present on nominating committees, audit committees, and compensation committees.[139]

3. The "Disinterested" Director

Far more important than federal law in the United States for purposes of internal corporate governance is state law, and this for the most part—at least in terms of economic impact—means the law of Delaware. U.S. corporation law at the state level does not generally provide for the institution of independent directors as such or define them.[140] Instead, state corporate statutes focus on particular conflict-of-interest transactions—transactions, for example, between a corporation and one of its directors or officers, or between a corporation and another entity in which one of its directors or officers has an interest, or the taking by corporate officers of business opportunities that arguably belong to the corporation—and provide that certain consequences will follow depending on whether those with decisionmaking power who have a conflict of interest recuse themselves from the decisionmaking process.

Modern state statutes typically operate by displacing the common law rule on conflict-of-interest transactions—that they may be set aside at the instance of any stockholder[141]—and permitting them provided certain conditions are met. These conditions usually pertain to disclosure of the

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[139] *See* HASHIMOTO, *supra* note 8, at 10.

[140] A limited exception can be found in Michigan, where corporations may, subject to certain requirements, designate one or more directors as "independent directors," upon which certain statutory consequences follow. *See* Scott J. Gorsline, *Statutory "Independent" Directors: A Solution to the Interested Director Problem?*, 66 U. DET. L. REV. 655, 659 (1989); Cyril Moscow et al., *Michigan's Independent Director*, 46 BUS. LAW. 57, 57 (1990).

[141] *See, e.g.*, Wardell v. R.R. Co., 103 U.S. 651, 658 (1880) ("The law, therefore, will always condemn the transactions of a party on his own behalf when, in respect to the matter concerned, he is the agent of others, and will relieve against them whenever their enforcement is seasonably resisted."). Note that the law did not prohibit such transactions. Like many "rules" of company law, this rule is simply the provision of a private cause of action, not an outright prohibition. The common law rule made conflict-of-interest transactions very vulnerable to attack by shareholders.

conflict of interest and approval of the transaction by disinterested decisionmakers, whether directors or shareholders.[142]

The Delaware General Corporation Law (DGCL) announces in Section 144 that a transaction in which a director or officer stands on both sides[143] shall not be voidable by reason of a conflict of interest if one of the following conditions are met: (1) the relevant facts are known to the board and a majority of disinterested directors approve; or (if, for example, the entire board has a conflict of interest) (2) the relevant facts are known to the shareholders, and a majority of disinterested shareholders approve; or (if for any reason neither of the first two occurs) (3) the terms of the transaction are, as of the time it is authorized by the directors or the shareholders, fair to the corporation.[144]

The Model Business Corporation Act has an entire subchapter (Subchapter F) devoted to directors' conflicting interest transactions. Like the Delaware statute, it provides that transactions are not voidable on the grounds of a conflict of interest provided that there was sufficient disclosure followed by approval of a majority of disinterested directors.[145] Both the DGCL and the MBCA, then, have a concept of independence, but it amounts only to *disinterest* in a particular conflict-of-interest transaction—something quite different from abstract independence. Both attempt to deal with such transactions generally through disclosure to, and approval by, directors who are not involved in the transaction. But they do not assume that such directors will always be the same person, and do not require the institution of abstractly independent directors. Instead, they take a transaction-by-transaction approach, and ask in each case whether there was approval by directors (or other decisionmakers) who were

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[142]*See* DEL. CODE ANN. tit. 8, § 144 (2001). It is important to note that if the conditions are *not* met, the transaction is not for that reason unlawful. It merely means that a court may apply the common law rule to the transaction if a shareholder brings suit to set it aside. But the common law rule is whatever the court says it is, and it is not at all clear that American courts of the early twenty-first century will find such transactions as offensive per se as did American courts of the nineteenth century. Thus, modern state corporation statutes provide a safe harbor for conflict-of-interest transactions, but one cannot assume that transactions falling outside the safe harbor are necessarily all barred.

[143]The statutory definition is more complicated, but this simplified version will do for present purposes.

