

THE DUTY OF LOYALTY OF COMPANY DIRECTORS IN CHINA: TRACING ITS ORIGINS AND PLUGGING THE GAPS

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The duty of loyalty is a core duty under the legal framework for directors' duties. The concept as borrowed by China originates from the UK and has further developed into many variations across common law jurisdictions. The different legal environments and development history lead to divergences in elaborating the duty in common law jurisdictions. The divergences can provide useful references for countries that have adopted and intend to improve the duty so as to enrich the content of the duty and plug any gaps. Chinese company law is still struggling to deal with the abstract nature of the duty, its scope of application and the test to apply in determining whether it has been breached. In practice, the Chinese judiciary is attempting to understand the duty. Nonetheless, their efforts are not entirely successful because the law omits several core aspects of the duty: the test for determining whether the duty has been breached, the ability to contract out of the duty and an applicable definition or understanding of a conflict of interest. The common law literature can be used as a starting point to sketch out a reasonable structure for the design of a better duty of loyalty in China.

I INTRODUCTION

Director's duties comprise an intrinsic part of company law. Professors Jensen and Meckling argue that the most significant internal problem of a firm is managerial self-dealing and shirking caused by asymmetric information between the firm's management and beneficiaries.¹ The problem is termed the 'agency problem', which is an integral part of company law research.² Company law designs many mechanisms to mitigate costs incurred by the agency problem so that a company can be an efficient way to organize business to maximize the return of investors.³ The quintessential mechanism for alleviating the agency problem are directors' duties. The duties are designed to provide a sufficient deterrence *ex ante*, and comprehensive remedies *ex post*, to police and penalize managerial self-interested conduct.

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¹ See, e.g., Michael Jensen, William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305-360.

² Reinier H Kraakman, Et Al., *The Anatomy Of Corporate Law: A Comparative And Functional Approach* (Oxford University Press, 2017) 35.

³ Id, 35-40.

Director's duties arguably have two primary components: a duty of care and a duty of loyalty.⁴ The former deals with the managerial shirking issue.⁵ It focuses on constructing a standard to assess whether directors and managers have exercised their utmost care in tending to corporate business.⁶ However, when personal interests conflict with the firm's interests, the duty of care is powerless, and the duty of loyalty applies to protect the corporate interest. In practice, the majority of the directors' duties cases relate to disloyal managerial conduct, rather than shirking. In order to encourage entrepreneurship, company law usually requires the judiciary to refrain from second-guessing business decisions.⁷ Nonetheless, company law has traditionally been rigorous with respect to self-interested dealings, given that directors and managers by nature should prioritize the company's interests before their own when managing company business⁸ and that the duty to avoid a conflict of interest is a central part of the fiduciary duty of directors. The modern duty of loyalty originates from common law jurisdictions. Non-common law jurisdictions have for centuries been transplanting and modifying the duty and their experience provides a spectrum for observing and explaining the duty in practice. China is an interesting case in point.

China introduced the duty of loyalty during the promulgation of the first version of the company law in 1993.⁹ Nevertheless, before 2005, it was debatable whether China had established a workable mechanism for directors' duties.¹⁰ After an exhaustive overhaul of company law in 2005, an explicit expression was inserted in the company law to require the duty of loyalty. While the expression of the duty was simplistic and abstract, the most recent version of the company law, the Company Law of the People's Republic of China 2018 (Company Law 2018), maintains the simplicity of the 2005 description of the duty.¹¹ Article 147 of the Company Law 2018 stipulates as follows:

⁴ See Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?* 83 S. CAL. L. REV. 1231, 1301 (2010).

⁵ *Supra* note 1.

⁶ IAN RAMSAY, ROBERT AUSTIN, *COMPANY DIRECTORS: PRINCIPLES OF LAW AND CORPORATE GOVERNANCE* § 6 (2nd ed, 2020).

⁷ For example, Delaware law recognises a strong business judgment rule presumption in favour of directors, which operates as a de facto standard of review requiring proof of gross negligence, bad faith or a conflict of interest to find directors culpable. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM LAW REVIEW, 440, 437 (1993).

⁸ Tamar Frankel, *Fiduciary Law* 108 (Oxford University Press, 2011).

⁹ See e.g. Xudong Zhao [赵旭东], *Open-up Policy and Chinese Commercial Law Development* [改革开放与中国商法的发展], Vol.8 LEGAL SCIENCE [法学], 1- 16 (2018).

¹⁰ Ciyun Zhu, *The Internationalization and Adaptation of Chinese Company Law: History, development and future since open-up* Vol.2 EASTERN LAW REVIEW, 91, 94-95 (2020).

¹¹ *Id.*

The directors, supervisors and senior managers shall comply with the laws, administrative regulations, and bylaws. They shall bear the obligations of loyalty and diligence to the company.

No director, supervisor or senior manager may accept any bribe or other illegal gains by taking advantage of their powers, or encroach on the property of the company.

The provision imposes two duties on directors and other managerial staff: a duty of diligence (arguably the equivalent of a duty of care) and a duty of loyalty (also translated from the Mandarin as a duty of fidelity).¹² The second paragraph offers further explanations as to what the duty of loyalty is, but creates difficulties in terms of applying it in practice and leaves many questions unanswered.¹³ For instance, what is the duty of loyalty? Should there be a conflict of interest element in identifying any contravention of the duty? What, then, is a conflict of interest? What is an illegal gain? The amorphous nature of the statutory duty of loyalty calls for further clarification. Since 2005, the Chinese judiciary has, in practice, applied the article to police disloyal conduct on the part of directors, despite the uncertainties involved. Further, the Supreme People's Court (SPC) has enacted some judicial interpretations to facilitate the performance of the duty of loyalty.¹⁴ There is, however, a question as to how the duty is enforced in China. Given the fact that China's economy is the most dynamic and the second-largest in the world, the legal mechanisms and practices that reduce agency costs in a corporate context have attracted particular attention from both domestic and international investors. This Article traces the duty of loyalty in China as borrowed from the common law duty of loyalty, identifies its gaps and proposes how those gaps might best be plugged in the light of the unique local settings in China.

Part II of the article traces the origins of the duty of loyalty in common law jurisdictions and undertakes an in-depth discussion of the statutory duty of loyalty in China from a normative perspective. Part III analyzes gaps in connection with the statutory duty of loyalty and undertakes a case study of the Chinese judiciary in applying the legislation. Part IV offers some preliminary solutions for plugging the gaps and comments on the practice of the Chinese judiciary. Part V concludes.

II DUTY OF LOYALTY IN CHINA

¹² Charlie (Xiao-chuan) Weng, A Promising Path or a Dead End? Director's Duty of Care in China, *UNSW LAW JOURNAL*, forthcoming (2022).

¹³ Zhu, *supra* note 10.

¹⁴ To date there are five judicial interpretations from the Supreme People's Court of China. For all the interpretations see <http://www.court.gov.cn/fabu-gengduo-16.html>.

A The Origins of the Duty of Loyalty

The modern duty of loyalty from which Chinese law has borrowed originates from English fiduciary law.¹⁵ It is widely recognized that the duty of loyalty is a quintessential part of the fiduciary duties owed by directors to the company.¹⁶ Put simply, a fiduciary duty is a principle of equity that requires a fiduciary to refrain from any self-interested dealing that would be at the expense of their beneficiary.¹⁷ In the 1880s, the English common law believed that self-dealing transactions by directors without authorization or ratification were voidable by the company.¹⁸ Of course, the contents of fiduciary duties now differ between jurisdictions. For example, fiduciary duties include the duty of care in most of the US states, while Australian case law and scholarships explicitly exclude the duty of care from fiduciary duties.¹⁹ However, common law jurisdictions commonly accept that the duty of loyalty is a quintessential part of fiduciary duties.²⁰ Even though the duty of loyalty has evolved in common law jurisdictions in ways that make the elements of the modern duty of loyalty differ significantly across jurisdictions, the origins for the development of the duty, from the perspective of a fiduciary obligation, are the same: the no-conflict rule and the no-profit rule.²¹

The no-conflict rule can be traced back to *Aberdeen Railway Co v Blaikie Brothers* and is designed to prevent a director from ‘entering into engagements in which [they have], or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom [they are] bound to protect.’²² In *Boardman v Phipps*, Lord Upjohn described the no-profit rule as the ‘fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of his trust which is part of the wider rule that a trustee must not place himself in a position of conflict.’²³ The focus of the no-profit rule in the context of directors has been

¹⁵ David Kershaw, *The Foundations of Anglo-American Corporate Fiduciary Law* 285 (Cambridge University Press, 2018).

