

CHINA'S COMPANY LAW: ONE STEP FORWARD, TWO STEPS BACK? A MODEST COMPLAINT

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I. INTRODUCTION

The 15th National Party Congress of the Communist Party of the People's Republic of China ("PRC" or "China") opened on September 12, 1997 with a much heralded call by Secretary General Jiang Zemin to intensify reformation of the state-owned sector. Jiang provided critical ideological authorization of the selling down of the State's interest in China's state-owned enterprises by equating "state ownership" with "public ownership" and then "ownership by the public," declaring:

Public ownership can and should take diversified forms . . . even if the state-owned sector accounts for a smaller proportion of the economy, this will not affect the Socialist nature of the economy.¹

The key vehicle for this newly invigorated reform, and in fact the process of restructuring that has been underway for several years, is China's basic corporate statute, only three years old. The promulgation of the Company Law of the People's Republic of China² (the "Company Law") in late 1993 was met with a chorus of praise in the official Chinese

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1. See *Jiang Pushes for Quick Reform: Chinese President Backs State Sell-offs in Move to Mixed Economy*, FINANCIAL TIMES, Sept. 13, 1997, at 1.

2. Company Law of the People's Republic of China (adopted by the 5th Session of the Standing Committee of the 8th National People's Congress on Dec. 29, 1993, and effective July 1, 1994) [hereinafter Company Law].

press and abroad.³ However, the immediate reaction among the more reform-oriented members of China's securities regulatory authorities, the nascent Chinese securities bar, and foreign bankers, lawyers and accountants intimately involved with the PRC's first securities offerings in Hong Kong and New York, was less sanguine.⁴ In many cases, the Company Law was privately termed a "disaster," a keen expression of conservative compromises or the wholesale avoidance of difficult issues implicit in China's transition from state ownership and the mandated allocation of capital to a "socialist market economy." Some PRC professionals and regulators even expressed the opinion that China's developing body of corporate law and securities markets would have been better off without the new legislation, and with continued reliance on the then-existing patchwork of laws, regulations, notices, opinions and standards which provided the legal basis for China's earliest corporate reorganizations⁵ and public issuances of stock in Shenzhen, Shanghai, Hong Kong and New York.

The most pessimistic view of the Company Law is probably not justified, especially in light of subsequent rule-makings which remedied the damage done by the Company Law, at least with respect to PRC companies listing shares abroad. However, it is true that the Company Law, understood in the context of the legal reform implemented with respect to corporate organization in the PRC, was a distinct step backwards

3. See, e.g., Stuart Valentine, *Company Law, 1994: A Welcome Move, of Limited Application*, SOUTH CHINA MORNING POST, Feb. 9, 1994; Owen Nee, *China's Company Law Sets Out the Next Stage of Reform*, INT'L FINANCIAL LAW REV. 13-15 (Apr. 1994); Marilyn Selby Okoshi, *China's New Company Law: An Overview*, 5 ASIAN BUSINESS LAW REV. 14-20 (1994); David Ho, *China's Company Law: Something Concrete to Go By*, EAST ASIAN EXECUTIVE REPORTS, Feb. 15, 1994, at 9; Sunny Huo, *The Company Law of the People's Republic of China* 13 UCLA PAC. BASIN L. J. 373 (1995).

4. Of course, much of this discontent was not made public; but see *New Laws Pose Big Challenges for Next Listings*, SOUTH CHINA MORNING POST, Jan. 31, 1994, Business at 6; and Jerome A. Cohen and Charles F. Goldsmith, *Company Law - Unfinished Business*, INTERNATIONAL CORPORATE LAW, May 1994.

5. This article does not use the popular but very misleading term "privatization," as the great majority of transactions seen to date in China have involved merely the corporate reorganization of productive entities (or groups of assets), with only a minority portion of the new issuer's stock being sold to truly "private" actors. In most cases, the state has maintained majority shareholdings through stockholders representing the administrative organs previously governing the issuer in question - so-called "state-owned" or "state-owned legal person" shareholders. For a superb discussion of this phenomenon, see Lan Cao, *The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model*, 21 BROOKLYN J. OF INT'L LAW 97 (1995).

from local or provisional national legislation and "practice" as it had developed in the immediate run-up to the promulgation of the Law.

Part II of this article summarizes the policy and organizational background to China's corporatization drive and the relevance of this initiative for foreign capital – which will be one important "purchaser" in the disposition of share interests in newly-corporatized Chinese enterprises. In Part III, a precis of concrete legislative developments in China's corporate law is provided. Part IV of this article present a critique of the Company Law, both generally (Section A) and with reference to the specific problem of "companies limited by shares" and the creation of viable Chinese issuers in China and abroad (Section B). The article also addresses how competing departments of the PRC government have since taken express steps to remedy some of these problems. This article seeks to provide a view of what the enumerated defects, and the process of remedial rule-making, mean – for the corporatization experiment, China's legislative process and the ongoing struggle to define the balance between state and central control and independent economic power. It is also hoped that this article will provide insight into how corporate law in China will, or at least should, develop in both the immediate and the long-term future.

II. FOREIGN CAPITAL IN CHINA – WHY PRC COMPANIES MATTER

A. *Restructuring of the State Sector and the Creation of Corporate Entities*

Like other socialist countries, the PRC has since 1949 been burdened with the concrete manifestation of the ideological construct "ownership of the means of production by the people": state-owned enterprises ("SOEs") and a centrally-controlled planned economy. As economic reform has progressed, much of the Chinese leadership has realized that this system of ownership and control does not contribute to sustained economic growth or rational production decisions. By the end of 1994, more than 50% of the approximately 110,000 SOEs in China ran at a loss.⁶ In the same year, direct subsidies to such SOEs amounted to the equivalent of US\$ 4.7

6. See Lincoln Kaye, *Fire When Ready*, FAR EASTERN ECONOMIC REVIEW, Feb. 23, 1995, at 50. A more recent report indicates that over 118,000 enterprises comprise the state sector, of which about 70% lost money in 1996. See Tony Walker, *Unbinding China: Chinese Leaders Are Slowly Facing up to the Huge Task of Reforming Bankrupt State-owned Enterprises*, FINANCIAL TIMES, Sept. 10, 1997, at 31.

billion, or 60% of China's budget deficit.⁷ This crisis is all the more compelling as such SOEs continue to hold absolute dominance in the capital-intensive and infrastructure sectors, monopolizing key industries where goods and services could be delivered by more efficient enterprises which would not require ongoing subsidies. It is no wonder that Li Tieying, chief of the Commission for the Restructuring of the Economic System ("CRES"), said in early 1995: "China will [now] shift its focus of reform to state-owned enterprises . . . with the aim to establish a modern enterprise system."⁸

Reform of the state-owned sector actually began in the late 1970s and has continued to find expression in the creation or alteration of legal norms.⁹ SOEs were originally conceived of as the mere vehicles of a centrally-controlled state plan; thus, SOEs were only accumulations of assets, entirely "owned by the State on behalf of all the people," with no independent legal personality and lacking the key attributes of "property" or the ability to confer on any party that bundle of rights that constitutes "ownership" in industrial market economies: the rights of "utilization"; "return" (the right to possess the fruits—and bear the burdens—of the utilization right); and "alienation" (the right to transfer such rights to another party, for value or by gift).¹⁰ In addition to lacking any attributes of property, such SOEs effected their production tasks pursuant to mandatory goals set by the government, submitted all of their revenues or profits to the state, and possessed little management independence.