[144]*See* DEL. CODE ANN. tit. 8, § 144 (2001). The Delaware statute, deliberately or not, contains no requirement that shareholder approval be by *disinterested* shareholders only, but this requirement has been read into the statute by case law. *See, e.g.*, Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.").

[145]*See* MODEL BUS. CORP. ACT subch. F.

disinterested *in the transaction in question*. Recent cases have also stressed the need for a fact-intensive inquiry.[146] Although this approach has costs, it also has hidden savings: the cost of policing an abstract independence requirement in the many companies where it will never be needed.

C. *The Independent Director in China*

As we have seen in the United States, the NMD has traditionally been seen as the solution to the problem of managerial domination of the board.[147] This model assumes the existence of the paradigmatic Berle-and-Means corporation, where powerful managers exploit dispersed and rationally apathetic shareholders.[148] This explains why, as far as American law is concerned, it is generally considered a good thing, not a bad thing, for NMDs to own stock in the company on whose board they sit.[149] When

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[146]See, for example, *In re Oracle Corp. Derivative Litigation*, in which Vice Chancellor Strine spoke of Delaware's "flexible, fact-based approach to the determination of directorial independence," 824 A.2d 917, 937 (Del. Ch. 2003), and added:

> This contextual approach is a strength of our law, as even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue.

Id. at 941. *See also* Krasner v. Moffett, 826 A.2d 277, 286 (Del. 2003) (Veasey, C.J.) ("The independence of the special committee involves a fact-intensive inquiry that varies from case to case.").

[147]*See, e.g.*, Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporate Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 563-64 (1984).

[148]*See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Macmillan 1933). As has been shown above, China has few, if any, such listed corporations. Indeed, it is not clear how dominant they are even in the United States. *See, e.g.*, Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293 (1988) (finding a modest concentration of ownership even among the largest U.S. firms); R. La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1146 (1998) (finding that ownership of the three largest shareholders in the ten most valuable U.S. companies has a mean average of 20% and a median of 12%).

[149]In *Unitrin, Inc. v. American General Corp.*, for example, the Delaware Supreme Court granted extra deference to the views of outside directors who held "substantial equity stakes" in a corporation that was the target of a takeover bid, presuming that they would "act in their own best economic interests" as stockholders and not out of a desire to entrench existing management. *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1380-81 (Del. 1995); *see also* CHANDLER & STRINE, *supra* note 98, at 51-53 (favoring stock ownership by independent directors and questioning the suspicious approach of the SOA); Balotti et al., *supra* note 113, at 672, 677 (reviewing empirical evidence in support of link between substantial equity ownership and improved director monitoring and decisionmaking, and arguing in favor of presumption of due care for directors with substantial equity ownership); J. Travis Laster, *Exorcizing The*

the law's concern includes dominant shareholder exploitation of minority shareholders, the concept of the abstractly defined *independent* director fades away, to be replaced by the notion of a *disinterested* director—disinterested not in the abstract, but with respect to a particular challenged transaction.

The abstractly defined independent director is quite common in U.S. federal law and the national securities markets, but as discussed above the concern of the law seems to be to defend the interests of the shareholders as a whole against management self-seeking, not to defend minority shareholders against dominant shareholders.

The Chinese literature and regulations contemplate a number of roles for independent directors. One sees generalities about how they will reduce corruption, bring an objective view to board meetings, dare to ask uncomfortable questions, criticize company management, and ensure good corporate governance practices,[150] but specific, measurable goals and predictions are few. Yet one cannot design and evaluate rules about independent directors without knowing what problems the institution is designed to address.

As discussed above, a major perceived problem in Chinese corporate governance is the dominance of large shareholders. This is sometimes confused with the problem of insider control, although that problem stems from the inability of shareholders to supervise management effectively. Many Chinese commentators appear to view concentrated ownership as almost perverse and unnatural, and see the stereotypical Berle-and-Means corporation as the ideal ownership structure.[151]

Omnipresent Specter: The Impact of Substantial Equity Ownership by Outside Directors on Unocal *Analysis*, 55 BUS. LAW. 109 (1999) (discussing a series of cases in which Delaware courts have given deference to decisions by directors on the grounds that their substantial equity ownership aligned their interests with those of other shareholders).