¹⁶ *Id.*, 285-290.

¹⁷ *Keech v Sandford*, (1726) Sel Cas Ch 61.

¹⁸ See James Edelman, *The Fiduciary Self-Dealing Rule*, in *Fault Lines in Equity* 107 (Jamie Glistler & Pauline Ridge eds, Hart: 2012) (arguing that self-dealing transactions are void).

¹⁹ For the US view on the contents of fiduciary duty: see generally Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?* 83 S. CAL. L. REV. 1231 (2010) (arguing there are five fiduciary duties in the US); For Australian view on the contents of fiduciary duty: *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109; See Pamela Hanrahan, Ian Ramsay and Geof Stapledon, *Commercial Applications of Company Law* (13th ed.), CCH Australia, 2012, 20; Jennifer G. Hill, *Shifting Contours of Directors’ Fiduciary Duties and Norms in Comparative Corporate Governance* (ECGI, Law Working Paper N° 489/2020, January 2020, 10; 5 U.C. Irvine Journal of International Transnational & Comparative Law 163, 173 (2020).

²⁰ Kershaw, *supra* note 15, 285-290.

²¹ Stephen Bottomley et al., *Contemporary Australian Corporate Law*, 355 (Cambridge University Press, 2020)

²² *Aberdeen Railway Co v Blaikie Brothers* (1854) 1 Macq 461, 471.

²³ *Boardman v Phipps* (1967) 2 AC 46, 123.

placed on whether consent from the beneficiary can counter a claim of breach of fiduciary obligation.²⁴

The two rules are overlapping but distinct.²⁵ However, the elements of the current duty of loyalty in modern company law are justified by, and originate from, the two rules. As a preventative approach to avoiding managerial self-dealing, disclosure has been widely used in common law jurisdictions as a vital part of the duty of loyalty.²⁶ When a conflict exists, any non-disclosure can lead to sanctions, regardless of whether or not harm has been done to a firm.²⁷ In the event that some damage has been incurred, an *ex post* investigation into whether the position or information of a firm has been abused becomes the primary avenue to afford a remedy to a firm.²⁸ Further, in order to protect the interests of a public company, company law usually demands that transactions with related parties be subject to heightened scrutiny.²⁹ The rules on disclosure and related party transactions sketch out a comprehensive duty of loyalty framework in most modern company laws, including China's company law.

There are at least three primary areas that are the linchpins to defining the duty of loyalty: the test that courts apply in determining whether the duty has been breached (the 'test for breach'); the ability to contract out of the duty; and its definition.³⁰ They are critical for the following two reasons: first, a certain degree of divergence in some areas that has occurred in the process of their development reflects the values of different development paths, which could affect how to assess an optimal duty of loyalty for a developing jurisdiction such as China; secondly, they are the core issues in the implementation of the duty. Any uncertainty or vagueness could seriously diminish the effectiveness of the duty.³¹ These three areas are outlined below.

1 *The Test for Breach – the Entire Fairness Approach or the Absolute Approach?*

The test for breach follows idiosyncratic logic across common law jurisdictions. US jurisdictions emphasize the significance of the concept of 'entire fairness' when

²⁴ Bottomley, *supra* note 21, 360

²⁵ *Chan v Zacharia* (1984) 154 CLR 178, 199.

²⁶ PAUL REDMOND, *CORPORATIONS AND FINANCIAL MARKETS LAW* 529 (7th ed, 2017). See Corporations Act 2000 (Cth) of Australia, s 191(1).

²⁷ Ramsay and Austin, *supra* note 6, 344.

²⁸ Redmond, *supra* note 26, 529-35.

²⁹ Kraakman et al, *supra* note 2, 154.

³⁰ Given the fact that this Article discusses the substantive law governing the duty of loyalty, the standing requirements for stakeholders to launch derivative litigation for breach of the duty is out of scope.

³¹ Velasco, Julian, *The Diminishing Duty of Loyalty* (August 27, 2018). 75 Wash. & Lee L. Rev. 1035 (2018).

adjudicating duty of loyalty cases.³² When the directors' and managers' business decisions are affected by material personal interests, the decisions could be valid if they are proved to be "entirely fair" to the company.³³ In this way, the "entire fairness" standard acts as a shield against breach of directors' duties. However, after *Aberdeen Railway Co v Blaikie Brothers*, the UK and Australia have closely followed the absolute approach, under which the existence of a conflict of interest constitutes a breach of the duty and renders a transaction voidable. As to the issue whether fairness should be considered in the duty of loyalty cases, Lord Cranworth in *Aberdeen Railway Co v Blaikie Brothers* observed: "so strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into".³⁴ UK and Australian courts are simply not allowed to evaluate directors' conducts from the perspective of fairness.³⁵ Such a threshold for divergence in the test for breach is believed to be deeply rooted in the development history of the relevant jurisdictions.³⁶

The US fairness standard for defining the test for breach in duty of loyalty cases was developed from the 1880s fiduciary law as developed in the UK.³⁷ Professor David Kershaw argues that "the path of US self-dealing law from voidability to fairness is not illogical and unexplained ... [T]he path to fairness is consistent with the early 19th-century fiduciary law and the options made available by the US conception of the corporation."³⁸ There are reasons why the US law opts for the fairness review path over maintaining an absolute approach as in the UK and Australia. However, the US concept of a corporation and its understanding of corporate power are the primary driving forces for moving beyond the absolute approach and aligning its approach more closely with the law of trust than the law in the UK and underscore the significance of who wields corporate power based on the analogue of a trust and trustee relationship.³⁹ The US corporate law usually accords corporate power to the board of directors, while the UK counterpart believes that power is held by individual directors.⁴⁰ Therefore, under UK and Australian company law, an individual director's breach is enough to void a transaction, while the US law treats individual conflict as exerting an influence over

³² See generally Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions*, 62 *L. & Contemp. Prob.* 243 (1999); Hill, *supra* note 18, 10.

³³ Norwood P. Beveridge, Jr., "The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction" (1992) 41 *DePaul Law Review* 655.

³⁴ *Aberdeen Railway Co v Blaikie Brothers* (1854) 1 *Macq* 461, 471.

³⁵ Hill, *supra* note 19.

³⁶ Kershaw, *supra* note 15, 309-315.

³⁷ Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35 at 36, 39-40. (1966) (exploring the history of the enforcement of the duty of loyalty).

³⁸ Kershaw, *supra* note 15, 405.

³⁹ Kershaw, *supra* note 15, 344-360.

⁴⁰ Nathaniel Lindley, *A Treatise on the Law of Companies considered as a Branch of the Law of Partnership* (5th edn, Sweet & Maxwell: 1889) at 364.

the exercise of the corporate power, which calls for assessing the fairness of the decision.⁴¹

2 *Ability to Contract Out of the Duty (“Contractibility”)*

The degree to which parties may contract out of the duty is another significant divergence between the US and the UK in the development of the duty of loyalty. Although statutory evidence shows that the US corporate laws explicitly authorize charters to install exculpation provisions that exclude some of the liabilities for negligence or permit the waiver of the duty of loyalty under certain situations,⁴² the degree to which parties may contract out of the duty in the UK is higher and not primarily reflected by corporate statutes.⁴³ Professor Kershaw describes the difference between US and UK in this regard as arising because “the substantive legal rule travelled, but their contractibility did not”.⁴⁴ The common law duty of loyalty practice is significantly affected by its contractibility.

