

# ESSAYS

## RE-EXAMINING CORPORATE POWERS ALLOCATION AND THE ROLE OF COMPANY LAW: A PERSPECTIVE FROM CHINESE COMPANY LAW

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*Corporate governance has been a hot topic in all jurisdictions. In China, both scholars and lawyers have been criticizing the corporate powers authorized by the statutory law and the role of the company law. In this article, the author will analyze these issues though a comparative approach, concluding that the law divides the corporate power clearly and logically though it looks rigid and inflexible. Given the context of China's transitional economy, it is premature and not appropriate to allow the shareholders and the board of directors to re-allocate the fundamental powers via the articles of association.*

### INTRODUCTION

Corporate governance involves the allocation of powers to manage the affairs of the business.<sup>1</sup> Some commentators propose shareholders to initiate and vote to adopt changes in the company's basic corporate governance arrangements<sup>2</sup>, while others invoke their director primacy model of corporate governance.<sup>3</sup> Nevertheless, the most important trend in corporate governance today, in common law jurisdiction, is the move toward "shareholder democracy."<sup>4</sup>

Most transplanted from the German company law, the article 38 and article 47 of Chinese Company Law allocate corporate powers between the shareholders' meeting and the board of directors. After the Company Law

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<sup>1</sup> See Julian Velasco, *The Fundamental Rights of the Shareholders*, 40 U.C. DAVIS L. REV. 410 (2006).

<sup>2</sup> See Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

<sup>3</sup> See Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1746 (2005).

<sup>4</sup> See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

was revised in 2005, both the shareholders' meeting (SHM) and the board of directors (BOD) are granted "other powers (other functions)".<sup>5</sup> Thus, the line between the two organs seems to become more and more blurred. For example, whether shareholders could delegate some of their powers to the board of directors despite the fact that those powers are vested in the shareholders. In other words, are these powers provided in the two articles above exclusive power belonging to the shareholders' meeting and the board of directors respectively? Some Chinese company law scholars point out that the Chinese company law and relevant judiciary interpretations are not sophisticated enough to address this particular issue.<sup>6</sup> The author, however, will argue in the following sections that the law divides the corporate power clearly and logically though it looks rigid and inflexible.

## I. CORPORATE POWER ALLOCATION

### A. *Corporate Power Allocation in U.S.*

U.S. State corporate codes clearly define the role of directors: "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."<sup>7</sup> The role of the shareholder, on the other hand, is much less clear in the level of state legislation.<sup>8</sup> Theoretically, the shareholders are collectively on the top of the organizational structure, since they are regarded as the ultimate owners of the company.<sup>9</sup> This means that the shareholders as the owner of the public companies do not have much control in the management of the corporation. In the arena of federal legislation, the Model Business Corporation Act (MBCA) (1984) provided that a shareholder meeting shall be held annually at a time stated in or fixed in accordance with the bylaws,<sup>10</sup> however, the failure to hold an annual meeting does not "affect the validity of any corporate action",<sup>11</sup> which means shareholder may not initiate any managerial decision to influence the

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<sup>5</sup> See article 38 and 47 of the Company Law of PRC (2005).

<sup>6</sup> See GU MINKANG, UNDERSTANDING CHINESE COMPANY LAW 54 (2d ed. 2010).

<sup>7</sup> DEL.CODE ANN. tit. 8, § 141(a) (2006); see also MODEL BUS.CORP.ACT § 8.01(b) (2004).

<sup>8</sup> Supra 1.

<sup>9</sup> There are many theories on the nature of the corporation. Some of the theories suggest that the shareholders are just the supplier of the capital such as the nexus of contract theory, see ROBERT.W.HAMILTON, THE LAW OF CORPORATIONS 62, (1996). See also VANESSA STOTT, HONG KONG COMPANY LAW, 6-12 (10th ed. 2003). But in practice, the shareholders are collectively regarded as the owner of the corporation, while the corporation itself enjoys its own legal personality.

<sup>10</sup> See MBCA (1984) 7.01(a).