In *Stroud v. Grace*, the Delaware Court of Chancery addressed a party's argument that a corporate charter provision requiring independent directors on the board but *forbidding* them from owning stock should be invalidated. The court found the provision to be unusual, but not unlawful. The prohibition in that case stemmed from the particular needs of the dominant shareholder in a family-controlled close corporation. *See* Stroud v. Grace, No. 10,719 (Del. Ch. Nov. 1, 1990), *reprinted in* 16 DEL. J. CORP. L. 1588 (1991).

[150]*See, e.g.*, *Li Yining: Shangshi Gongsi Duli Dongshi Zhi Shang Nan Fahui Zuoyong* [*Li Yining: It Is Still Difficult for the Listed Company Independent Director System to Play Its Proper Role*], CHINA NEWS AGENCY, June 12, 2001.

[151]*See, e.g.*, Li Jianming, *Gongsihua Gaizao Yilai Woguo Qiye Zhili Jiegou de Shizheng Fenxi* [*An Empirical Analysis of the Corporate Governance Structure of Chinese Enterprises Since the Corporatization Reform*], GAIGE [REFORM], No. 4, 1999, at 34, 41; Ma, *supra* note 12, at 62; Zheng & Chen, *supra* note 49, at 180. One Chinese academic asserts (incorrectly) that corporate law in the United States prevents large shareholders from dominating by prohibiting any person from exercising over 20% of shareholder voting rights. *See* Gu, *supra* note 84, at 60.

Independent directors will, it is hoped, represent the interests of small shareholders and prevent the recurrence of corporate scandals.[152]

A study conducted by the Shanghai Securities Exchange identified the following major problems in Chinese corporate governance, several of which are evidently connected with the exploitation of small shareholders by large shareholders: (1) irrational shareholding structure;[153] (2) lack of independence (presumably from management) of the board of directors; (3) inability of the board of supervisors to play its proper role; (4) relative weakness of oversight role of creditors; (5) unlimited powers of key management personnel; (6) low level of transparency and professionalism in investment decisions; (7) lack of a market for corporate control; (8) lack of a market for management services; (9) skewed system of incentives; (10) lack of protection of interests of small shareholders; (11) lack of a system for accountability; and (12) lack of a shareholder culture and corporate governance culture.[154] Thus, many of the criticisms of existing independent directors center around their powerlessness to protect the interests of small and medium shareholders from the depredations of large shareholders and management.[155] They are said to fail in this mission because, among other things, they are a minority on the board and they are nominated by controlling shareholders.[156]

The emphasis on the need to protect the small shareholder from the dominant shareholder or shareholders is no doubt due to the shareholding structure of stock companies in China. Companies with widely dispersed public ownership where no individual owns a controlling block of shares

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[152]*See, e.g.*, Jiang, *supra* note 89; Yan Fuhai, *Yang Yao Nan Yi Zhongguo Bing* [*Foreign Medicine Can't Cure a Chinese Sickness*], FAZHAN [DEVELOPMENT], No. 8, 2002, at 41; Ye Xiangsong & Cao Zongping, *Tuixing Duli Dongshi Zhidu, Wanshan Faren Zhili Jiegou* [*Promote the Independent Director System, Perfect the Legal-Person Governance Structure*], QIU SHI ZAZHI [SEEKING TRUTH MAGAZINE], No. 6, 2002, at 30-31.

[153]It is not clear what this is intended to mean, but probably means the presence of dominant shareholders in large numbers of companies.

[154]*See Shoufen Gongsi Zhili Zhiyin Chutai* [*First Guide to Corporate Governance Appears*], ZHONGGUO JINGJI SHIBAO [CHINA ECON. TIMES], Nov. 6, 2000. It is not clear what the study meant by "shareholder culture" and "corporate governance culture" that is not included in the preceding stated problems.

[155]*See, e.g.*, *Ruhe Rang Zhongguo Duli Dongshi Fahui Youxiao de Duli Zuoyong* [*How to Have the Independent Director in China Play an Effective Independent Role*], JINGJI RIBAO [ECON. DAILY], June 16, 2001.