The developmental path of UK corporate law largely explains its high contractibility, not just in respect of the duty of loyalty, but also in respect of its development generally. Before the introduction of incorporation in 1844, the unincorporated companies, which were known as deed of settlement companies, achieved some of the features of the modern corporation, such as designated management, through contracts and trust law.⁴⁵ Contracts connect company participants, while trust law deals with the pool of assets.⁴⁶ More importantly, after the UK's introduction of incorporation, the general incorporation-related rules and regulations were deemed as the continuation, if not complete recognition, of unincorporated companies.⁴⁷ Therefore, the terms between directors, shareholders and the firm were still regarded as private contracts. Professor Kershaw believes “the English incorporated company was viewed predominantly as private: the product of endogenous business activity”.⁴⁸ However, most US state corporate laws never held such a purely private view on the incorporated company. Through the analysis of the iconic debates between Adolf A. Berle, Jr. and E. Merrick Dodd, Professors William Bratton and Michael Wachter submit that the US corporation

⁴¹ Kershaw, *supra* note 15, 356-366.

⁴² Hill, *supra* 19; also see generally Gabriel V. Rauterberg & Eric L. Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 *Colum. L. Rev.* 1075 (2017).

⁴³ Kershaw, *supra* note 15, 308.

⁴⁴ *Id.*

⁴⁵ Redmond, *supra* note 26, 37-40.

⁴⁶ Francis B. Palmer, *Company Law: A Practical Handbook for Lawyers and Business Men* 5 (5th edn, Stevens and Sons: 1905).

⁴⁷ Kershaw, *supra* note 15, 288.

⁴⁸ *Id.*, 293-294.

is, or should be, a public institution.⁴⁹ It is because of the State company law's concession that the corporation derives its desirable features and rights to engage in business. Therefore, a corporation is empowered by the State.⁵⁰ Further, the constitution of a corporation is valid only with the recognition of the State company law. The question of contractibility under US law is therefore the product of statutes, rather than private negotiation.

Contractibility significantly facilitates the enforcement of the duty of loyalty. Under the UK absolute approach as outlined above, shareholders and directors can reach agreement to avoid the risk that foreseeable value-increasing transactions with conflicted interests are set aside by courts. It offers flexibility for the "unbendable rule" that all conflict of interest transactions should be voidable.⁵¹ Nonetheless, the fairness standard in the US duty of loyalty adjudication is flexible because the wording "fairness", *per se*, implies that individual cases merit the discretion of the courts. Therefore, contractibility in US law has less judicial significance than under UK law. The less-dependent "entire fairness" standard also places its emphasis on the efficiency and professionalism of the duty of loyalty adjudication, which serves as a forum competition element and helps a "winning state" to attract more incorporation. In other words, the "entire fairness" approach could be problematic if it were in a jurisdiction where incorporators do not have an option to choose a judicial interpretation on "fairness" that suits their purpose and with a less competent corporate bar to decipher the proper meaning of "fairness".⁵²

3 *Definition or Understanding of a Conflict of Interest ('cognizability')*

The policy objective of the duty of loyalty is to ensure that fiduciaries, directors and managers always consider a beneficiary's interest first when there is a conflict between the beneficiary's interest and the fiduciaries' personal interests.⁵³ As mentioned before, the enforcement of the duty provides *ex ante* and *ex post* motivation for fiduciaries to prioritize the beneficiary's interests over their own interests.⁵⁴ It is, nevertheless, impossible and unnecessary to subject all conflict of

⁴⁹ Bratton, William Wilson and Wachter, Michael L., Shareholder Primacy's Corporatist Origins: Adolf Berle and 'The Modern Corporation'. *Journal of Corporation Law*, Vol. 34, Pg. 99, 2008. See also Hill, *supra* note 18, 10.

⁵⁰ Allen, W "Our Schizophrenic Conception of the Business Corporation" (1992) *Cardozo Law Review* 261 at 261-272.

⁵¹ Kershaw, *supra* note 15, 309-315.

⁵² Certainly, the level of variation in the definition of "entire fairness" does not need to be very high. So long as it is not a one-size-fit-all one that can introduce a value-destroying effect, it should be appropriate to adopt the standard. The degree of variation in a civil law jurisdiction, with multiple local supreme courts having final adjudication power, usually suffices, because courts at locality level have a degree of freedom to adjust the standard to fit the needs of local business.

⁵³ Tamar Frankel, *Fiduciary Law* 108 (Oxford University Press, 2011).

⁵⁴ Kraakman et al, *supra* note 2, 162.

interest to the duty of loyalty. For instance, some common law jurisdictions do not believe that executive compensation should be subject to surveillance by the duty of loyalty.⁵⁵ Given the divergence across common law jurisdictions regarding which conflicts of interest should attract scrutiny, it is submitted that reform to the Chinese duty of loyalty would be better served by having an articulated definition of “material personal interests” to determine when a cognizable conflict of interest arises instead of excluding certain arrangements from the application of the duty.

US corporate law provides a relatively straightforward framework of “material personal interests”. Showing sufficient “material personal interests”, including business, financial or familial interest,⁵⁶ is one of the prerequisites to invoke the “entire fairness” standard for judicial review.⁵⁷ By contrast, in jurisdictions such as Australia, the concept of a “material personal interest” is relevant to the issue of disclosure.⁵⁸ The critical point in discerning “material personal interests” is whether the interest is “material”.⁵⁹ The degree of materiality dissuades fiduciaries from always putting the beneficiary’s interests first. Therefore, materiality “requires a showing that such an interest is reasonably likely to affect the decision-making process of a reasonable person.”⁶⁰ When the term “a reasonable person” is used in corporate law, the unavoidable question is whether the reasonable person standard is subjective or objective. Pursuant to *Orman v. Cullman*, it is clear that the standard should be subjective, which means that the interest must be significant enough in the director’s own economic circumstances.⁶¹ As mentioned before, corporate power in the US is vested in the board of directors, rather than in individual directors. Therefore, in order to review the fairness of a conflicted transaction, plaintiffs need

⁵⁵ Bottomley, *supra* note 21, 376; also see *Grobow v. Perot*, 539 A.2d 180, 188 (1988) (“Plaintiffs plead no facts demonstrating a financial interest on the part of GM’s directors . . . [except] the allegation that all GM’s directors are paid for their services as directors. However, such allegations, without more, do not establish any financial interest.”); but for different opinion on the compensation issue, see Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)* (October 3, 2014). European Corporate Governance Institute (ECGI) - Law Working Paper No. 267/2014, Available at SSRN: <https://ssrn.com/abstract=2505188> or <http://dx.doi.org/10.2139/ssrn.2505188>.

⁵⁶ See ALI, *PRINCIPLES OF CORPORATE GOVERNANCE* § 1.23 (1994) (defining a “Material personal interests” as the one that “he or she is a party to the transaction, or if a person with whom the director or officer has a business, financial or familial relationship, has a material pecuniary interest, or if the director or officer is subject to controlling influence by a party to the transaction or one having a pecuniary interest in it”).

⁵⁷ *Sinclair Oil v. Levien*, 280 A.2d 717, 720 (Del. 1971).

⁵⁸ See *Corporations Act 2000* (Cth) of Australia, s 191.

⁵⁹ Velasco, Julian, *The Diminishing Duty of Loyalty* (August 27, 2018). 75 *Wash. & Lee L. Rev.* 1035, 1055 (2018); where a case involves classic self-dealing (the defendant is on both sides of a transaction), showing materiality is not necessary. See *Orman v. Cullman*, 794 A.2d 5, 26 & n.50 (Del. Ch. 2002) (discussing materiality requirement).

⁶⁰ *Cede & Co.*, 634 A.2d at 363.

⁶¹ See *Orman v. Cullman*, 794 A.2d at 23 (Del. Ch. 2002).

to show that the majority of board members are affected by the “material personal interests”.⁶²

B *The Development of the Duty of Loyalty in China*

China enacted the first version of its company law in 1993, when the elemental directors’ duties were first established.⁶³ This is, arguably, the beginning of the development of the Chinese duty of loyalty.⁶⁴ Article 59 of the 1993 company law stipulated as follows:

*Directors, supervisors and managers of a company shall abide by the articles of association, perform their duties faithfully, and safeguard the interests of the company. They are not allowed to exploit their positions and powers in the company for personal gains. Directors, supervisors or managers of a company are not allowed to exploit their position to accept bribes or other illegal income or wrongfully take over the company property.*⁶⁵

This provision was conduct-mode-oriented rather than a statement of a director’s duty of loyalty. Due to its civil law tradition, Chinese company law received little influence directly from common law jurisdictions in the 1990s.⁶⁶ The 2005 Chinese Company Law, by contrast, formed a version of directors’ duties that was much closer to the modern way of describing them as outlined in Part IIA above. Chinese company law underwent a comprehensive revision in 2005, drawing significantly on Anglo-American company law.⁶⁷ Article 148 of the 2005 Company Law states as follows:

The directors, supervisors and senior managers shall comply with the laws, administrative regulations, and bylaws. They shall bear the obligations of loyalty and diligence to the company.