<sup>11</sup> MBCA (1984) 7.01(c).

corporate action. The only way for them to involve in the corporate of governance is to replace or remove the incumbent board of directors.<sup>12</sup>

*B. Corporate Power Allocation and the Shareholders' Powers in Chinese Company Law*

According to the current Chinese Company Law, generally, companies are required to have three governing bodies: the shareholder meeting, the board of directors and the board of supervisors. These three governing bodies hold different functions as prescribed in the Company Law.

*C. Shareholders' Meeting*

The shareholders meeting of a limited liability company or a joint stock company shall be composed of all the shareholders. The shareholders meeting shall be the organ of power of the company and shall exercise its functions and powers in accordance with this Law.<sup>13</sup> The most important function of the shareholder meeting is to elect the board of directors and deliberate and approve the budget of the corporations among around ten fundamental powers.<sup>14</sup> The company law also allows shareholders to exercise other functions and powers of stipulated in the articles of association.<sup>15</sup> As is discussed in last section, these powers allocated by the company law are obviously mandatory rules which can not be waived or expropriated by any means. Similarly, other powers of shareholders stipulated in the articles of association are subject to absolutely necessary provisions, which are not allowed to waive either.<sup>16</sup> Otherwise, shareholders may bring lawsuits before the court.<sup>17</sup>

*D. The Board of Supervisors*

According to the Chinese Company Law, the board of supervisors should be composed of representative from the shareholders and the

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<sup>12</sup> See ROBERT C. CLARK, CORPORATE LAW, 21-24, 93-140 (1986).

<sup>13</sup> See article 37 and article 99 of the Company Law of PRC (2005).

<sup>14</sup> See article 38 and 100 of the Company Law of PRC (2005).

<sup>15</sup> *Ibid.*

<sup>16</sup> Article 25 clause 6 states: the articles of association of a limited liability company shall specify the organization of the company, its method of creation, functions and powers and the rules of procedure. Article 82 clause 12 provides that the articles of association of a joint stock company shall specify other matters that shareholders general meeting deems necessary to be specified.

<sup>17</sup> This kind of lawsuit could be either direct suit or derivative suit. See article 152, 153 of Company Law of PRC (2005).

employees. Among them, the number of employee representative should not be less than one third of the all representatives. The board of supervisors monitors the activities of directors and senior managers, ensuring that they act in the interests of the company.

#### *E. The Board of Directors*

The board of directors should consist of 5 to 19 members under the current law<sup>18</sup>. The members of the board should be elected by the shareholder's meeting, and the representatives of the employees can sit in the board<sup>19</sup>. Before 2001, there was no independent director or outside directors sit in the board. In 2001, CSRC issued a regulation which requires the listed companies to have one third of their directors consist of independent directors.

#### *F. The Exclusive Powers and Mandatory Rules*

The article 38 and article 47 of Chinese Company Law stipulates the powers allocation between the SHM and the BOD. Whether the powers specified in article 38 and article 47 of Chinese company law are exclusive? To put in another way, it matters whether these two articles are mandatory Rules. If they are mandatory rules, the possibility of discretionarily applying them would be ruled out and the powers listed in article 38 are exclusively subject to shareholders' meeting, those in article 47 can be exercised by the board of directors only. If not, delegation of power between these two organs are possible and further examination of the relations between them are required.

With regard to the nature of these two articles, several aspects shall be taken into account: First, legislative intent. As a matter of fact, company ensures the independence of corporate governance and corporate operation through its independent personality and limited liability. As a legal entity, it requires company to have the autonomy and the capacity to participate in civil activities and to take civil liabilities. Accordingly, being the highest authority and the executive organ, the shareholders' meeting and the board of directors shall have their own powers. Furthermore, it is more reasonable that the types, ranges and ways of exercising these powers can be decided autonomously by the articles of association. If they can only be authorized by the statutory law rigidly, it would be quite difficult for company to adapt

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<sup>18</sup> Article 109 of the Company Law of PRC (2005)

<sup>19</sup> *Ibid.*

to the complexity and volatility of the market, so that the interests of the company and shareholders would be damaged consequently.