[156]*See id.* Not surprisingly, nomination by those in control of the company continues. A survey conducted in early 2003 found that 90% of independent directors had been nominated by the controlling shareholder or by management. *See* Jin Xin Securities, *Dui Woguo Shangshi Gongsi Duli Dongshi Zhidu Shishi Zhuangkuang de Fenxi ji Jianyi* [*Analysis and Suggestions Concerning the Situation of Implementation of the Independent Director System in China's Listed Companies*], Aug. 8, 2003, *at* http://news1.jrj.com.cn/news/2003-08-07/000000618234.html.

are virtually, and perhaps completely, non-existent. Thus, the agency problem identified by Berle and Means in their classic work, *The Modern Corporation and Private Property*,[157] is not a major concern. As demonstrated above, Chinese listed companies typically have a few large, dominant shareholders (often holding unlisted state or legal person shares) and a minority of small shareholders holding listed shares. Certainly the perception in the literature seems to be that there is a serious problem of abuse of power by dominant shareholders, who handpick compliant boards and management who will operate the company in a way that favors those dominant shareholders. Thus, the problem to be addressed by the institution of the independent director is that of abuse of dominant share ownership at the expense of small shareholders.[158]

A major problem with this approach is that it starts from the notion that control of the company by any particular large shareholder is itself bad. The literature is full of lamentations that shareholder votes are mere formalities because one shareholder owns an overwhelming block. But directors, independent and otherwise, are supposed to be elected by shareholders. For the majority shareholder to out-vote minority shareholders is precisely the intended consequence of the voting system set forth in China's Company Law[159] and the corporate laws of other countries. Thus, the complaints of some commentators that companies with dominant shareholders are not run "democratically,"[160] or lack true collective decisionmaking,[161] seem based on a conception of the company as a political enterprise, not as an economic one.[162]

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[157]BERLE & MEANS, *supra* note 148.

[158]See, for example, the remarks of Laura Cha (Shi Meilun), the deputy head of the CSRC, who spoke of "egregious behavior" by controlling shareholders of listed companies, as reported in Richard McGregor, *China Plans New Market Rules*, FIN. TIMES, Apr. 19, 2001, at 25.

[159]*See Company Law*, *supra* note 17, art. 104.

[160]*See, e.g.*, Sun Guangyan, *Woguo Ying Ruhe Yinru Duli Dongshi Zhidu* [*How China Should Introduce the Independent Director System*], FAXUE [JURISPRUDENCE], No. 7, 2001, at 65, 65; Wu Jianxiong et al., *Duli Dongshi Zenme Yangle—Shangshi Gongsi Tuixing Duli Dongshi Zhidu Xianzhuang Diaoyan Fenxi* [*How Are Independent Directors Doing? An Investigation and Analysis of the Current Situation in the Implementation by Listed Companies of the Independent Director System*], ZHENGQUAN SHIBAO [SECURITIES TIMES], Jan. 10, 2002.

[161]*See, e.g.*, Luo Peixin & Mao Lingling, *Lun Duli Dongshi Zhidu* [*On the System of Independent Directors*], ZHENGQUAN SHICHANG DAOBAO [SECURITIES MARKET HERALD], Feb. 2001, at 48, 50.

[162]Ma complains that the board represents the interests of only a numerical minority (*shao bufen*) of the shareholders. *See* Ma, *supra* note 12, at 63. In economic terms, of course, the board may represent all too effectively the interests of the majority holder. It is the political conception of the company that makes the number of small shareholders, regardless of their holdings, significant.

Given that large shareholders get to choose directors, it is hard to see how directors representing minority shareholders could be elected to the board in the first place unless the basic principles of director selection were changed. Cumulative voting is a possible solution—it is in fact encouraged by the Corporate Governance Principles[163]—but this system will at best elect directors representing a concentrated minority, not a dispersed minority, and even then such directors will be in a minority on the board and can always be outvoted.