⁶² See Orman, 794 A.2d at 22 (“To rebut successfully business judgment rule presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating ‘that a majority of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director.’”).

⁶³ See e.g. Nicholas Calcina Howson, *Twenty-Five Years On — The Establishment and Application of Corporate Fiduciary Duties in PRC Law* In EVAN CRIDDLE, PAUL B. MILLER, ROBERT H. SITKOFF THE OXFORD HANDBOOK OF FIDUCIARY LAW 6 (Oxford University Press, 2018);

⁶⁴ Weng, *supra* note 12.

⁶⁵ Article 59, Zhonghua Renmin Gongheguo Gongsifa [Company Law of the PRC] (passed by the Standing Comm. Nat’l People’s Cong. December 27, 1993, effective July 1, 1994).

⁶⁶ Ciyun Zhu, *The Internationalization and Adaptation of Chinese Company Law: History, development and future since open-up* Vol.2 EASTERN LAW REVIEW, 91, 94-95 (2020).

⁶⁷ *Id.*

*No director, supervisor or senior manager may accept any bribe or other illegal gains by taking advantage of his powers, or encroach on the property of the company.*⁶⁸

Compared with article 59 in the Company Law of 1993, article 148 of the 2005 version enunciates that loyalty and diligence are legal obligations for directors.⁶⁹ As mentioned above, article 147 of the most recent version of the Company Law in 2018 maintains the same expression as in the 2005 version.⁷⁰ However, the wording of the provision is amorphous. The second paragraph of the article does not mention anything relevant to the concept of a conflict. However, it has a narrative similar to the "no-profit rule"; that is, that no one should make a secret profit because of their fiduciary position. There is no further explanation on ratification and authorization in circumstances where directors and other management who profit through using their position seek an exemption. In addition, it is arguable whether the function of the second paragraph of the article is to explain the duty of loyalty in the first paragraph or if it simply adds more information, even if not exhaustively, to the duty of loyalty. However, the provision leaves some latitude for introducing more information to enrich the definition of the duty through the term "illegal". Not only can authorization and ratification procedures be included in the duty but also, with further legal interpretation, the cognizability issue may be partly addressed. Additionally, the provision does not require a purpose to find a breach of the duty. Although the article fails in terms of defining the duty of loyalty in China, the provisions addressing related transactions and, in particular, the authorization and ratification provisions in public companies can throw light on the issues.

The regulation of related transactions is an indispensable aspect of the duty of loyalty.⁷¹ Traditionally, the related transaction mechanism was an essential part

⁶⁸ Art. 148, *Zhonghua Renmin Gongheguo Gongsifa* [Company Law of the PRC] (passed by the Standing Comm. Nat'l People's Cong. October 27, 2005, effective January 1, 2006).

⁶⁹ *Id*; *supra* note 69.

⁷⁰ The only difference being is that it has been moved to article 147 due to the deletion of other articles in the 2018 version. *Zhonghua Renmin Gongheguo Gongsifa* [Company Law of the PRC] (Adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993; amended for the first time in accordance with the Decision on Amending the Company Law of the People's Republic of China adopted at the 13th Session of the Standing Committee of the Ninth National People's Congress on December 25, 1999; amended for the second time in accordance with the Decision on Amending the Company Law of the People's Republic of China adopted at the 11th Session of the Standing Committee of the Tenth National People's Congress on August 28, 2004; Revised at 18th Session of the Standing Committee of the Tenth National People's Congress on October 27, 2005; and amended for the third time in accordance with the Decision on Amending Seven Laws Including the Marine Environment Protection Law of the People's Republic of China adopted at the Sixth Session of the Standing Committee of the 12th National People's Congress on December 28, 2013; and amended for the fourth time in accordance with the Decision of the Standing Committee of the National People's Congress on Amending the Company Law of the People's Republic of China (2018) adopted at the Sixth Session of the Standing Committee of the 13th National People's Congress on October 26, 2018).

⁷¹ Ramsay and Austin, *supra* note 6, 571-575.

of the no-profit rule and provided the conditions for facilitating a conflicted transaction.⁷² Although prescribing a procedure for related transactions to facilitate a conflicted transaction could be expensive and inflexible in practice, it is necessary in the case of a public company where its shareholders usually do not have sufficient financial interests, and are unable to work collectively, to provide sufficient supervision.⁷³ Article 21 of China's Company Law provides as follows:

Neither the controlling shareholder, nor the actual controller, nor any of the directors, supervisors or senior management of the company may injure the interests of the company by taking advantage of its related relationships.

Anyone who causes any loss to the company due to violating the preceding paragraph shall be liable for compensation.

The related transaction rule has two purposes: first, to facilitate transactions through offering a standardized procedure (including setting out exceptions) in situations where there is a conflict; secondly, to protect public investors in public companies by closely scrutinizing conflicted transactions. The core issue of the related transaction rule is the definition of what is a related transaction. Paragraph four of Article 216 of China's Company Law provides the following definition:

...

(4) The term "Related relationship" refers to the relationship between the controlling shareholders, actual controllers, directors, supervisors, or senior management persons of a company and the enterprise directly or indirectly controlled thereby and any other relationship that may lead to the transfer of any interest of the company. However, the enterprises controlled by the state do not incur a related relationship simply because the state controls their shares.⁷⁴

⁷² Bottomley, *supra* note 21, 380

⁷³ Kraakman et al, *supra* note 2, 154-56.

⁷⁴ Article 216, *Zhonghua Renmin Gongheguo Gongsifa* [Company Law of the PRC] (Adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993; amended for the first time in accordance with the Decision on Amending the Company Law of the People's Republic of China adopted at the 13th Session of the Standing Committee of the Ninth National People's Congress on December 25, 1999; amended for the second time in accordance with the Decision on Amending the Company Law of the People's Republic of China adopted at the 11th Session of the Standing Committee of the Tenth National People's Congress on August 28, 2004; Revised at 18th Session of the Standing Committee of the Tenth National People's Congress on October 27, 2005; and amended for the third time in accordance with the Decision on Amending Seven Laws Including the Marine Environment Protection Law of the People's Republic of China adopted at the Sixth Session of the Standing Committee of the 12th National People's Congress on December 28, 2013; and amended for the fourth time in accordance with the Decision of the Standing Committee of the National People's Congress on Amending

The definition is basic but all-inclusive. Unlike many common corporate law definitions, it only lists corporate “insiders”, such as the directors, senior management and controllers of the firm, all of whom are just a subset of related parties in common law corporate law. For instance, blood relatives and spouses of the insiders are not mentioned in the provision. Despite the omission of many traditional related parties, a catch-all provision invites the judiciary to determine who a related party is: “any other relationship that may lead to the transfer of any interest of the company”. The provision implies that, provided that the relationship can be a primary reason for the transfer of the interest of the company by related parties, the transaction should be termed a “related transaction”. Further, it is not clear what is meant by the phrase “transfer of any interest of the company”. It could mean either that a decision regarding a transaction has been made or that interests belonging to the company have been transferred to others. The latter implies a fairness requirement in reviewing the related transaction in question.

Article 148 of the Company Law 2018 prohibits acts that a director or senior management should not engage in, which comes closest to exemplifying an unfair transaction that transfers the company's interest:

No directors or senior managers may commit any of the following acts:

- (1) Misappropriate the company's fund;
- (2) Deposit the company's fund into an account under their own name or any other individual's name;
- (3) Without consent of the shareholders' meeting, shareholders' assembly, or the board of directors, lend the company's fund to others or provide any guarantee to any other person by using the company's property in violation of the bylaws;
- (4) Enter into a contract or trading with the company by violating the bylaws or without the consent of the shareholders' meeting or shareholders' assembly;
- (5) Without consent of the shareholders' meeting or shareholders' assembly, seek business opportunities that belong to the company for themselves or any other persons by taking advantages of their powers, or operating similar business of the company for which they work for themselves or for any other persons;
- (6) Take commissions on the transactions between others and the company into their own pocket;
- (7) Illegally disclose the company's confidential information;
- (8) Undertake other acts inconsistent with the obligation of loyalty to the company.