Cognizant of the need to somehow incentivize SOEs as actors in a real market economy, initial reforms sought to adjust the relationship of SOEs to the government by causing SOEs to be responsible for their own profits and losses (as independent accounting units) and allowing such enterprises to discontinue the submission of profits to the center, in favor

7. These SOEs have proven unable to remunerate the 100 million people directly employed by them, or provide sustained support for the 200 million others who depend upon them for their livelihood. See Kaye, *supra* note 6, at 50.

8. See Kaye, *supra* 6, at 50. For a comprehensive PRC treatment of the problem, see Yu Dong, *Thoughts on State Enterprise Reform and Development for the Ninth Five-Year Plan*, FOREIGN BROADCAST INFORMATION SERVICE, FBIS-CHI-96-01, Mar. 28, 1996, at 46.

9. The best summary of this process is Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149 (Spring 1995).

10. See Louis Putterman, *The Role of Ownership and Property Rights in China's Economic Transition*, 144 THE CHINA QUARTERLY 1047-1064 (1995).

of a rudimentary system of taxation.¹¹ These policy initiatives were followed by the promulgation of a civil code which stipulated that certain SOEs could acquire "legal person" status and assume civil obligations independently¹² and a 1986 draft SOE bankruptcy law which made clear that SOEs would assume civil liability to the extent of the assets given to such SOE to manage ("on behalf of the people").¹³ These notions were explicitly codified in a State-owned Enterprise Law, adopted in April 1988. Further policy and legal reforms followed that conferred upon the management of such SOEs some independent decision-making powers, subject always to the condition that they passed some of their earnings to the state, as taxes, repayments of "debt," or a return of government-allocated funds.

Even more profound and visible legal changes occurred at the national level beginning in 1992 with the promulgation by CRES of the "Standard Opinions" discussed in this article, which for the first time in the history of the PRC provided the legal basis for corporate forms which could own and operate productive assets, and, most important in the present context, allow shareholders to benefit from and alienate interests in such corporate forms. After two years of experimentation with the so-called "Standard Opinions," the People's Republic's first "Company Law" became effective on 1 July 1994, and the corporate twins – "companies limited by shares" and "limited liability companies" – were at last granted existence in a national law. ("Companies limited by shares" are what Western lawyers and businessmen recognize as equity or joint stock companies, with liquid interests, and separation of management and ownership. "Limited liability companies" are akin to "closely-held companies" with fewer shareholders, holding more illiquid interests, and a board that is made up of the direct representatives of the shareholders.) Though flawed, it confirmed that the corporate form would henceforth be a key instrument in China's industrial development. Policy followed the creation of a legal basis, as 1995 was designated the year to focus on reform of the SOE sector, with a pilot program to create 1,000 large state

11. Caizhengbu Guanyu Guoyingqiye Ligaishui Shixing Banfa [Implementing Rules on Converting State-owned Enterprise Profits Submission into Taxation] (approved and distributed by the State Council on Apr. 24, 1983); and Caizhengbu Guanyu Dui Guoyingqiye Zhengshou Suodeshui de Zhanxing Guiding [Temporary Regulations on Levying Ownership Tax on State-owned Enterprises] (promulgated by the Ministry of Finance on Apr. 29, 1983).

12. Minfa Zhongze [General Principles of The Civil Law of People's Republic of China] (passed by the Fourth Session of the Sixth National People's Congress on Apr. 12, 1986).

13. *See id.* art. 48.

enterprises, 100 experimental transregional and multisectoral companies in 18 cities, with 57 "enterprise groups" of national scope.¹⁴

Notwithstanding these formal legal changes, reform and reorganization of the state sector in China has taken two distinct paths. SOEs continue to exist in abundance, and many will not be converted into "companies limited by shares" or "limited liability companies" at any time in the near future. If they are, then they will be recast as "wholly state-owned limited liability companies" under the Company Law.¹⁵ Many other SOEs have been re-formed into "companies limited by shares," with a state or "legal person" shareholder owning a controlling position (usually 60 to 80%) in the resulting corporate entity. While various strategies are available for saving the state-owned sector, the most encouraged is the reordering of such industrial units by merger pursuant to the 1989 "Provisional Measures for the Merger of Enterprises"¹⁶ (including the creation of large scale industry groups that the Chinese authorities hope will compete with major multinationals),¹⁷ the splitting up of large SOEs into more efficient units, sales (by privately negotiated sale or auction) of assets to stronger economic actors, the distribution of "ownership" in enterprises to employees¹⁸ and, depending upon the will of China's leadership, bankruptcies.

B. *The Accepted Uses of Foreign Capital*

The process described above has not occurred in isolation from the huge influx of foreign capital in China. In the period 1979-84, the PRC was able to report promised (or "contracted") foreign investment of US\$6.9

14. See *Progress in Reform of State-Owned Enterprises*, BEIJING REVIEW (English Edition), June 17-23, 1996. As this report makes clear, the worthy pilot initiatives have run into serious difficulties due to a lack of understanding on the part of the government and enterprise managers as to the true implications of corporatization and related management and ownership structures.

15. See *Company Law*, *supra* note 2, arts. 64-72.

16. See *Provisional Measures for the Merger of Enterprises* (adopted by the PRC Commission on the Restructuring of the Economic Systems ("CRES"), the State Planning Commission, the Ministry of Finance and the State-owned Assets bureau on Feb. 19, 1989).

17. See Li Rongxia, *Second High Tide of the Merger of Enterprises*, 40 BEIJING REVIEW, No. 38, Sept. 22-28, 1997, at 11-16, which reports that, to 1993, official statistics show that more than 2,900 enterprises in Shanghai, Wuhan, Chengdu and 13 other cities were formally merged or sold, implicating the transfer of over Renminbi 6 billion yuan in assets.

