



# Corporate Governance

## Board structures and directors' duties in 42 jurisdictions worldwide

# 2009

Contributing editors: Ira Millstein and Holly Gregory



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# China

**Matthew McKee, Sherry Guo and Wei Wei Ye**

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## Sources of corporate governance rules and practices

### 1 Primary sources of law, regulation and practice

What are the primary sources of law, regulation and practice relating to corporate governance?

Regulations governing this area include:

- the Company Law of the People's Republic of China (2005);
- the Securities Law of the People's Republic of China (2005);
- Code of Corporate Governance for Listed Companies;
- Measures for the Administration of Listed Companies Issuing New Shares;
- Measures for the Administration of the Takeover of Listed Companies (Takeover Measures);
- Administrative Regulations on Company Registration;
- Provisions on Registration Administration of Legal Representatives of Enterprise Legal Persons;
- Shanghai Stock Exchange Trading Rules; and
- Basic Standard for Enterprises' Internal Control.

### 2 Responsible entities

What are the primary government agencies or other entities responsible for making such rules and enforcing them? Are there any well-known shareholder activist groups whose views are often considered?

The primary agencies are:

- the China Securities Regulatory Commission (CSRC);
- the Ministry of Commerce (MOFCOM);
- the Administration for Industry and Commerce (AIC);
- the Ministry of Finance;
- the Shanghai Stock Exchange; and
- the Shenzhen Stock Exchange.

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## Rights and equitable treatment of shareholders

### 3 Shareholder powers

What powers do shareholders have to appoint or remove directors or require the board to pursue a particular course of action?

Shareholders with a majority of the voting rights have the authority to appoint and remove directors. Article 152 of the Company Law provides shareholders with the right to commence a derivative action on behalf of the company to prevent or remedy injury to the company. The requirement to commence a derivative action is that the shareholders must hold 1 per cent or more of the total shares of the company.

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### 4 Shareholder decisions

What decisions must be reserved to the shareholders?

The following decisions must be made by the shareholders (subject to any qualifications mentioned). The decisions must be approved by more than half the voting rights:

- a decision to provide a guarantee to a shareholder or actual controller of the company (article 16 of the Company Law);
- important matters, such as the transfer or acceptance any significant asset or to provide a guarantee for any other person (article 105 of the Company Law);
- determining the company's operational guidelines and investment plans (article 38 of the Company Law);
- electing and changing the directors and supervisors assumed by non-representatives of the employees and deciding the matters relating to their salaries and compensation (article 38 of the Company Law);
- deliberating and approving reports of the board of directors (article 38 of the Company Law);
- deliberating and approving annual financial budget plans and final account plans of the company (article 38 of the Company Law);
- deliberating and approving company profit distribution plans and loss recovery plans (article 38 of the Company Law);
- making resolutions about the increase or reduction of the company's registered capital (article 38 of the Company Law);
- making resolutions about the issuance of corporate bonds (article 38 of the Company Law);
- adopting resolutions about the assignment, split-up, change of company form, dissolution, liquidation of the company (article 38 of the Company Law);
- revising the by-laws of the company (article 38 of the Company Law);
- other functions as specified in the by-laws (article 38 of the Company Law).
- where a listed company purchases or sells any important asset, or provides guarantees that exceed 30 per cent of the company's total assets within a year, such actions shall be authorised by the resolutions made by the shareholders' assembly and adopted by the shareholders representing two-thirds of the voting rights of the shareholders who attend the assemblies (article 122 of the Company Law); and
- a decision for the company to purchase its own shares (article 143 of the Company Law).

Any resolution made at a shareholders' meeting on revising the by-laws, increasing or reducing the registered capital, mergers, split-ups, dissolution or change of the company form shall be adopted by the shareholders representing two-thirds or more of the voting rights.

**5 Disproportionate voting rights**

To what extent are disproportionate voting rights or limits on the exercise of voting rights allowed?

**Limited companies**

Article 43 of the Company Law provides that in respect of limited liability companies, '[t]he shareholders shall exercise their voting rights at the shareholders' meetings based on their respective percentage of the capital contributions unless it is otherwise prescribed by the by-laws.' Accordingly, the question of limits on the exercise of voting rights is dependent upon the by-laws of the company.

**Joint-stock companies**

Article 104 of the Company Law states that shareholders attending meetings of joint-stock companies shall have one vote for one vote held. Shares held by the company shall not have voting rights. However, article 127 provides that the same class of shares should carry the same rights implying that the company may issue different classes of shares with different rights. Given the express terms of article 104, it is unclear whether companies are permitted to have shares with different voting rights.