In this regard, the author is apt to believe that the articles in respect of powers allocation shall be considered as the mandatory rules. In practice, facing the fierce market competition, obviously, those powers authorized by the company law are not sufficient for modern companies. Thus, the article 38 and 47 merely provided a most fundamental range of the corporate powers division, which thus are deemed exclusive powers for each organ in the management of the company. On the other hand, it is undeniable that other powers not included in these articles are discretionary, which can be regulated by the articles of association so as to make them flexible.

Second, textual interpretation of the legal statutes is also important. According to article 38, the law explicitly enumerates ten powers, while the clause 11 of this article states “other functions as specified in the articles of association”. Accordingly, it is evident that the company law does not allow the articles of association to discretionarily allocate the ten powers granted by the law. It is the same in the article 47. Furthermore, some powers arranged by the law reflect a type of correspondence between article 38 and 47. For example, the article 47 stipulates the board of directors has the power to “work out the company’s profit distribution plans and loss recovery plans”. By contrast, the article 38 prescribes the power of “examining and approving the company’s distribution plans and loss recovery plans” belongs to the shareholders’ meeting. It actually takes into account the disparity of these two organs’ position, therefore, it also shows that the articles regarding the powers allocation can not be considered as discretionary rules.

Meanwhile, only if the article 38 and 47 are deemed mandatory, it is possible to integrate them with the article 22 of the company law, which mainly concerns the case where resolutions in both shareholders’ meeting and meeting of board of directors are null or revocable. It states “The contents in the resolutions of shareholders meeting or the shareholders general meeting or the board of directors of a company if in violation of laws or administrative regulations shall be null and void... if the contents in the resolutions thereof are in violation of the articles of association, the shareholders of the company may, within the 60 days upon the date of making the resolution, request the people’s court to revoke it.”<sup>20</sup> Assuming article 38 and 47 are mandatory rules, the nullity of the resolution includes the violation of these two articles, and the revocable resolution covers the

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<sup>20</sup> See article 22 of the Company Law of PRC (2005).

violation of “other functions and powers stipulated in the articles of association”. Thus, these three articles seem to be more logically integrated. Suppose article 38 and 47 are discretionary clauses, it means that the shareholders’ meeting may delegate their powers authorized by the company law to the board of directors. In this situation, it is difficult for the shareholders to seek remedies when their interests are illegally infringed by employing the article 22, as this delegation is in accordance with the articles of association, and not against the law. Consequently, the article 22 can not provide shareholders with any help at this point.

As is discussed above, it is appropriate to summarize that: (1) The article of association may enlarge the scope of powers; (2) The articles of association may decide the powers which are not authorized by the company law; (3) The powers stipulated in the articles of company law are mandatory, which can not be changed or delegated through the articles of association.<sup>21</sup> In addition to critics from academic arena, in practice, some legal documents and administrative regulations can be referred to backup this interpretation. For example, Guideline on the Articles of Association for Listed Companies issued by China Securities Regulatory Commission (CSRC) article 40 and article 107 listed 16 powers of shareholders’ meeting and the BOD, and 10 powers thereof are provided by the company law. Special attention should be paid to the end of these two article is that they added notes stating “above powers of shareholders’ meeting are not allowed to be exercised by the BOD, other institutions and individuals by means of authorization. And the matters out of the scope of shareholders’ meeting authorization shall be submitted to the general shareholders’ meeting for examination.”<sup>22</sup> It is clear that the company law and related regulations follow the principle of “shareholder primacy”.

## II. WHAT IS THE ROLE OF COMPANY LAW?

After the textual analysis of powers allocation between the BOD and the SHM, the author seeks to find the theoretical principles behind the statutory law. Why the company law codes around the world are categorized to enabling rules and mandatory rule?