18. Sometimes called the "cooperative shareholding system," although it is doubtful the extent to which many of the new employee shareholders are in fact willing buyers. See *Enterprise Ownership with Chinese Characteristics*, 40 BEIJING ZHOUBAO, No. 37, Sept. 15-21, 1997, at 9-12.

billion. In 1994 alone, this number had ballooned to US\$81 billion, with actual investment for the year reaching US\$33.7 billion.¹⁹ (These statistics are exclusive of foreign borrowing, and the proceeds of international debt and equity offerings, which, together with foreign direct investment, accounted for a gross capital inflow in 1994 of US\$53 billion.²⁰)

The introduction of foreign capital into China during the implementation of the "open door policy" has also resulted from policy and legal initiatives, as well as the needs and expectations of the foreign capital itself. The Chinese leadership believed that the absorption of direct foreign investment would give China access to new sources of capital, advanced (foreign) technology and management practices, and allow participation in an advanced international marketplace able to absorb China's exports and provide foreign exchange to finance her import needs. However, the notion of introducing foreign capital was (and remains) controversial, as it went against long-held ideas of "self-reliance" and represented a potential threat to state control of China's development strategy, not to mention Chinese/"Socialist" values. Thus, the PRC struck a compromise which continues to animate China's policy and laws respecting foreign investment and corporate law: China would strive to absorb enough foreign capital to bring about desired developmental benefits, while at the same time maintaining state control over the terms of such investment through a system of approval controls, taxation policy, access to foreign exchange and production and distribution requirements.

Most important, China sought to attract "interested" foreign capital, i.e., large, product-tied foreign multinationals desiring to set up manufacturing enterprises in China, create a bridgehead in the "largest market in the world" and see a return (through distributed profits not dispositions of stock or assets) only over the "long term." This strategy found perfect expression in the development of the joint venture form, and the great amount of associated law-making completed through the 1980s²¹

19. THE BULLETIN OF THE MINISTRY OF FOREIGN TRADE AND ECONOMIC COOPERATION OF THE PRC, No. 2, Apr. 25, 1994, at 10; and BANKING TIMES, Jan. 26, 1995, at 1.

20. It is important to note that some of this "foreign investment" is actually capital recycled into the PRC by PRC-owned entities offshore.

21. For example, The Law of the PRC on Chinese-foreign Equity Joint Ventures of (July 1, 1979) (amended on Apr. 4, 1990); Implementing Regulations for the Law of the PRC on Chinese-foreign Equity Joint Ventures (Sept. 20, 1983); Law of the PRC on Chinese-foreign Cooperative Joint Ventures (Apr. 13, 1988); Implementing Regulations for the Law of the PRC on Chinese-foreign Cooperative Joint Ventures (Sept. 4), 1995; Law of the PRC on Wholly Foreign-owned Enterprises (Apr. 12, 1986); Implementing Regulations for the Law of the PRC on Wholly Foreign-owned Enterprises (Dec. 12, 1990). These are only a few of the many statutes, rules and

allowing for the establishment of joint venture manufacturing entities, wherein the foreign investor obtains an illiquid "registered capital" interest in the joint venture entity operating in a non-strategic sector (most often consumer goods), which entity in turn is bound to export (pursuant either to approval commands or the need to earn foreign exchange) much of its products. Thus, through the 1980s, the largest number of "foreign investors" were multinationals establishing long-term productive ventures, often in conjunction with SOEs, or Asian interests establishing small-scale processing or "bonded" operations designed to take advantage of China's low-cost labor inputs.

This landscape changed radically in the early 1990s, as a result of both a new interest in China by foreign finance professionals, and the needs of China's industrial actors ("private" and state-owned alike). The 1990s saw the arrival in Hong Kong of great teams of investment bankers (and associated professionals) expecting a rich stream of IPO and debt offering business. In the same period, the real ineffectiveness of the SOE form had become apparent to all but the most conservative Chinese leaders, brought about in part (ironically) by the strong challenge presented to such SOEs by foreign-invested operations. For various reasons, China did not prove able to complete a substantial number of capital markets transactions, and the somewhat under-employed investment bankers (and the funds they had assembled) began to agitate for pure financial investments in Chinese industry: investments which could earn a respectable (and enforceable) return, while offering the appropriate realization of value (or "exit") in a relatively short time frame. This pressure dovetailed perfectly with the urgent need of much of Chinese industry for finance capital, on almost any terms, particularly when faced with stringent controls on lending mandated by Beijing in the wake of runaway inflation and unchecked industrial construction.

And, it is precisely this pressure which has made the corporate form of such interest and concern to foreign capital. Far from being an arcane sidelight of emerging markets legal reform discussion, the PRC Company Law, and the interests which foreign capital may obtain in Chinese corporate entities, is of compelling concern to foreign industrialists, investment professionals and regulators. By way of introduction for the discussion following, it may be useful to discuss the interests now available, which include the following:

notices concerning the establishment, funding, registration, and taxation of foreign-invested enterprises in the PRC.

Foreign investors may of course acquire registered capital interests in Sino-foreign joint ventures. They may also, in theory, acquire interests in PRC "limited liability companies," which are tantamount to registered capital interests in joint ventures.²²

Companies limited by shares offer a plethora of interests, identified according to the holder of such interests or their listing site. For PRC investors in unlisted companies limited by shares, there are: (i) state shares (owned by a representative of the state, often the relevant state-owned assets bureau); (ii) legal person shares (owned by large institutions, often affiliated with the state); (iii) "internal" shares (employee-owned shares); and (iv) individual shares. Foreign investors in non-listed companies limited by shares own "foreign-invested shares." State shares are not transferrable, and legal person shares are generally only transferable among legal persons—in some cases through STAQ, the Shanghai automated over-the-counter trading mechanism.

For PRC companies limited by shares that are listed, there are: "A" shares (purchased by and traded among domestic investors and listed on the Shanghai or Shenzhen Stock Exchanges); "B" shares (purchased by and traded among foreign investors and listed on the same Exchanges); and "H" or "N" shares (share capital of PRC companies listed on the Hong Kong or New York Stock Exchanges).

Thus, a foreign investor may be faced with the following options in attempting to buy into Chinese industry: (i) a registered capital interest in a joint venture; (ii) an interest in an unlisted privately held company limited by shares; (iii) "B" shares traded on the Shanghai or Shenzhen Stock Exchanges; or (iv) "H" or "N" shares traded on the Hong Kong or New York Stock Exchanges. All but the interest described in item (i) above is an interest in a "company limited by shares" established pursuant to (or in conformity with) the Company Law. Having clarified the alphabet soup which confront foreign capital, it is also necessary to critically examine the law which purports to govern the rights, obligations and value obtained through ownership of such interests – the Company Law and its associated laws and regulations.