**6 Shareholders' meetings and voting**

Are there any special requirements for shareholders to participate in general meetings of shareholders or to vote?

No.

**7 Shareholders and the board**

Are shareholders able to require meetings of shareholders to be convened, resolutions to be put to shareholders against the wishes of the board or the board to circulate statements by dissident shareholders?

**Limited companies**

Shareholders that individually or collectively hold more than 10 per cent of the voting rights in the company may request a meeting of the shareholders.

**Joint-stock companies**

Shareholders that individually or collectively hold more than 10 per cent of the shareholdings in the company may request a meeting of the shareholders. Shareholders individually or collectively holding more than 3 per cent of the shareholdings may submit a written proposal of an interim agenda for a shareholders' meeting to the board of directors. The directors must inform the other shareholders of the proposal within two days of receipt.

**8 Controlling shareholders' duties**

Do controlling shareholders owe duties to the company or to non-controlling shareholders? If so, can an enforcement action against controlling shareholders for breach of these duties be brought?

Specifically, under article 21 of the Company Law, controlling shareholders, or the 'actual controller' owe a duty not to injure the interests of the company by taking advantage of their relationship with the company. Any one shareholder that causes any loss to the company by breaching that duty is liable for the compensation. As noted above, shareholders can bring a derivative action in the name of the company pursuant to article 152 of the Company Law.

It should also be noted that all the shareholders of a company owe a duty to abide by the laws, administrative regulations and by-laws and shall exercise shareholders' rights under the law. None of them may injure any of the interests of the company or of other shareholders by abusing shareholders' rights, or injure the

interests of any creditor of the company by abusing the independent status of a legal person or the shareholders' limited liabilities. Where any of the shareholders of a company causes any loss to the company or to other shareholders by abusing shareholders' rights, it shall be liable for compensation.

**9 Shareholder responsibility**

Can shareholders ever be held responsible for the acts or omissions of the company?

Where any of the shareholders of a company evade the payment of debts by abusing the independent status of legal person or the shareholders' limited liabilities, if it seriously injures the interests of any creditor, it shall bear several and joint liability for the debts of the company.

Further, under article 64 of the Company Law, if the shareholder of a one-person limited liability company is unable to prove that the property of the one-person limited liability company is independent from his or her own property, he or she shall bear joint liability for the debts of the company.

**Corporate control****10 Anti-takeover devices**

Are anti-takeover devices permitted?

The anti-takeover methods available to the board of directors are very limited. Further, given the ambiguity between article 104 and 127 it is unclear whether a company can utilise a dual share structure as a takeover defence.

**11 Restrictions on the transfer of fully paid shares**

Are restrictions on the transfer of fully paid shares permitted, and if so what restrictions are commonly adopted?

**Limited companies**

Under article 72 of the Company Law, where a shareholder intends to transfer his/its stock rights to any one other than the shareholders, he shall obtain the consent from more than half of the other shareholders. This rule may be displaced or altered in the by-laws.

**Joint-stock companies**

Article 138 of the Company Law provides that 'shareholders may transfer their shares in accordance with the provisions of the law'. Further, article 142 provides that 'the articles of association may make restrictive provisions on the transfer of shares of the company held by directors, supervisors and senior management personnel.' From the article, it would seem that a company is not able to ordinarily place restrictions on the transfer of shares.

**12 Compulsory repurchase rules**

Are compulsory share repurchase rules allowed? Can they be made mandatory in certain circumstances?

Article 143 of the Company Law provides that a company shall not purchase its own shares, except under any of the following circumstances:

- to decrease the registered capital of the company;
- to merge with another company holding shares of this company;
- to award the employees of this company with shares; or
- it is requested by any shareholder to purchase his or her shares because this shareholder objects to the company's resolution on a merger or split-up made by the assembly of shareholders.

Any share repurchases made pursuant to points one to three must be approved by the shareholders in a general meeting.

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### Responsibilities of the board (supervisory)

#### 13 Board structure

Is the predominant board structure for listed companies best categorised as one-tier or two-tier?

The predominant board structure for listed companies in China is two-tier. The shareholders' meeting is considered as the 'supreme organ of power' in a company. The Company Law empowers the shareholders' meeting to exercise wide decision-making powers, including some powers that are normally exercised by the board, such as approval of business operation and investment plan and annual financial budget and final accounts. In practice, such arrangement is inefficient in decision-making and often results in a slow response to rapidly changing market situations.