The income of any director or senior manager from any act in violation of the preceding paragraph shall belong to the company.⁷⁵

the Company Law of the People's Republic of China (2018) adopted at the Sixth Session of the Standing Committee of the 13th National People's Congress on October 26, 2018).

⁷⁵ *Id.*, Article 148, *Zhonghua Renmin Gongheguo Gongsifa*.

Item (8) of this Article refers to acts that involve a breach of the duty of loyalty. Items (1) to (3) and (7) are similar to misappropriation rules in common law jurisdictions, which means that a director may not appropriate company property either for the director's personal benefit or for the benefit of any other person without the authorization of the company.⁷⁶ There are no intention requirements for the four corporate property misappropriation scenarios.

Item (4) requires any contracts between a director or senior manager (not all related parties) and the firm to be either approved or confirmed by a shareholder's meeting or authorized by the company's constitution. Although the application of the procedure for approving a related transaction is limited to contracting as opposed to all types of trading and management, it demonstrates that a conflicted transaction can be authorized or ratified by shareholders. Item (5) stipulates corporate opportunity and provides that engaging in competing business can only be approved by a shareholder's meeting. Altering the company's constitution usually requires a special resolution (in China this means two-thirds of the total voting power), which represents a preponderance of shareholders preferences. It is questionable why the constitution cannot authorize management *ex ante*. Item (6) does not offer any means for approving the taking of a commission for business undertaken with the company by related parties. The law is silent as to whether a company can allow its management to take a commission, on a fully informed basis, as an incentive to promote the company's interest.

Article 116 attempts to address a traditional related transaction issue that arises where management transacts with a subsidiary of the company.⁷⁷ Interestingly, Article 15 only forbids the borrowing of funds directly from the company or from a subsidiary rather than all types of transaction. Furthermore, there is no information relevant to the authorization or ratification procedure in this context. Article 16 can be broadly categorized as related transactions as well as it requires shareholder's meeting approval for any debt guarantee activities in respect of the company's shareholders and actual controllers.⁷⁸ It applies to all types of companies and to both controlling and non-controlling shareholders. Article 116 and 16 are unique in terms of their application conditions as compared with common law jurisdictions. The difference is deeply rooted in Chinese jurisprudence and realities. Egregious self-dealing with respect to borrowings and guarantees were most frequently seen in all types of companies in the 1990s and the beginning

⁷⁶ Ramsay and Austin, *supra* note 6, 360

⁷⁷ *Id.*, Article 116 says "A Company shall regularly disclose to its shareholders information about remuneration received by the directors, supervisors and senior managers from the company."

⁷⁸ *Id.*, the third paragraph of 216 defines an actual controller as "anyone who is not a shareholder but can hold actual control of the acts of the company by means of investment relations, agreements or any other arrangements."

of the 2000s.⁷⁹ Further, financing between companies is often discouraged in China.⁸⁰

The most problematic aspect of the duty of loyalty issue in China is its disclosure mechanism for a conflicted transaction.⁸¹ Under the Company Law there are limited disclosure requirements for directors and managers. A source of business, especially for small scale firms, is business recommended by existing professional management. It is also not uncommon for a capable individual to take on multiple directorships in different companies. Therefore, modern company laws do not usually directly prohibit a director from placing themselves in a position of conflict.⁸² Some company laws in common law jurisdictions demand disclosure, which cannot be contracted out, should a director's personal interest conflict with the company's interests.⁸³ So long as a director fully discloses the conflict to the board, the transaction may proceed, and the director can vote.⁸⁴ The disclosure requirement sometimes is escalated to ban the conflicted director from voting in the case of public companies.⁸⁵ However, Article 124 of the Chinese Company Law 2018 is the only provision dealing with matters relevant to disclosure. It holds simply that a director of a listed company with a "related relationship" cannot vote.⁸⁶ Of course, Chinese securities regulatory agencies, such as the Chinese Securities Regulatory Commission, and stock exchanges have promulgated rules requiring related directors to disclose and recuse themselves from the board meetings.⁸⁷ The rules are, however, in the nature of soft laws that play a different role in the Chinese regulatory ecosystem.⁸⁸

Although the existing Chinese company law does not articulate the required test for breach of the duty of loyalty, a recent judicial interpretation shows the judicial preference in respect of the threshold. The SPC enacted the fifth

⁷⁹ Jun Wang, *Research on the Validity of Borrowing Contracts between companies*, Vol. 3 LEGAL SCIENCE, 171 (2018).

⁸⁰ Zhong Huang, *Review on the Invalidity Theory for Borrowing Contracts between companies*, Vol.4 TSINGHUA LAW REVIEW 144 (2013).

⁸¹ Jianwei Li, *The Legal System and Development of Related Transaction*, 19 PEOPLE'S ADJUDICATION 31 (2014)

⁸² Bottomley, *supra* note 21, 375.

⁸³ Section 191- 195, Corporations Act 2001 (Cth) (the existing Australian corporate law).

⁸⁴ Section 191, Corporations Act 2001 (Cth).

⁸⁵ Section 195, Corporations Act 2001 (Cth).

⁸⁶ *Supra* note 78, Article 124, *Zhonghua Renmin Gongheguo Gongsifa*. It stipulates "[w]here any of the directors has any relationship with the enterprise involved in the matter to be decided at the meeting of the board of directors, he shall not vote on this resolution, nor may he vote on behalf of any other person. The meeting of the board of directors shall not be held unless more than half of the unrelated directors are present at the meeting. A resolution of the board of directors shall be adopted by more than half of the unrelated directors. If the number of unrelated directors in attendance is fewer than 3 persons, the matter shall be submitted to the shareholders' assembly of the listed company for deliberation."

⁸⁷ Circular of China Securities Regulatory Commission on Printing and Distributing the Guidance for the Articles of Listed Company (Revised in 2006); see Jianwei Li, *supra* note 85, 35.

⁸⁸ See Jianwei Li, *supra* note 81, 35-37.

interpretation (Interpretation V) for the Chinese Company Law in 2019.⁸⁹ The first article of Interpretation V states:

Where the interests of a company are damaged by any related transaction, and the company as the plaintiff requests any of the controlling shareholder, the actual controller, directors, supervisors and senior executives to compensate for the loss caused in accordance with the provision of Article 21 of the Company Law, and the defendant makes a defense merely on the excuse that the procedures prescribed by laws, administrative regulations or the company's bylaws such as information disclosure and approval by the shareholders' meeting or general assembly of shareholders have been fulfilled in this transaction, the people's court shall not support [the defense] ...

Given that the provision stipulates that under no circumstances can a defendant argue against compensating a loss for a firm caused by a related transaction, the likely threshold should be an entire fairness one. However, it is surprising that the law does not allow a shareholder's meeting to authorize or ratify a related transaction. The issue is whether the Chinese judiciary is following an absolute entire fairness standard in scrutinizing the related transaction, which does not allow for a shareholder's meeting to cure a related transaction, or whether there are more systematic considerations for company law that eclipse the significance and reasonableness of the test for breach of the duty of loyalty. Part III provides further analysis on this issue.

III THE EXPERIENCE OF JUDICIAL PRACTICE IN CHINA

No study can ignore the law in action in China, given that the civil law system operates through the judiciary's "law-explanatory activities".⁹⁰ Having detailed research on how courts are enforcing the generic, if not simplistic, duty of loyalty is a critical aspect to mapping out a comprehensive and accurate duty of loyalty landscape. This Part surveys cases over the last three years on the duty of loyalty in Shanghai, a significant jurisdiction in China, and raises several primary concerns in respect of the fragmented and defective design of the duty. The case analysis

⁸⁹ Provisions (V) of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China, Interpretation No. 7 [2019] of the Supreme People's Court.