22. As is noted below, there is as of yet no formal legal basis allowing for foreign investment in PRC "limited liability companies" as opposed to "companies limited by shares." See section IV.A.xv of this article. Presumably, foreign invested limited liability companies are merely Sino-foreign equity joint ventures, authorized and governed by the law and implementing regulation governing that foreign direct investment form.

III. LEGISLATIVE BACKGROUND

It is beyond the scope of this article to examine in detail the long history of China's attempts at corporate law-making, which commenced in 1904, with the promulgation by the Qing court (or more precisely the Commerce Board (Shangbu)) of a "Company Law." Suffice to say, as William Kirby has shown,²³ that the motivation behind even the earliest law making efforts were similar to that behind the PRC's Company Law: to create a tool to promote China's industrial development, and as part of a more generalized legal reform intent on somehow conforming Chinese industrial organization and relationships with perceived Western (developed, industrial capitalist) norms and structures. Add to this the present-day desire to use corporate entities not only to compete with the West (and Japan), as was the case in the Qing, but also to provide a suitable (and recognizable) receiving entity for foreign capital investment and Chinese capital rapidly accumulating as a result of reforms, and the aims and means of the 1904 and 1994 projects are not too distinct.

The very recent history of Chinese law making and local experimentation with the corporate form, and its relationship to foreign investment, can also best be summarized very briefly:²⁴

A. *Local Legislation (1992-93)*

The promulgation of the Company Law was only the culmination of a process which, like a great deal of law-making in China, began both locally and experimentally.²⁵

Legislation concerning the establishment and form of Chinese corporations commenced in earnest in 1992 with the issuance of the "Tentative Provisions of Shenzhen Municipality on Companies Limited by Shares"²⁶ which were replaced – at least with relation to companies formed in the Shenzhen Special Economic Zone – on 1 October 1993 by the

23. See William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China*, 1 THE JOURNAL OF ASIAN STUDIES 43 (1995).

24. This is well described and analyzed in an excellent article by Professor Fang Liugang, perhaps China's best academic writing on corporate law matters. See Fang, *supra* note 9.

25. See *id.*

26. On March 17, 1992, by the Shenzhen Municipal Government. This article uses the term "company limited by shares" perhaps more familiar to readers versed in English law for the Chinese term *Gufen Youxian Gongsi*. Many North American writers and translators have rendered the term as "joint-stock companies." The underlying Chinese animal is the same.

"Regulations on Companies Limited by Shares of the Shenzhen Special Economic Zone."²⁷ Meanwhile, in 1993, Guangdong Province also promulgated its own "Regulations on Companies Limited by Shares."²⁸ Not to be left too far behind, Shanghai had also issued its own regulations providing a basis for companies limited by shares: "Tentative Provisions on Companies Limited by Shares of Shanghai Municipality" of 18 May 1992. Importantly, this collection of provisions and regulations allowed for the formation of companies limited by shares only in the jurisdiction promulgating the legislation in question: thus a company limited by shares could not for instance be established in Chengdu, Sichuan Province based upon the conditions set forth in any of the Shenzhen, Shanghai or Guangdong rules.

In the midst of this explosion of local corporate law-making, and the continuing lack of a national corporate law, certain central government authorities took it upon themselves to promulgate two documents which collectively asserted basic minimum national standards: the "Share System Experimental Procedures of the PRC"²⁹ and the "Opinion Regarding Standards for Companies Limited by Shares," the second known simply as the "Standard Opinion."³⁰ The first document mandated that all companies limited by shares established in the PRC comply with the Standard Opinion. Although the status of the Standard Opinion as "law" or "regulation" (as opposed to a mere "guiding document" or "principles") was originally open to some doubt, the State Council later obligingly confirmed in a Notice³¹ that the Standard Opinion had been duly promulgated and had the effect of ministry-level law and regulation (*zhengfu bumen guizhang*). Because of the peculiar timing of the promulgation of the Standard Opinion – two months after the Shenzhen rules and three days before the

27. On Apr. 26, 1993.

28. On May 14, 1993 (effective on Aug. 1, 1993).

29. Issued on May 15, 1992, by CRES, the State Planning Commission, the Ministry of Finance, the People's Bank of China and the State Council Production Office. Note that these Procedures were promulgated two months after the initial Shenzhen regulations, and only three days before the Shanghai provisions.

30. Also promulgated on May 15, 1992 [hereinafter Standard Opinion]. A separate opinion on standards applicable to "limited liability companies" was also promulgated on the same day [hereinafter Limited Liability Company Standard Opinion].

31. Notice of the State Council Office Concerning Implementation of the Standard Opinion (May 15, 1993, in GUOBANFA, No. 27, 1993). This was deemed necessary as many of the original "A" and "B" share issuers were concurrently being organized in accordance with a pronouncement that did not have the status of law, merely that of an "opinion."

Shanghai provisions – the relationship amongst the three was not clear.³²

In the event, companies limited by shares listed on the Shanghai and Shenzhen stock exchanges were formed under the Shanghai provisions and the Shenzhen regulations respectively, while issuers which listed almost simultaneously on the Shanghai and Hong Kong exchanges (“A” and “H” share issuers), and the first direct issuer on the New York Stock Exchange (an “N” share issuer, with no underlying tranche inside the PRC or in Hong Kong), were established pursuant to the Standard Opinion.

B. Trans-National (Territorial) Initiative (1992)

To facilitate the listing of the shares of PRC issuers on the Hong Kong Stock Exchange, relevant Chinese authorities and the Hong Kong Securities and Exchange Commission held discussions in late 1992 to clarify certain perceived gaps in the Standard Opinion. These discussions led to the signature of a “Cooperative Supervision Memorandum” and the promulgation (in mid-1993) of the “Addendum” to the Standard Opinion and “Mandatory Provisions of the Articles of Incorporation for Mainland Companies Listing in Hong Kong.”³³ The Addendum and the Hong Kong Mandatory Provisions proved extremely effective in enhancing the viability (and acceptance) of PRC issuers looking to Hong Kong.³⁴

32. The Standard Opinion, *supra* note 30, did say, at art. 118, that the Shenzhen regulations would continue to apply to companies limited by shares established in Shenzhen or listing on the Shenzhen stock exchange. However, no national authority was able, before the promulgation of the Company Law, to state clearly whether or not the Shenzhen regulations, or the subsequent Shanghai provisions, had priority over the terms of the Standard Opinion.