Obviously, even one isolated director can provide a degree of protection to minority shareholders by publicizing, or threatening to publicize, majority shareholder abuses of which he or she becomes aware. It is not clear, however, if this is the kind of strong protection envisaged by advocates of the independent director system, some of whom propose that independent directors should constitute a majority of the board,[164] even while expecting them to serve the interests of minority shareholders.

This view also ignores the problems with dispersed share ownership pointed out so long ago by Berle and Means, as well as the considerable evidence that having a controlling shareholder may be good for corporate performance.[165]

Finally, this view runs up against the special position the state wants to reserve for itself when it is the dominant shareholder.[166] The Dean of the Changjiang School of Business, who serves as an independent director, was recently quoted as saying, "I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the

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[163]*See* China Securities Regulatory Commission, *Shangshi Gongsi Zhili Zhunze* [*Principles of Corporate Governance for Listed Companies*], art. 29, issued Jan. 7, 2002 [hereinafter *Corporate Governance Principles*]. The CSRC never explained how cumulative voting could be carried out consistently with article 106 of the old Company Law, which mandated one vote per share. Fortunately, the October 2005 revisions to the Company Law have eliminated this problem by explicitly permitting cumulative voting. *See Company Law*, *supra* note 17, art. 106.

[164]*See, e.g.*, Hu Ruyin et al., *Zhongguo Shangshi Gongsi Zhili Mianlin De Wenti Yu Duice* [*Corporate Governance Problems Confronting Chinese Listed Companies and Measures to Address Them*], *in* GUO & WANG, *supra* note 33, at 172, 188.

[165]See, for example, TENEV & ZHANG, *supra* note 80, at 110. *See also supra* Part II.A.4.

[166]The view that independent directors have a role to play in counteracting the (presumably deleterious) effects of state shareholding is not unique to Chinese commentators. See, for example, Harry G. Broadman, Lessons From Corporatization and Corporate Governance Reform in Russia and China 23 (unpublished manuscript, prepared for the International Conference on Corporate Governance Development in Vietnam, Hanoi, Oct. 11-12, 2001) (calling for the election of "independent, non-state representatives" to the board of directors).

large shareholder, because the large shareholder is the state."[167]

A second proposed function for independent directors is to monitor related-party transactions, where there could be a conflict of interest.[168] Note that if independent directors are to perform this function effectively, "independence" cannot be an abstractly defined concept referring to independence from management. A transaction-based approach that looks at the director's interest in a particular transaction is required; otherwise a director wholly independent of management would be deemed fit to vote on a transaction between the company and himself.

A third function for independent directors frequently mentioned is that of brain trust or consultant.[169] This is an often-touted virtue of *outside* directors as well.[170] In either case, however, it is not clear why the company would not do better hiring consultants and other experts for advice, instead of having them sit on the board until such time as they might be needed.[171] What incentives do such directors have to devote time and resources to their advisory task? If outside or independent directors who give valuable advice are compensated any differently from directors who do not, then they may cease to meet the definition of outside or independent director. Furthermore, if giving advice is the appropriate role, why do the directors need to satisfy any criterion of independence at all?[172]

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[167]Xiang Bing, *quoted in Duli Dongshi Xiang Huaping?* [*Are Independent Directors Just Decorative?*], GANG-AO XINXI RIBAO [HONG KONG-MACAO NEWS DAILY], Jan. 1, 2003, *available at* http://www.chinainfobank.com. Note that Xiang made this remark well after the promulgation of the CSRC's Independent Director Opinion, which specifically rejects his interpretation of an independent director's responsibilities. *See infra* Part IV.E.2.

[168]*See* Yan, *supra* note 152; Ye & Cao, *supra* note 152.

[169]*See, e.g.*, Wu et al., *supra* note 160; Yan & Chen, *supra* note 12, at 26; Ye & Cao, *supra* note 152.

[170]*See supra* text accompanying note 131.

[171]A few skeptics in the Chinese literature make this point as well. *See* Han Qiang, *Zhiyi "Duli Dongshi"* [*Doubts About the "Independent Director"*], Nov. 6, 2002, *available at* http://finance.sina.com.cn/ychd/20021106/1301275475.html; Yu Guanghua, *Yiding Yao Duli Dongshi Ma?* [*Do We Really Need Independent Directors?*], 21 SHIJI JINGJI BAODAO [21ST CENTURY ECONOMIC REPORT], July 19, 2002.