Directors are appointed by shareholders and are accountable to shareholders. Similar to the shareholders' meeting, the powers of the board of directors are also provided in the Company Law. As the shareholders' meeting has a wider range of decision-making powers, consequently the powers of the board are narrow. The main function of the board is to implement resolutions of the shareholders' meeting. However, the law does recognise that the board is a decision-making organ and the executive powers are given to company managers, who are subject to the appointment and dismissal by the board. In this way, the board and managers jointly formulate the management in a listed company. However, in practice, the board often faces the dilemma of confronting a powerful shareholders' meeting and a strong CEO.

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#### 14 Board's legal responsibilities

What are the board's primary legal responsibilities?

According to the Company Law of PRC, the board's primary legal responsibilities are as follows:

- convening shareholder's meetings and presenting reports thereto;
- implementing the resolutions made at the shareholders' meetings;
- determining the company's business and investment plans;
- working out the company's annual financial budget plans and final account plans;
- working out the company's profit distribution plans and loss recovery plans;
- working out the company's plans on the increase or reduction of registered capital, as well as on the issuance of corporate bonds;
- working out the company's plans on mergers, splits, changes of the company form, or dissolution, etc;
- making decisions on the establishment of the company's internal management departments;
- making decisions on hiring or dismissing the company's manager, vice managers and financial managers and their salaries and compensation;
- working out the company's basic management system; and
- other functions as specified in the by-laws.

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#### 15 Board obligees

Whom does the board represent and to whom does it owe legal duties?

Directors are elected by shareholders. They are fiduciaries of the company and its shareholders. The board represents the company and shall be responsible for the shareholders' meeting. The Code

of Corporate Governance for Listed Companies in China provides that all directors shall faithfully, honestly and diligently perform their duties for the best interests of the company and all the shareholders. Directors shall attend the board of directors meeting in a diligent and responsible manner, and shall express their clear opinion on the topics discussed. In cases where the resolution of the board of directors violates laws or regulations or a listed company's articles of association and causes losses to the listed company, the directors responsible for making such resolutions shall be accountable for compensation, except those proved to have objected and the objections of whom have been recorded in the minutes.

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#### 16 Enforcement action against directors

Can an enforcement action against directors be brought on behalf of those to whom duties are owed?

Yes. According to article 152 and 153 of the Company Law, if any director causes any loss to the company by violating any law or regulation, any shareholder, the board of supervisors, the board of directors or the acting director may have the rights to file a lawsuit against such directors in the people's court.

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#### 17 Care and prudence

Do the board's duties include a care or prudence element?

Yes. According to article 148 of the company law, all the directors, supervisors and senior managers shall bear the obligation of fidelity and diligence to the company. Any act inconsistent with the obligation of care or prudence is illegal and the income received from the violation of care or prudence shall belong to the company.

The board's care and prudence duty requires the members of board not to engage in any following activities:

- misappropriating the company's funds;
- depositing the company's funds into an account under his or her own name or any other individual's name;
- without consent of the shareholders' meeting, shareholders' assembly, or the board of directors, loaning the company's funds to others or providing any guarantee to any other person by using the company's property as in violation of the by-laws;
- entering a contract or trading with this company by violating the by-laws or without consent of the shareholders' meeting or shareholders' assembly;
- without consent of the shareholders' meeting or shareholders' assembly, seeking business opportunities that belong to the company for himself or herself or any other persons by taking advantages of his or her powers, or operating similar business of the company for which he or she works for himself or herself or for any other persons;
- taking commissions on the transactions between others and the company into his or her own pocket;
- illegally disclosing the company's confidential information; and
- other acts inconsistent with the obligation of fidelity to the company.

The income of any director or senior manager from any act in violation of the above list shall belong to the company.

Furthermore, if this kind of violation is serious enough, the directors in charge may face criminal penalties.

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#### 18 Board member duties

To what extent do the duties of individual members of the board differ?

There is currently no specific law or regulation in China regarding the difference of duties of individual members depending on their vari-



ous skills and experience, etc. Generally, all board members own the same fiduciary duties regardless of their individual skills. However, directors in charge of certain specific works shall bear more responsibilities than others, because they more actively participate in and have greater knowledge of this area.

### 19 Delegation of board responsibilities

To what extent can the board delegate responsibilities to management, a board committee or board members, or other persons?

The Company Law of PRC generally lists the responsibilities of the shareholders' meeting, the board and managers. Apart from those statutory responsibilities, the board has the authority to delegate day-to-day management and other aspects of its responsibilities to management or other persons. See question 14 regarding the statutory responsibilities of the board. The following are the managers' statutory responsibilities provided in the Company Law:

- taking charge of the management of the production and business operations of the company, organising the implementation of the resolutions of the board of directors;
- organising the execution of the company's annual business plans and investment plans;
- drafting plans on the establishment of the company's internal management departments;
- drafting the company's basic management system;
- formulating the company's specific rules and policies;
- proposing to hire or dismiss the company's vice managers and the person in charge of finance;
- deciding on the hiring or dismissal of the persons-in-charge other than those who shall be decided by the board of directors; and
- other powers conferred by the board of directors.