33. Addendum Regarding the Implementation of the Standard Opinion by Companies Listing in Hong Kong (May 24, 1993 by CRES) [hereinafter Addendum] and Mandatory Provisions for Articles of Association of Companies Listing in Hong Kong (June 10, 1993 by CRES) [hereinafter Hong Kong Mandatory Provisions].

34. The Addendum and the Hong Kong Mandatory Provisions, *supra* note 33, effected improvements in several areas, including: (i) the introduction of “H” shares; (ii) enhanced protection of minority shareholders; (iii) waivers of some provisions in the Standard Opinion, including: (a) the requirement of at least three promoters; (b) the external investment ceiling (on the issuer) of 50% of the value of its total assets; (c) the required twelve month interval between any two issuances of stock; (iv) allowance for an “authorized (but unissued) capital” concept; (v) recognition of foreign jurisdiction judgments as to share ownership; (vi) the keeping of the shareholder register at the (foreign) listing venue; and (vii) allowance for perpetual terms of such companies.

C. *The National Company Law and Its "Overseas" Progeny (1994)*

As stated above, the Company Law finally became effective on 1 July 1994.³⁵ However, various shortcomings, particularly with respect to the establishment of issuers intent on accessing foreign capital markets, were perceived immediately. Thus, the China Securities Regulatory Commission ("CSRC") formulated and saw to the promulgation by the Standing Committee of the State Council of the "Special Regulations of the State Council on Foreign Offerings and Listings of Companies Limited by Shares"³⁶ – which sought to codify many of the waivers set forth in the Addendum and the NYSE Shandong Huaneng listing³⁷ – and the "Articles of Association for Overseas Listed Companies"³⁸ – which also seek to incorporate previous arrangements made with Hong Kong authorities (chiefly the Addendum and the Hong Kong Mandatory Provisions) and in connection with the Shandong Huaneng offering.

D. *What is Being Compared and Why*

Amid this abundance of law-making it may be difficult to decipher what exactly, in a remarkably fluid situation, can be usefully compared. It is the purpose of this article to compare the Standard Opinion, as supplemented by the Addendum and amplified by market practice on the one hand,³⁹ and the subsequent Company Law on the other, to illustrate (i)

35. First attempts to draft a Company Law began in 1983, but stalled after multiple drafts. In 1986, the effort commenced to at least draft standards for companies limited by shares and limited liability companies, which resulted in the two "standard opinions." After the adoption and before the coming into effect of the Company Law, the State Council issued "Regulations on the Administration of Company Registration" (effective on July 1, 1994).

36. Promulgated on Aug. 4, 1994 by the State Council of the PRC, but published only on August 19, 1994 in the People's Daily [hereinafter Overseas Listing Rules].

37. The listing of Shandong Huaneng Power Development Co., Ltd. on the NYSE represented the first direct listing by a PRC company on a stock exchange outside of Hong Kong. Thus, while Shandong Huaneng was technically formed under the Standard Opinion and prior to the effectiveness of the Company Law, it was not subject to the special arrangements agreed between the PRC and Hong Kong for the initial "H" share issuers. The author and a team of his colleagues at Paul, Weiss, Rifkind, Wharton & Garrison represented the lead underwriter and global coordinator in the transaction: CS First Boston.

38. Promulgated by CRES and the State Council Securities Commission on Aug. 27, 1995 [hereinafter Overseas Mandatory Articles].

39. This paper will also make reference to the Provisional Regulations on the Administration of Share Issuances and Trading, promulgated by the State Council of the PRC on Apr. 22, 1993 [hereinafter Issuance and Trading Regulations].

important ways in which the Company Law was in fact a step backwards from the Standard Opinion and accepted practice, and (ii) how the Company Law represents a missed opportunity to improve upon the Standard Opinion. This comparison of two important milestones will not however ignore subsequent ameliorations of the Company Law, especially the relief provided by the Overseas Listing Rules – at least insofar as overseas issuers are concerned.

Such a comparison is intended to illuminate the corporate law issues under discussion in China presently, and thus provide a basis for understanding the direction of corporate legislative reform of wider application. To some extent, this discussion will reveal issues inherent in the drive to remove certain portions of the industrial economy away from central state control. In addition, the following discussion will highlight difficulties and deficiencies in the Company Law which could have been obviated by a more open (or “transparent”) legislative process, or at least one which took account of a wider circle of informed opinion.

IV. CRITIQUE OF THE COMPANY LAW

This section IV is divided into two sub-parts, the first, which offers more generalized comments on flaws inherent in the Company Law, and the second, which details how the Company Law in its present form makes the establishment of viable participants in the capital markets difficult. The first set of issues address more fundamental contradictions in the statute, while the latter set may pertain to the concerns of a more focused taste.

A. *General Critique*

- i. Shareholders Rights and Liabilities. The Company Law declares that a company's shareholders “have the right to enjoy the benefits of the assets of the company, make major decisions and choose the managers in accordance with the amount of capital they have invested in the company.”⁴⁰ This rather extraordinary provision seems to contravene the basic theory behind stock companies: to wit, that shareholders exercise powers, and enjoy rights,

40. See Company Law, *supra* note 2, art. 4, para. 1.

in accordance with the amount (and terms and conditions) of the stock they hold, not "the amount of capital they have invested in the company." What are the respective rights of shareholders who have invested different amounts of capital, but received the same amount of stock? The concept is clearly better suited to the determination of a shareholder's rights with respect to limited liability companies, as the Company Law recognizes.⁴¹ (Note also that, in other sections of the Company Law, the drafters seem to recognize and affirm the correct concept: for instance, companies limited by shares are commanded to distribute profits (after making up losses and making allocations to statutory funds) to shareholders "in proportion to the number of shares held by the shareholders."⁴²) The provision is matched only by the equally inappropriate stipulation of the Standard Opinion declaring that "shareholders shall assume liability for company debts, up to the quantity of shares held."⁴³ Of course, shareholders are not directly liable for the debts of corporations which they invest in. And even if they are, indirectly, then they should be liable only for such debts up to the value of the stock they have subscribed for, not their pro rata portion (determined by shareholding) of such corporate debts. The Company Law improves upon this provision only in part, with its declaration that "shareholders shall be liable to a company limited by shares to the extent of the shares held by them,"⁴⁴ a formulation that clarifies who exactly such holders are liable to but keeps open the door to liability for such shareholders in excess of the amounts they have paid into the company.⁴⁵

41. See *id.* provisions regarding limited liability companies: arts. 33 (dividends assigned in accordance with the proportion of capital contributions) and 41 (voting in accordance with the proportion of capital contributions).