⁹⁰ Charlie Xiao-chuan Weng, *Chinese Shareholder Protection and the Influence from the US Law: The Idiosyncratic Economic Realities and Mismatched Agency Problem Solutions*, Vol. 40 (4) SECURITIES REGULATION LAW JOURNAL 1-36 (2013).

approach is employed to reflect the problems in interpreting and applying the duty of loyalty, rather than as an empirical approach to use the data to support arguments.

The first search term we used on the case database of Wolters Kluwer was “duty of loyalty” (Zhongshi Yiwu), focusing on the reasoning and facts (Caipan Liyou Ji Yiju) aspect of judgments. In order to retrieve the most recent cases that reflect the most updated information on the duty of loyalty, we limited the judgment publication date to between 1 January 2017 and 1 April 2020. Since we were only interested in private enforcement cases, rather than criminal cases and jurisdictional disputes, we selected civil cases (Minshi Anjian) and judgments (Panjue). The search rendered 136 results. Each case was examined so as to exclude irrelevant cases, such as the wrongful application of the duty. Subsequently, 41 cases relevant to the duty of loyalty were identified.

The first and most striking observation is that the definition of the duty of loyalty is amorphous. Only one case attempted to define what the duty is. Although it is an incomplete and possibly controversial attempt, it may nonetheless demonstrate the degree of understanding that the judiciary has in respect of the duty. In *Shi v Zhou*, the court opined that -

*the duty of loyalty requires directors, senior executives representing shareholders as a whole to work for the firm's interests to their best efforts. The highest effort level and the utmost degree of protecting the firm's interest are the standards for evaluating compliance with their duty. When their interests conflict with the firm's, they should put the firm's interests first over their own ones and any other thirdparties' interests.*⁹¹

The first two sentences of the quotation emphasize the significance of the duty of loyalty alone, while the last sentence clarifies that management should always put the firm's interest first. Of course, the description in the judgement outlines the fundamental aspect of the no-conflict rule in that the fiduciary should prioritize the interest of the firm over their own. However, the most practical question for the application of the duty was left untouched; namely, what is a conflict of interest? If the ambit of the duty is not clarified, it is challenging for courts to enforce the duty of loyalty. Unfortunately, no case in the sample selection offered an explicit definition of a conflict of interest.

The absence of a definition might be attributed to various reasons, including an assumption among law-makers and judges in China that the concept of a conflict of interest is self-explanatory or self-evident and therefore does not need to be defined. By contrast, the law in common law jurisdictions as it relates to directors'

⁹¹ (2016) SH01CIVILFINAL13372

duties generally locates the analysis within the context of acting in the interests or “best interests” of the company.⁹² This approach is also adopted in other contexts, such as the professional duties of lawyers, where a conflict of interest is defined by reference to the concept of “best interests” and is considered to arise where (1) separate duties to act in the best interests of two or more clients in the same or a related matters conflict (known as a “client conflict of interest”); or (2) the duty to act in the best interests of a client in a matter conflicts, or there is a significant risk that the duty to act in the best interests of a client conflicts, with the fiduciary’s own interests in relation to that matter or a related matter (known as an “own interest conflict”).⁹³ Accordingly, the concept of “best interests” provides a test by which the duty of loyalty can be defined and adjudicated. It also directs attention not towards identifying a conflict of interest “in the abstract” but towards assessing the specific circumstances to determine whether the interests of the director or fiduciary are truly in conflict with the best interests of the company or the client and whether directors have truly prioritized the company’s interests over their own.

The absence of a definition or understanding of a conflict of interest directly leads to a unique application phenomenon: the majority of the Chinese duty of loyalty cases in the sample focus on misappropriating corporate assets and violation of the non-compete obligation. The most frequently litigated case-types indicate that Corporate China is still not sure about the consequence of launching litigation where management has a not-so-typical conflict of interest in a transaction. *Shanghai Zhengda Property Management Ltd. v Zhang and others* provides an example as to how unfamiliar the court can be when adjudicating a “non-typical” conflict of interest. This case involved an interest in an entity controlled by the defendant’s mother.⁹⁴ The defendant was a director and general manager of company A. The defendant was well compensated by company B, which engaged in the same business as company A. Company B was the entity that was under the control of the defendant’s mother (holding 65% of the shares of the company). The court did not believe that this was a conflict of interest that necessitated the defendant’s disclosure of the secret profit to Company A. An entity controlled by the close relative of an insider is a typical conflict of interest in common law jurisdiction requiring explicit and detailed disclosure.⁹⁵ The court’s reasoning may be ascribed to the omission of a definition or understanding of a conflict of interest in the duty of loyalty in China.

⁹² See, for example, Corporations Act 2001 (Cth) s 181(1)(a). For a detailed discussion of conflicts of interest, see Rosemary Teele Langford, *Company Directors’ Duties and Conflicts of Interest* (Oxford, 2019). It is generally accepted that acting in the interests of the company is synonymous with acting in the “best interests” of the company. For a discussion of related issues, see Langford, 18ff.

⁹³ See, for example, the UK Solicitors Regulation Authority Code of Conduct, paragraphs 6.1 and 6.2.

⁹⁴ (2019) SH01CIVILFINAL10137

⁹⁵ E.g., Chapter 2E of Corporation Acts 2001 (Cth) in Australia has similar requirements.

The second issue is that the test of breach is unclear. As previously mentioned, the test for breach in common law jurisdictions follows one of two options: the entire fairness approach in the US or the absolute approach in the UK and Australia.⁹⁶ The former concerns the fairness of the deal under the influence of a conflict of interest, while the latter deems all conflicted interest transactions to be in breach of the duty.⁹⁷ The Chinese Company Law of 2018 does not articulate the test for breach. Based on the analysis of the sample, it would appear that loss, rather than the entire fairness approach or the absolute approach, has become the test or breach to offer remedies. In the sample cases, the courts unanimously required the plaintiffs to prove loss in all cases. There is a significant inference that the plaintiffs' claims would not receive judicial support should they fail to prove that self-dealing had incurred a loss. For instance, in *Shanghai Puzhen Electronics and Technologies Co., Ltd v Charles Lo and others*, Lo ran a competing business while being a director and supervisor of the plaintiff company.⁹⁸ The plaintiff company showed a reduction in revenue of 60% when Lo was engaged in the competing business. However, the court refused to find a breach of the duty because the plaintiff company was unable to show the loss convincingly. The loss-based approach is confusing because even an impartial and fair transaction could cause loss. The approach, of course, leans more towards the fairness standard, as many unfair conflicted transactions incur a loss. There are, nevertheless, some unfair transactions that reduce profits or make calculating the loss difficult. However, *Shanghai Zhongqi Anhua Auto Service Co., Ltd v Jin*, is an exception to the loss-based approach.⁹⁹ The defendant, the general manager of the plaintiff, secretly ran a competing car renting company for two years. The court supported the plaintiff's claim that there had been a violation of the director's duty and ordered a small amount of compensation, although the plaintiff could not directly prove loss caused by the competing business. What does the small amount of compensation indicate? Is it an indication of a violation of the duty of loyalty or is it compensation for reasonable loss incurred as a result of the breach of the duty? The judgement does not articulate the issues. Despite the unresolved questions, the loss-based approach exhibited in the sample is consistent with the proposition of the Supreme People's Court. As mentioned before, Interpretation V confirms that loss is the linchpin of a related transaction, regardless of the duty of loyalty mechanism that is transplanted from common law jurisdictions.¹⁰⁰ Although the judicial interpretation only focuses

⁹⁶ Kershaw, *supra* note 15, 286.

⁹⁷ Even in the US, states are choosing one of the two approaches to adjudicate the duty of loyalty case. For the voidability approach, see, e.g., *North Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146 (Me. 1995); for the fairness standard, see, e.g., *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 155 (Del. 1996).

⁹⁸ (2017) SH0104CIVILFIRST11854

⁹⁹ (2019) SH0115CIVILFIRST48070

¹⁰⁰ Zhu, *supra* note 10, 95.

on related transactions, the judiciary has been closely following the loss-based approach in determining whether a breach of the duty of loyalty has occurred.