[172]Although outside directors are common in Japan, the Revised Corporate Governance Principles of the Japan Corporate Governance Forum specifically view their advisory function as secondary: "In Japan, although there is a strong bias towards requesting managerial advice from outside directors, this phenomenon is, at best, a secondary function, and managers and employees alike in Japan need to be reminded that the primary role of outside directors is that of governance." JAPAN CORPORATE GOVERNANCE FORUM, *supra* note 136, at 7. Miwa and Ramseyer, however, cast doubt on the primacy of the governance role at least as a descriptive matter. Noting that outside directors often come from companies and institutions that are customers of the company in question, they hypothesize that outside directors are useful to Japanese companies because of their understanding of customer needs. Such directors need not be in any way independent of management in order to fulfill this function, and indeed such directors apparently assume full-time employment as company directors—that is, they resign any

Finally, a fourth function sometimes mentioned is that of serving the public interest.[173] I use this broad category to include concepts of the independent director as a kind of agent of state regulatory bodies[174] or as a kind of mole operating on behalf of the state to monitor its assets and prevent managerial waste. As Han points out, however, this is exactly what the directors appointed by the state shareholder—and in many cases, there will be a dominant state shareholder perfectly capable of appointing whatever directors it pleases[175]— are supposed to be doing. Why does there need to be a special independent director to carry out this task?

Where the director serves the "public interest," arguably he or she should be independent of *everyone*—dominant shareholders, management, and indeed all those who have an interest in the company—and follow only the dictates of his or her conscience.[175] Assuming accountability to be a good thing, however, it is hard to see how such a director could properly be made accountable.[176] In the real world, of course, any director without security of tenure will, in the absence of counterincentives and assuming that the position is desirable, tend to be accountable to whoever was responsible for appointing him or her.

A final issue to be addressed here concerns the relationship between the independent director and the board of supervisors in the Chinese company. Chinese company law provides for a two-tier board structure, with a board of supervisors (elected by shareholders) as well as a board of directors, and contemplates a relatively active managerial role

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other positions—upon taking their position. *See* Miwa & Ramseyer, *supra* note 98.

[173]*See, e.g.*, Yan Zheng, *Wo Ruhe Xuezhe Dang "Duli Dongshi"* [*How I Am Learning to Be an "Independent Director"*], KAIFANG [OPENING] No. 7, 2002, at 34. Yan is the head of the Fujian Academy of Social Sciences, which makes him a senior academic of national standing. He writes with pride of his position as the only independent director on the seven-member board of the Shuikou Electric Power Generating Company, a limited liability company (*youxian zeren gongsi*) with only two shareholders. According to the article, Yan believes he can be legally liable for his votes at board meetings, yet accepts no fee for his position and is honored to feel that he is making a contribution to the state. For the story of Lu Jiahao, another academic who despite no experience in business was asked to serve as an independent director, did so without compensation, and ended up being fined 100,000 *yuan* by the CSRC for his troubles, see Wu Guofang, *Cong Lu Jiahao An Fansi Duli Dongshi Zhidu* [*Reflections on the Independent Director System from the Lu Jiahao Case*], JIANCHA RIBAO [PROCURATORATE DAILY], Nov. 20, 2002, and Wei Yahua, *Duli Dongshi Bei Fa Di Yi An* [*The First Case of an Independent Director Being Fined*], ZHONGGUO L HI WANG [CHINESE LAWYER NET], Dec. 13, 2002, *at* http://www.chineselawyer.com.cn/article/200212135599.html. *See also* Appendix 1 (discussing directors' liability in China).

[174]Mentioned but ridiculed by Han, *supra* note 171.

[175]This argument is made in Ye & Cao, *supra* note 152, at 30.

[176]He and Yu point out that there is no reason to think that a director accountable to nobody will do more for corporate results than an inside director. *See* He & Yu, *supra* note 104, at 29.