42. *Id.* art. 177, para. 4 (emphasis added).

43. Standard Opinion, *supra* note 30, art. 42.

44. Company Law, *supra* note 2, art. 3, para. 3 (emphasis added).

45. For a good history of the concept of limited liability in China (and explicit comparison with U.S. concepts) but a non-critical view of the drafting style of the Company Law, see Chuan Roger Peng, Note, *Limited Liability in China: A Partial Reading of China's Company Law of 1994*,

- ii. Piercing the Corporate Veil "With Chinese Characteristics": The State Reaches Through to "its" Assets. No doubt to provide comfort to conservative figures who did not welcome the lessening of state control and the advent of corporations in China, the Company Law states: "the state-owned assets of a company belong to the state."⁴⁶ This stipulation is nonsense, as a corporation's assets should belong to the corporation, which corporation in turn belongs to all of the shareholders, it being impossible to identify a portion of the company's assets that belong exclusively to certain shareholders participating in the corporation. There was no similar concept in the Standard Opinion. Thus, pursuant to the terms of the Company Law, if a company limited by shares is owned 60% by a state entity or state proxy, yet all of the factory, capital equipment and fixed assets of the company were contributed to the corporation by such state entity or proxy (the other shareholders contributing cash), conceivably the 60% shareholder would own 100% of the assets of the corporation, or the corporation would not be able to dispose of such assets without the approval of the state-owned assets bureau.
- iii. Fiduciary Duty. Before the earliest "H" share offerings, the Hong Kong securities authorities demanded that PRC directors and officers of Chinese companies be subject to some strong and credible notion of fiduciary duty. So it was that the Standard Opinion,⁴⁷ in conjunction with an explanation rendered to the Hong Kong Securities and Exchange Commission by CRES on the meaning of Article 62 thereof, established the notion of "fiduciary duty" (chengxin zeren) for directors and senior managers

10 COLUM. J. ASIAN L. 263 (1996).

46. See Company Law, *supra* note 2, art. 4, para. 3.

47. See Standard Opinion, *supra* note 30, art. 62.

in Chinese law for the first time.⁴⁸ Sadly, the Company Law eliminated this key concept (and phraseology), and thus any commonly accepted notion of how, or in whose interest, such key personnel should act.⁴⁹ (Instead, directors, supervisors and managers are to "protect the company's interests.")⁵⁰ The exact concept (and phraseology) was recovered, and only with respect to companies issuing stock overseas, in the Overseas Listing Rules of August 1994.⁵¹ The damage in this regard is significant. First, it may have retarded the wide and undisputed application of a key concept of corporate responsibility which ensures that the board and management of a corporate entity will act in the interests

48. See CRES's letter to the Hong Kong Stock Exchange of June 10, 1993 (TIGAIHANSHENG, No. 74, 1993) [hereinafter CRES Hong Kong Stock Exchange Letter]. In item 6 of the letter, CRES stated that: "the duty... described in Article 62 of the Standard Opinion has the same meaning as the 'Chengxin Zeren [fiduciary duty]' of Hong Kong law." (Note the English words "fiduciary duty" are set out in the original Chinese form of the letter.) The equivalent concept exists in Taiwan's corporate law as "Shanliang Guanli."

49. The Company Law does stipulate that a company's articles of association are binding upon the company's shareholders, directors, members of the supervisory committee and senior managers (See Company Law, *supra* note 2, arts. 11, 59). The Overseas Listing Rules, *supra* note 36, expanded the application of this concept to other senior officers, which includes the CFO, the secretary of the company and other officers specified in the articles of association. The Company Law does contain specific prohibitions against directors, supervisors and management personnel acting in an interest contrary to the company's: See Company Law, *supra* note 2, arts. 59 (exploit position, accept bribes or take over company property), 60 (misappropriate company funds), 61 (enter into competition with, or sign contracts with, the company), 62 (disclose confidential company information), 118 (vote for resolutions which violate laws, the articles of association or result in serious losses), 128 (supervisors), 198 (members of liquidation group) and 214 (misappropriation, etc.)

50. Company Law, *supra* note 2, art. 59. Some analysts have understood this Article and all the other indications of responsibility in the Company Law as the concept of fiduciary duty. Even if this view is credible, it raises the question as to why the Overseas Listing Rules had to restate the Standard Opinion formulation (See Overseas Listing Rules, *supra* note 36, art. 31) and why the former CRES-explicated language was dropped. In addition, there is continuing dispute among various analysts and regulators as to whom or what precisely such duty is owed: the company, the shareholders or – in the most conservative view – the state.

51. See Overseas Listing Rules, *supra* note 36, art. 23, para. 1. This provision refers to such persons' (including supervisory committee members') "fiduciary duty" and "duty of due care." There may be a problem of legislating logic in this case. The above-cited provision of the Overseas Listing Rules makes implicit reference to an interpretation of a statutory provision (See Standard Opinion, *supra* note 30, art. 62) contained in a superseded law (the Standard Opinion) by a now seemingly dis-empowered authority (CRES – which is granted no power to explain the Company Law).

of the entity, not the particular shareholder who has appointed such director or executive (or the state). Second, the omission leaves a mystery as to the exact standard which directors and senior executives of PRC companies must measure up to. Contrary to the U.S. and English systems, there is no common law system in China which will in time produce jurisprudence explaining and amplifying such a key concept; like the continental system, an authoritative explanation will have to be rendered – difficult, even if the substantive omission is remedied, because the Company Law designates no authoritative interpreter of the Law.⁵² Of course, even if an authoritative body was appointed to explain the Law, and develop a coherent jurisprudence, there would remain the nettlesome problem of how, and who would enforce the duty so identified.⁵³

- iv. State Officials. As China makes the transition from a Party-led, state-mandated economy to a “socialist market economy,” various state officials have been placed in positions of “leadership” (i.e., managerial control) of newly transformed enterprises. In many cases, such newly-minted managers are simply the senior cadres of the enterprise's previous “leading department.” As the underlying assets have become corporatized, so the leading department's relationship with the assets has changed from one of administrative control to share ownership. Thus, the laudable prohibition in the Company Law against “state officials” (guojia gongwuyuan) acting as directors, supervisors or managers of Chinese companies seems strange and certain to be widely dishonored,⁵⁴ and contributes to the sense that the Company Law is not to be understood as a statute that has

52. Most Chinese legal theorists would think that, by default, it is the Standing Committee of the National People's Congress. See below, Section IV.A.xiv of this article.

53. See the definitive work on this most important question, Donald C. Clarke, *Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments*, 10 COLUM. J. ASIAN L. 1 (1996).