The third issue in the sample analysis is ascertaining who should approve a conflicted transaction. As previously noted, Article 148 of Company Law lists some self-dealing situations that may be validated with approval from a shareholder's meeting.¹⁰¹ However, the situations only cover lending funds or providing a guarantee for others, directly trading with the firm, and engaging in competing businesses and misappropriation of business opportunities. The provision therefore does not provide much practical assistance. Courts are endeavoring to ascertain who should have the power to permit conflicted transactions. Although in *Tai Lin International Holding Co., Ltd v Guo and others*, the court opined that “the obligations (the duty of loyalty and the duty of care) under Article 147 of Company Law 2018 should be owed to a company instead of its shareholders”, many cases determine that only the shareholders’ meeting can authorize a self-dealing.¹⁰² No case in the sample referred to the US model that allows a company to organize an independent committee to approve a conflicted transaction. For example, in *He v Sheng*, Sheng submitted that he should not be liable for misappropriating corporate accounts because the company had issued him with a duty of loyalty exemption letter.¹⁰³ The court, instead of confirming that Article 148 of Company Law 2018 does not allow contracting out of the duty in respect of the misappropriation of corporate accounts, held that misappropriations are legal if the shareholders of the firm unanimously agree with the duty of loyalty exemption. The court’s decision is closely aligned to the approach in common law jurisdictions that allows a shareholder’s meeting to *ex ante* approve and *ex post* ratify any breach of duty of loyalty.¹⁰⁴ The shareholder’s exemption, however, also invites some disputes. In theory, the approval or ratification of the breach of the duty of loyalty should be on an *ad hoc* basis. It is always problematic to simplistically exempt all types of breaches in a catch-all approval.

An issue that is directly relevant to the exemption is the ability to contract out of the duty. Based on the observation in the sample, firms seldom contract out of the legal settings. Only a few cases tried to contract out of the prohibitions in Article 148 of the Company Law 2018.¹⁰⁵ The issues subject to contracting out were all items in respect of which Article 148 makes provision for approval by a shareholder’s meeting. For instance, in *Shanghai Yixian Information and Technologies Co., Ltd, v Zhu and others*, the plaintiff permitted Zhu, a senior executive of the plaintiff, to establish a firm in the same industry as the plaintiff

¹⁰¹ Company Law 2018, Article 148.

¹⁰² (2017) SH01CIVILFINAL10634.

¹⁰³ (2017) SH01CIVILFINAL14607.

¹⁰⁴ See e.g. (2019) SH02CIVILFINAL95555.

¹⁰⁵ See e.g. (2017) SH0120CIVILFIRST81111.

company.¹⁰⁶ The court believed that the permission should be honoured, and the plaintiff company could not claim that the defendant violated his duty when he engaged in the competing business. There was no case that attempted to contract out of the duty beyond the issues that can be approved by the shareholder's meeting as listed in Article 148. This means, in practice, that private parties do not believe contracting out of the duty of loyalty can receive support in court in circumstances where the law does not expressly authorize a shareholders' meeting to approve or ratify the transaction. The judicial practice establishes the proposition that company law is not a recognition of private contracts. Instead, judicial practice suggests that the law empowers companies, which implies that corporate power is derived from the concession of the State.

IV THE PATH TO A BETTER DUTY OF LOYALTY IN CHINA

After discussing the practice of the duty of loyalty in common law jurisdictions and Chinese legislation and practice, this Part offers suggestions for improving the duty of loyalty in China. Given that China does not have a common law tradition that draws on a rich body of cases in respect of a fiduciary duty,¹⁰⁷ establishing practical rules that clarify the critical components of the enforcement of the duty is a priority. This is, of course, a challenging task. However, based on previous research on the Chinese law and practice, we submit that there are at least four aspects that can be improved: (1) establishing a prophylactic (i.e. preventative) mechanism; (2) defining a conflict of interest; (3) clarifying the test for breach; and (4) establishing a true related-transaction mechanism.

Establishing a prophylactic mechanism is the first step for an efficient duty of loyalty mechanism. The existing duty of loyalty mechanism in China fails to provide a means for preventing the occurrence of disloyal activities. All the existing rules only create *ex post* approaches imposing liabilities to punish the violators and requiring them to compensate the victims.¹⁰⁸ There are only rules requiring a listed company's management to disclose a potential conflict and recuse themselves from making a decision.¹⁰⁹ However, as mentioned before, disclosure plays a crucial role in common law jurisdictions to inform a company so as to scrutinize a particular deal in order to avoid conflict of interest transactions.¹¹⁰ The lack of disclosure mechanism for a conflicted interest transaction creates a legislative gap, which must

¹⁰⁶ (2017) SH0120CIVILFIRST81111.

¹⁰⁷ See e.g. Nicholas Calcina Howson, *Twenty-Five Years On — The Establishment and Application of Corporate Fiduciary Duties in PRC Law* In EVAN CRIDDLE, PAUL B. MILLER, ROBERT H. SITKOFF THE OXFORD HANDBOOK OF FIDUCIARY LAW 6 (Oxford University Press, 2018);

¹⁰⁸ Peixin Luo, *Director's Duty of Loyalty, An Analysis from Self-dealing Perspective*, Vol. 49 FINANCE LAW REVIEW, 77, 79-81 (2001).

¹⁰⁹ PRC Company Law 2018, Article 124.

¹¹⁰ Redmond, *supra* note 26.

necessarily be plugged. There also needs to be clarity about how much information should be offered by management. This means that not only should a conflict be disclosed but also that the details of the conflict be explained. Of course, one consideration would be to ask conflicted management in a large company to recuse themselves from the decision-making process in order to adequately protect passive investors who are not actively involved in corporate supervision. Given the fact that Chinese companies are divided into limited liability companies and companies limited by shares according to the number of shareholders and accessibility to public finance, the disclosure and recusal requirements could be imposed on the company limited by shares.

Secondly, despite the fact that the existing law does not offer a definition of the duty of loyalty, the law should at least provide an explanation as to what a conflict of interest is in order to facilitate the enforcement of the law. The case analysis undertaken shows that most of the cases are rudimentary forms of the duty of loyalty cases, such as misappropriating corporate assets or engaging in competing businesses. When it comes to the discussion of the nature of a conflict of interest, courts are generally conservative and reluctant to recognize an interest that is not expressly articulated by law. This may lead to unfair applications of the law and incomplete investor protection. The most practical way for statute-based jurisdictions to improve the clarity of the duty of loyalty mechanism is to articulate the core element; namely, a conflict of interest. Based on the experience of the common law, the company law should first consider defining the “material personal interests” that might conflict with the interests or “best interests” of the company. The “material personal interests” definition should, however, be slightly broader than the common law definition. This is because the Chinese business society is reliant on people’s connections, which may also be a significant factor that induces management to engage in a conflicted transaction.¹¹¹ For instance, the interests of a spouse’s relatives are usually excluded from the “material personal interests” list. However, it is not surprising that the interests of a spouse’s relatives become the primary reason for related transactions in practice.¹¹² Therefore, the interest should be any financial or other personal interest, whether familiar or non-familial. Further, the law needs to confirm that only if the interest is strong enough to dissuade the management to deviate from working in the best interests of the company should it be called a “material personal interest”. In addition, as discussed in Part III above, the law should define the duty of loyalty by reference to the best interests of the

¹¹¹ deLisle, Jacques, *Traps, Gaps and Law in China’s Transition*, in *IS CHINA TRAPPED IN TRANSITION? IMPLICATIONS FOR FUTURE REFORMS* (Oxford Foundation for Law, Justice and Society, 2007).

¹¹² Some Chinese judges also hold similar view on broadening the arrange of “material personal interests”, see Xiaojing Hu, *Analysis on Director’s Related transactions*, available at <http://cdfy.chinacourt.gov.cn/article/detail/2011/02/id/577100.shtml>

company. Although a determination of the “best interests” of the company is not amenable to an easy definition and will always require a consideration of the specific circumstances, it nonetheless provides a basis on which a court can determine substantively whether the duty of loyalty has been satisfied as distinct from simply determining whether a conflict of interest has arisen “in the abstract” .