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<sup>21</sup> Most scholars engaging in amending the company law (2005) also support this argument. *See* ZHAO XUDONG, TEXTUAL INTERPRETATION FOR THE NEW COMPANY LAW, 96 (2005). *See also* JIANG PING & LI GUOQUANG, UNDERSTANDING AND APPLYING THE NEW COMPANY LAW, 29 (2005).

<sup>22</sup> *See* article 40 and article 107 of Guidelines on the Articles of Association for Listed Companies (2006).

Company law codes can be perceived as products.<sup>23</sup> Its producers are states and consumers are companies. What kind of products do states offer to their customers? This is one of the central and fundamental question that concerns the states' choice of product attributes: what is the role of company law? Frank Easterbrook and Daniel Fischel argue that the company law codes seem to be the contractual context of the company by taking an enabling approach. The company law provides a standard-form contract to companies that will use for their particular needs.<sup>24</sup> Their focus is on the importance of efficient capital markets in maintaining an enabling structure.<sup>25</sup> However, Jeffery Gordon contends that many provisions in the company law codes are mandatory, which allocate power throughout the governance structure, in particular, affecting the balance of power between directors and shareholders.<sup>26</sup> A U.S. scholar categorized the provisions of the Model Business Corporation Act by whether they were mandatory or enabling, and found that almost half of all the provisions are mandatory.<sup>27</sup>

If all the parties would voluntarily make their own rules or if companies may easily sidestep them, is the rule mandatory in a meaningful sense? For example, how much do you think investors would make investment to a new company whose articles of association contains a provision that delegate the power of electing directors from the SHM to the BOD? Is it plausible that shareholders would vote to amend the articles of association to permit directors or managers to steal companies' assets by rescinding the powers allocation authorized by the company law code? To the author's view, perhaps, it may occur, only in some exceptional circumstances. For example, in a very small sized and closed company, shareholders want to advance the efficiency of decision making process. In this case, more supplementary provisions should be added in the articles of association in order to secure future shareholders' interest. However, it will never be the normal case. Particularly, taking into account the China's underdeveloped corporate governance mechanism, the short history of Chinese company law plus the transitional economy, it is premature to give more powers which are franchised to shareholders to the BOD.

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<sup>23</sup> See ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW*, 114 (2d ed, 2010).

<sup>24</sup> Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM.L.REV. 1416 (1989).

<sup>25</sup> They contend that terms of corporate charter are priced in an efficient market, and investors will not bear the cost of harmful provisions.

<sup>26</sup> See Jeffery Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM.L.REV. 1549 (1989).

<sup>27</sup> See MacKerron, *A Taxonomy of the Revised Model Business Corporation Act*, 61 U.M.K.C. L. REV. 663 (1993).

## CONCLUSION

It is reported that, in practice, shareholders in some relatively small sized companies prefer to take more powers from the BOD, as it is much easier for them to convene a shareholders' meeting in order to decrease the cost for the company and to avoid the delay of decision making. In contrast, in big sized companies, especially in listed companies, due to the large number of shareholders and their passivity on the management, it seems more appropriate to give more powers owned by the SHM to the BOD.<sup>28</sup> In Delaware, US, a well known and often quoted opinion states "If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."<sup>29</sup> However, in China, because of many unspoken reasons<sup>30</sup>, shareholders do not in fact have at their disposal those "powers of corporate democracy." The current Chinese company law has clearly divided the fundamental corporate powers via article 38 and article 47, which should be treated and applied as mandatory rules. Although it seems not flexible to make various companies to adapt to the newly developed market, it is premature to change this mechanism into a more sophisticated one. We still need to let shareholders set the rules.<sup>31</sup>

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<sup>28</sup> Xu Hao, *Challenge on the Terms Revealing All Details of Powers of Shareholders' Meeting and the Board of Directors*, 4 NORTHERN LAW 24, 82 (2010).

<sup>29</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985).

<sup>30</sup> For example, Guanxi network, particular Chinese culture, i.e., 面子 (Mianzi) [face].

<sup>31</sup> See Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV.L.REV. 1784, 1813 (2006).