If the by-laws provide otherwise for the powers of managers, the by-laws shall be followed.

### 20 Non-executive and independent directors

Is there a minimum number of 'non-executive' or 'independent' directors required by law, regulation or listing requirement? If so, what is the definition of 'non-executive' and 'independent directors' and how do their responsibilities differ from executive directors?

Currently in China, there is no specific regulation regarding the minimum number of 'non-executives', which are also called outside directors, but in practice, the number of non-executive directors shall not be less than half of the total number of directors. The number of independent directors is one-third or more of the total number but shall not less than two.

'Non-executive' directors mean those who do not have any title in the company besides the title of 'director', but may have another relationship with the company to some extent. 'Independent' directors mean those who are independent from the company and shareholders. According to the Regulation on the Supervision and Administration of Securities Companies, independent directors shall assume no other posts except independent directors in the securities company that may disturb independence and objective judgement. Therefore, independence is the main difference between 'non-executive' and 'independent' directors and the scope of non-executive directors is obviously larger than independent directors. The board of directors, the board of supervisors, or any shareholders who separately or jointly hold 5 per cent of the shares of the listed companies can nominate candidates for independent director.

Independent directors have the following special powers other than those stipulated in the Company Law and other relevant laws and regulations:

- major related-party transactions (referring to transactions that a listed company intends to conclude with a related party and whose total value exceed 3 million renminbi (approximately US\$438,000) or 5 per cent of the company's net assets audited recently) should be approved by the independent directors before being submitted to the board of directors;
- to put forward the proposal to the board of directors relating to the appointment or removal of the accounting firm;
- to propose to the board of directors to call an interim shareholders' meeting;
- to propose to call a meeting of the board of directors;
- to appoint the outside auditing or consulting organisation independently; and
- to solicit the proxies before the convening of the shareholder's meeting.

### 21 Board chairman and CEO

Do law, regulation, listing rules or practice require separation of the functions of board chairman and CEO? If flexibility on board leadership is allowed what is generally recognised as best practice and what is the common practice?

There is no law or regulation requiring separation or joining of the functions of board chairman and CEO. However, according to the Company Law, the chairman may be appointed as the CEO or general manager simultaneously and either of them may be the legal representative of the company. The chairman shall report to the board while the CEO is appointed or dismissed by the board to which he should be responsible.

### 22 Board committees

What board committees are mandatory? What board committees are allowed? Are there mandatory requirements for committee composition?

According to the Rules on the Governance of Listed Companies issued by the Ministry of Commerce and State Security Supervision Commission jointly in 2002, the board of listed companies may establish certain special committees such as an audit committee, strategy committee, nomination committee, compensation committee, etc. All the special committees shall be composed of directors and independent directors shall not be less than one-half. In the audit committee, there should be at least one independent director who is a professional accountant.

### 23 Board meetings

Is a minimum or set number of board meetings per year required by law, regulation or listing requirement?

#### Limited companies

For a limited liability company, the board of directors shall be composed of three to 13 members while a relatively small limited liability company with a relatively small number of shareholders may have an executive director and no board of directors. There is no special requirement of the number of board meetings.

#### Joint-stock companies

For a joint-stock limited company, the board of directors shall be composed of five to 19 persons. The board of directors shall convene at least two meetings every year and shall give a notice to all directors and supervisors 10 days before it holds a meeting.

**24 Board practices**

Is disclosure of board practices required by law, regulation or listing requirement?

The discussion methods and voting procedures of the board of directors shall be ruled by the by-laws unless there are special provisions. Shareholders have the right to review and duplicate the company's by-laws as well as the resolutions of the board of directors' meetings and it is one way of disclosure of board practices. Shareholders have the right to ask directors to attend the shareholders' meeting and answer the shareholders' inquiries.

The Chinese Company Law specially provides that shareholders shall have the right to supervise the board of directors.

Of course, board of supervisors' meetings have the right to supervise the board of directors and may engage in a survey if necessary.

**25 Remuneration of directors**

Is there any law, regulation, listing requirement or practice that affects the remuneration of directors, the length of directors' service contracts, loans to directors or other transactions between the company and any director?

The Chinese Company Law provides that shareholders meeting may decide remuneration of directors. The term of office of the directors shall be provided for by the by-laws, but each term of office shall not exceed three years. It is different for a joint-stock company.