54. See Company Law, *supra* note 2, arts. 58 (with respect to the directors of limited liability companies), 123 (directors of companies limited by shares), 128, para. 2 (supervisors).

close connection with "actual circumstances" in China. (The Standard Opinion had no such provision.)⁵⁵ Unfortunately, the term "state officials" remains undefined, and worse, the underlying concept is presently honored mostly in the breach, where all of the directors, supervisors and managers of countless companies in the PRC also serve in government positions, or as the local or enterprise Communist party officials.⁵⁶

- v. Prohibition on Establishing Wholly-owned Subsidiaries. Although the Company Law states that companies may set up independent legal person subsidiaries,⁵⁷ it also mandates that "a limited liability company is established by capital contributions made together by at least two and no more than 50 shareholders."⁵⁸ Thus, any corporate entity intent on forming its own wholly-owned subsidiary (as a limited liability company) is effectively blocked, unless it finds at least one co-investor and thus takes only a partial interest in the subsidiary entity. This limitation is at odds with practice as it has developed throughout China since the mid-1980's and throws into serious doubt the true limited liability nature of such entities already established under pre-existing PRC companies. In a clear concession to the powerful remnants of the state-run economy, it is only state-authorized investment institutions or departments which may act as the sole investor in "wholly state-owned companies" (a special class of limited liability company).⁵⁹

55. See Standard Opinion, *supra* note 30, art. 61, which restricts certain individuals – incompetents, bankrupts, criminals, etc. – from serving as directors. The Company Law retains this concept, both with respect to limited liability companies (See Company Law, *supra* note 2, art. 57) and companies limited by shares (*id.* art. 123).

56. Of course, an argument can be made that "party" officials are not "state" officials, in a society and political system that confers separate status on party and state. The easy rejoinder to this argument is that China is a one-party state, where the party acts as a kind of executive, which ensures that its policies are implemented by the state.

57. See Company Law, *supra* note 2, art. 13.

58. *Id.* art. 20. This provision is identical to that contained in the Limited Liability Company Standard Opinion. See Standard Opinion, *supra* note 30, art. 9.

59. See Company Law, *supra* note 2, arts. 64-72.

- vi. Sloppy Drafting: Confusion Between "Issuer" and "Promoter," Etc. Some aspects of the Company Law reflect a rather pronounced ignorance of basic corporate or securities law or, at best, very sloppy drafting. For instance, many provisions of the Company Law speak of situations whereby "promoters offer shares to the public."⁶⁰ This use of the word "promoter" (faqiren) reveals some very basic confusion with the term for "issuer" (faxingren), or at least contemplates a situation whereby a promoter may engage in the direct public offer of stock of a company that is not yet even formed. It is true that many of the initial public offerings of stock in China were effected in connection with the formation of the issuer by promoters, but in all cases it is the "issuer" – not any "promoter" – which has engaged in the initial public offering. The Standard Opinion studiously avoids such a misconception, clearly identifying "the company" as the issuer. The Company Law has another equally confusing drafting mistake in that it refers in many places to "stock/share certificates" (gupiao) where in fact it means to address concepts of stock or share capital (gufen).⁶¹ In many other places, the drafters have made the correct choice, using "gufen." The inconsistency is inexplicable.
- vii. Quorum Requirements and Special Shareholders' Resolutions. The Standard Opinion contained basic quorum requirements for meetings at which both general and special resolutions would be addressed.⁶² It was commonly thought that the high quorum requirement for action on special resolutions (i.e., resolutions seeking to amend the articles of association or increase share capital) inhibited such actions unduly, or forced the company to

60. See, e.g., *id.* arts. 84, 85, 88, 89, 90.

61. See, e.g., *id.* art. 155 which refers to the listing of "share certificates" abroad.

62. See Standard Opinion, *supra* note 30, art. 46. This Article provides for a quorum of over 50% of the shareholders (by shareholding) for a general meeting at which an ordinary resolution (simple majority vote) is to be addressed, and a quorum of two-thirds of the shareholders (by shareholding) for a special resolution.

fall back on remedial provisions of the Standard Opinion allowing for the holding of a general meeting following the absence of a quorum (and after repeated notice to potential minority shareholders).⁶³ The lack of any mention of a quorum requirement (with respect to shareholders' meetings)⁶⁴ in the Company Law, or differentiation between general and special resolutions,⁶⁵ is an odd, if potentially benign (at least for controlling holders) omission. Certainly it does not evidence any consciousness on the part of the Company Law drafters of the rights of minority shareholders. The Overseas Listing Rules did subsequently re-introduce the Standard Opinion's 50% quorum requirement for general meetings for companies listing abroad.⁶⁶ The Overseas Mandatory Provisions go a step further, providing for general and specific meetings and resolutions, and following UK law, even "class" (called "type") meetings (*leibie gudong huiyi*) and voting.⁶⁷ (It has long been a feature of UK corporate law that shareholders of a certain class may

63. Standard Opinion Article 48 sets forth a procedure in the event that Article 46 quorum requirements are not met. *See* Standard Opinion, *supra* note 30, art. 48. First, further notice is given, and the meeting is postponed for 20 days. In the event a quorum is still not attained, then a quorum shall be deemed to exist, and the various majority and supermajority voting requirements shall be calculated based upon the total number of shares held by the shareholders who do attend.

64. The Company Law does recognize a quorum requirement for meetings of the board: 50% or more. *See* Company Law, *supra* note 2, art. 117.

65. Compare the Company Law's provisions with respect to action by shareholders of limited liability companies on increase of reduction of registered capital, division, merger, dissolution or change in corporate form (*See id.* art. 39, para. 2) and amendment of the articles of association (*id.* art. 40). With respect to companies limited by shares, the Company Law makes a distinction between general meetings (*id.* arts. 102, 103) and special meetings (*id.* art. 104), and voting requirements for certain kinds of resolutions at *general* meetings only (*id.* arts. 106, 107). Moreover, the Company Law does not address the respective quorum requirements at either type of meeting or for either type of resolution.

66. *See* Overseas Listing Rules, *supra* note 36, art. 22. But note the curious formulation of this Article and the corresponding article of the Overseas Mandatory Articles (*supra* note 38, art. 53), which asks for only 50% of the "shareholders who are planning to attend" (*Nichuxi Huiyide Gudong*) (which plans to attend must be confirmed in writing to the company at least twenty days before the meeting is convened per Article 20 of the Overseas Listing Rules). Thus, even if shareholders holding 90% of the stock of a company attend a meeting without having confirmed their desire to attend beforehand, while two of the remaining three shareholders holding in the aggregate 10% of the company stock and having confirmed their desire to attend miss their bus, a quorum is not established.