The third aspect that the company law can consider improving is the test for breach in respect of the duty of loyalty cases and the applicable standard. The standard is considered to be the basis for the adjudication of the duty because it is indispensable for assessing contraventions. Of course, as mentioned above, Interpretation V establishes a confusing and problematic standard in that it employs loss as a standard to assess any contravention on the duty of loyalty instead of entire fairness. Although it signals that the Chinese judiciary is willing to evaluate the fairness of cases involving the duty of loyalty, it incorrectly uses loss as the only factor to decide fairness (as distinct from using loss as a factor in determining the quantum of compensation for a breach of the duty of loyalty). As previously analyzed, the two approaches for the test for breach, namely the entire fairness approach and the absolute approach, have been applied in common law jurisdictions with different legal settings. We, therefore, also need to consider China’s legal environment when suggesting an ideal approach for adjudication.

A crucial condition for the absolute approach in the UK and Australia is that the law grants a private party power to contract out of the standard. In order to increase the flexibility of the proscriptive voidability rule, shareholders need to have not only the power to *ex ante* approve a conflicted transaction, but also should be able to ratify the transaction *ex post*. Two obstacles impede the ability of China to choose the absolute approach. The first impediment is that the existing company law does not articulate the degree of contractability for private parties, particularly given that the law has a long history of being restrictive and has a public-oriented tradition. The company is a transplanted notion in China, and Corporate China is accustomed to consulting the company law in order to define private parties' rights and obligations, which is fundamentally different from the practice in the UK.¹¹³ It is almost a presumption that if the law does not explicitly allow certain activity, private parties may not contract around the rules to engage in the relevant activity.¹¹⁴ Therefore, the door of *ex ante* approval is almost closed for allowing a conflicted transaction for the company's benefit. Secondly, the law only permits shareholders to ratify very limited types of conflicted transactions;¹¹⁵ for instance, where a director secretly rents out the company's warehouse for a small profit,

¹¹³ Peixin Luo, *On the Demarcation Line between Statutory and Arbitrary regulations of Corporation Law*, Vol.4 CHINA LEGAL SCIENCE, 69 (2007).

¹¹⁴ *Id.*

¹¹⁵ Zhongguo Gongsifa, Article 148.

which saves a significant amount of maintenance cost for the company. Without *ex post* ratification power, shareholders face an undesirable outcome for the company should a court find the deal invalid. It seems that the absolute approach can cause excessive transaction costs and unavoidable issues for firms when the company law permits low contractability for private parties and is mandatory for most company law provisions. Under the current mandatory rule-oriented company law mode, the absolute approach is therefore unlikely to be an ideal option for China.

The remaining issue in this regard is whether the entire fairness model might be a good fit. The Chinese judiciary may have realized that the absolute approach is less desirable for the existing company law. Therefore, the SPC has issued an interpretation that underscores that only transactions that incur loss should be considered as a related transaction.¹¹⁶ As previously discussed, however, the loss approach is not a correct approach to prove the fairness of a transaction. Sometimes the unfair related transaction may incur no loss, but generate less profit than would otherwise be the case. In order to establish an authentic entire fairness standard, the judiciary should weigh up if a transaction is fair to the company. Both Chinese and US corporate laws share a low level of contractability on the duty of loyalty feature, which leads to the conclusion that the test for breach should be more flexible than the absolute approach. However, as the more flexible approach, the entire fairness standard is demanding as it requires judges to be highly specialized and professional to decide whether a transaction is fair for a specific firm. The loss approach has become the existing method because it is easier for courts to apply. Therefore, the first obstacle in the way of introducing the entire fairness standard is the corporate law capability of judges. Many scholars have suggested that it would be preferable to have specialized commercial courts in China.¹¹⁷ Since 2018 China has been testing specialized commercial courts.¹¹⁸ Meanwhile, it would also be prudent to provide specific guidance to explain what the entire fairness standard is so as to mitigate the impact caused by the judge's second-guessing a business decision. It is expected through years of practice concerning the fairness standard that the local courts can construct ways to define further what is a fair transaction. Provided that the above conditions are adequately met, the entire fairness standard should be more appropriate than the absolute approach. After all, Chinese company law, similar to the US corporate laws, accords with the vesting of decision-power in the board, rather than in an individual director.

¹¹⁶ Provisions (V) of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China, Interpretation No. 7 [2019] of the Supreme People's Court.

¹¹⁷ See e.g., Jeffrey G. MacIntosh, *Securities law enforcement and the rule of law*, In ROBIN HUANG, NICOLAS HOWSON (EDS.), *ENFORCEMENT OF CORPORATE AND SECURITIES LAW: CHINA AND THE WORLD* 162- 184 (August 16 2017).

¹¹⁸ For instance, in 2018, the first specialized court for disputes on internet relevant activities was established in Hangzhou and later the first finance law court was installed in Shanghai.

The fourth and last improvement is rebuilding the related transaction mechanism. The Chinese Company Law has a related transaction mechanism as provided in Article 21, but this is not a real one. The related transaction mechanism is separate from the duty of loyalty for efficiency considerations. It usually applies to a public company where the shareholders cannot closely supervise corporate insiders from self-dealing. The mechanism requires fully informed consent to excuse any breach.¹¹⁹ More importantly, it defines itself by listing the insiders that have commonly experienced conflicts when dealing with the firm.¹²⁰ The mechanism singles out suspicious transactions to protect investor, simplifies disputes on the existence of substantive conflicts, and furnishes legal conduits to excuse a breach. Nonetheless, the Company Law does not define who the specific related parties are. Instead, it deems “any other relationship that may lead to the transfer of any interest of the company” as a related party, which fails to differentiate between a related transaction and the duty of loyalty.¹²¹ Further, none of the legislative benefits and functions conducive to excusing favourable self-dealings are available for the Chinese version of a related transaction. Therefore, as the first step to constructing the structure of a related transaction mechanism, the law should consider an identity-based related-transaction mechanism, which clearly identifies those transactions involving corporate insiders. In addition, disclosure and approval rules should be established to facilitate honest transactions involving insiders.

V CONCLUSION

The duty of loyalty is one of the most significant directors’ duties that traces its origins and inspiration to common law jurisdictions. Since the duty was established in the UK, common law jurisdictions have developed the duty extensively. These developments have led to a certain degree of divergence on the application of the duty in practice. China introduced the duty in 1993. In the past three decades the duty has progressed, but at a less-than-satisfactory pace. From a legislative perspective, the Chinese legislature has provided a simplistic and non-systematic narrative in respect of the duty. The provisions relevant to the duty are scattered throughout the Company Law and fail to construct a clear and applicable duty for enforcement. According to traditional common law wisdom, the duty has three significant topics; namely, the test for breach, the ability to contract out of the duty and the definition of a duty of loyalty, which have been discussed in detail. Through a case study examining the duty of loyalty cases in Shanghai over the past three

¹¹⁹ Bottomley, *supra* note 21, 380.

¹²⁰ *Supra* note 74, *Zhongguo Gongsifa*, Article 148.

¹²¹ *Supra* note 74, *Zhongguo Gongsifa*, Article 216.

years, we conclude that the courts are struggling to deliver judgments because the Company Law does not articulate any of the three key elements of the duty. The suggestions for improving the duty mechanism are four-fold. First, a prophylactic disclosure mechanism, absent in the existing law, should be established to provide investors with comprehensive *ex ante* protection. Secondly, given that there is no definition of “material personal interest”, which is a key element to improve cognizability of the duty of loyalty, it is helpful to promulgate a provision articulating the definition of a “material personal interest” and also defining the duty of loyalty by reference to the “interests” or “best interests” of the company. The definition could significantly facilitate Chinese courts in examining the specific circumstances and identifying various interests that are not listed in the law so that investors interests can be adequately defended under an exhaustive range of self-dealing cases. Thirdly, the law needs to clarify the test for breach. Although Interpretation V has enacted a rule very similar to a standard, it is incorrectly formulated and not conducive to defending the interests of shareholders. Finally, compared to the absolute approach in the UK and Australia, the entire fairness standard in the US fits the Chinese company law environment better, ideally supported by a specialized corporate court. Even though several provisions define a ‘related transaction’, there is no modern related-transaction mechanism under Chinese law. It is therefore imperative to adopt an identity-based related-transaction rule to capture relevant insider transactions and provide a conduit for honest related transactions to be excused.