It is also strictly limited for a company to transact with directors or companies closely related with the directors. For example, directors do not have the right to vote in the board meetings for the special transaction related to him or her.

**26 Remuneration of senior management**

How is the remuneration of the most senior management determined? Is there any law, regulation, listing requirement or practice that affects the remuneration of senior managers, loans to senior managers or other transactions between the company and senior managers?

The board of directors has the right to employ the manager as well as deciding his or her remuneration, while shareholders may vote to elect their directors and to decide their remuneration.

Transactions between directors and companies shall not violate the by-laws of the company. In other words, directors may transact with the company within the condition of the company by-laws. It is the right of shareholders meeting to decide the by-laws. So, shareholders may vote for transactions between directors and companies.

It is much harder for a listed company to do transaction with its directors. For example, directors shall not vote for the transactions where they are in conflict nor shall they vote on behalf of other directors.

**27 D&O liability insurance**

Is directors' and officers' liability insurance permitted or common practice? Can the company pay the premiums?

Presently, no law requires D&O insurance to be maintained, but in practice more and more people are taking up D&O insurance. The company may pay the premiums. It should be noted that the effectiveness of global 'best efforts' policies has not yet been established.

**28 Indemnification of directors**

Are there any constraints on the company indemnifying directors in respect of liabilities incurred in their professional capacity? If not, are such indemnities common?

Generally speaking, there are no restrictions on director indemnification. However, it is unlikely that a court would uphold an indemnity in relation to a derivative action brought by a shareholder on behalf of the company as this would be inconsistent with the legal rights conferred on shareholders under the Company Law. Indemnity agreements are not presently common.

**29 Employees**

What role do employees play in corporate governance?

Employees usually play no formal role in corporate governance. However, the Company Law requires the board of supervisors to have representatives of the employees at an appropriate ratio who are responsible for governing the company on behalf of the employees. Further, trade unions may have a role in corporate governance. For example, to make a decision on restructuring or any important issue relating to business operations, or to formulate any important by-laws, a company needs to solicit the opinions of its labour union, and needs to solicit the opinions and proposals of the employees through the assembly of the representatives of the employees.

**Disclosure and transparency****30 Corporate charter and by-laws**

Are the corporate charter and by-laws of companies publicly available? If so, where?

Both corporate charter and by-laws of companies are publicly available.

The general public may go to a company registration authority to search and consult the registration information filed by a company and the authority shall provide the research services for the public. The public may also go to the local authorities of Administration of Industry and Commerce to look up a corporate charter with his or her ID.

Chinese Company Law provides that to establish a company, by-laws are required. Shareholders shall have the right to review and duplicate the company's by-laws. If a member of the public wants to review the by-laws of certain companies, he or she may go to the Authorities of Administration of Industry and Commerce that are charge of the companies' registration.

**31 Company information**

What information must companies publicly disclose? How often must disclosure be made?

Information disclosure is most important for listed companies. With economic development, China has established relatively good listed company information disclosure systems.

More and more listed companies have begun to buy D&O insurance. For example, many listed companies pass the proposal to buy D&O insurance for directors and senior managers.

Generally, listed companies shall disclose information including: prospectus (the issuance of corporate bonds documents of raising fund), list company statements, the periodic reports, including annual reports and midterm reports, temporary reports, stock holdings of directors, supervisors and senior managers, information required by the security office, and other information.

Information disclosure shall be within the period required by law. For example, a listed company shall, within four months as of the

end of each accounting year, submit report to the securities regulatory authority and shall within two months as of the end of the first half of each accounting year, submit report to the securities regulatory authority.

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#### Hot topics

##### 32 Say-on-pay

Do shareholders have an advisory or other vote regarding executive remuneration?

It is the right of the shareholders' meeting to appoint, and decide the remuneration of directors, but for the board of directors to appoint, and decide the remuneration of managers. Basically, minority shareholders have little influence on decisions on remuneration of senior management.

##### 33 Proxy solicitation

Do shareholders have the ability to nominate directors without incurring the expense of proxy solicitation?

It is the right of the shareholders' meeting to elect and change directors assumed by non-representatives of the employees and deciding the matters relating to their salaries and compensation. In practice, to nominate directors is quite an important right in corporations, but it is difficult for shareholders, especially minority shareholders, to exercise their rights.

To solve this problem, the Chinese Company Law provides a rescue method. Shareholders separately or in aggregate holding 3 per cent or more of the shares of the company are entitled to put forward a written interim proposal to the board of directors 10 days before shareholders' meetings are held. The board of directors may notify other shareholders within two days and submit the interim proposal to the meeting of the shareholders' assembly for deliberation. Shareholders may nominate their directors in their proposal.

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