67. *See* Overseas Mandatory Articles, *supra* note 38, arts. 49-55, 64, 70, 71, 78-85.

vote, as a class, with respect to any proposal before the shareholders which may affect such class' rights.)

- viii. Ceiling on Individual Shareholdings. The Standard Opinion provided very explicit caps on the amount of shares to be owned by natural persons and/or employees.⁶⁸ The Company Law provides for no such restrictions. While the Standard Opinion formulation may appear, to Western eyes, overly restrictive, it sought to ensure wider dissemination of shareholdings among a diverse base of shareholders, not simply persons connected (presently, or in the very recent past) with huge entities representing the state, powerful individuals who exist in the twilight between government (or Party) administrative jurisdiction and enterprise management, or the employees of an enterprise, forced to take stock in lieu of cash compensation and/or benefits.⁶⁹ The Standard Opinion's method may have been overly blunt. However, it stood as the expression of an idea which seems to have been rebutted in the Company Law, with its many allowances for direct or indirect state control of corporations.
- ix. Shareholders' Resolutions. Those keen to promote shareholder democracy and/or protect the voice and leverage of minority stockholders will be disappointed by

68. See Standard Opinion, *supra* note 30, art. 24(3), which holds: (i) a natural person (other than "B" share or other foreign investors) may not own more than 0.05% of the stock of a company; (ii) employees may not own more than 20%, in the aggregate, of the total share capital of a company formed by directed share offer; (iii) employees, in the aggregate, may not own more than 10% of the publicly offered share capital, of a company formed by a public offer. Any natural person seeking to hold in excess of 10% had to gain approval therefor from CRES and the People's Bank of China (a power likely delegated to the CSRC). *Id.* art. 31. The Addendum altered this provision for "H" share holders, requiring only disclosure of such interests (pursuant to the Issuance and Trading Regulations, *supra* note 39) to the relevant stock exchange and notification to the issuer. See Addendum, *supra* note 33, art. 12.

69. There may of course be a contrary view, to the effect that a wide dissemination of shareholding dilutes the power of any independent owner of capital to govern the affairs of the industrial enterprise subject to the corporate form – especially in a "corporatization" system which deposits substantial shareholdings into the hands of state actors: whether holders of "state-owned shares" or "legal person" shares.

the Company Law, which – in addition to its failure to allow for different classes of stock and independent class rights⁷⁰– allows shareholders no right to propose resolutions for consideration at general or extraordinary meetings.⁷¹ This represents a retreat from the Standard Opinion, which allowed for shareholders representing at least 5% of a company's share capital to propose resolutions for consideration at a general meeting.⁷² Moreover, although pursuant to the Company Law shareholders holding 10% or more of a company's shares may call a special shareholders' meeting,⁷³ there seems to be no provision allowing such shareholders to propose resolutions at general or extraordinary meetings, only a notice to be given by the board to shareholders (thirty days before), and a prohibition against the adoption of any resolution at a special meeting not stated in the notice.⁷⁴ Thus, while a significant minority may cause the convening of a special meeting, it is not at all clear that such minority can propose resolutions to be validly considered at such meeting. And if such minority does not succeed in getting the board to notify all the shareholders of the matter giving rise to the special meeting, then resolutions with respect thereto may not be adopted. These anomalies were remedied somewhat in the Overseas Listing Rules, which allow shareholders holding 5% or more of a company's voting shares to submit draft resolutions at general meetings.⁷⁵ However, this remedial provision may have gone too far, in that there is no minimum period (before such meeting) when such shareholder resolutions must be submitted: opening

70. See Section IV.B.ii of this article.

71. See Company Law, *supra* note 2, arts. 102-111.

72. See Standard Opinion, *supra* note 30, art. 43(9).

73. The same provision is in the Standard Opinion, *supra* note 30, art. 44(2)(iii), and is confirmed in the Overseas Mandatory Articles, *supra* note 38, art. 72(1).

74. See Company Law, *supra* note 2, art. 105. See also Overseas Mandatory Articles, *supra* note 38, art. 55.

75. See Overseas Listing Rules, *supra* note 36, art. 21. Note however that the Overseas Mandatory Articles, *supra* note 38, echo Article 105 of the Company Law, prohibiting the adoption of any resolutions at a special meeting not contained in the notice for such meeting. *Id.* art. 55.

up shareholder meetings to the potential of *ad hoc* and disruptive resolutions being brought by vocal shareholder groups.

- x. Statutory Funds. The Company Law requires, seemingly without exception, that a portion (five to ten percent) of a company's after-tax profits be first allocated to a "statutory common welfare fund."⁷⁶ The Standard Opinion merely provided for the establishment of such a fund, but required no minimum allocation to it.⁷⁷ While it is true that in the past the PRC Ministry of Finance had promulgated notices requiring such allocations for Chinese corporate entities, the Ministry was reportedly in the process of amending such regulations to do away with such requirements. However, with the promulgation of the Company Law, such allocations are locked into a statute of national application, binding on all companies in China.
- xi. Ultra Vires and Third Parties. Chinese legal and organizational culture is fixated on the precise limitations described in a given entity's "business scope," such that no enterprise is authorized to undertake an activity not specifically delineated and authorized in an approved scope. Thus, it is somewhat surprising that the Company Law does not provide any protection for third parties acting in good faith, where a company or its directors or officers are acting *ultra vires* or beyond their scope of authority.⁷⁸ Conversely, the Standard Opinion provided for liability for those parties responsible for companies acting outside of their registered scope of business or engaging in illegal business.⁷⁹

76. See Company Law, *supra* note 2, art. 177.

77. See Standard Opinion, *supra* note 30, art. 74.

78. The Company Law only contains the affirmative statement to the effect that a company's business scope must be specified in its articles of association, and that a company must conduct its activities in accordance with its registered scope of business. See Company Law, *supra* note 2, art. 11, para. 2.

79. See Standard Opinion, *supra* note 30, art. 104(4).

- xii. Company Borrowing. The Standard Opinion made fairly clear the power of a company to borrow, give guaranties, and issue securities, and the ways in which such acts are to be authorized.⁸⁰ The Company Law provides a very exhaustive list of the powers of the board⁸¹ and the shareholders (acting in general meeting),⁸² all of which fail to state clearly whether a company actually has the power to borrow money, give guarantees, issue securities, etc.,⁸³ or if such power may be deemed to be implied, how such powers are to be exercised, and by whom.
- xiii. Established Entities: Conforming with the Company Law. The Company Law attempted to deal with the problem of how corporate entities established prior to the July 1, 1994 effective date of the Company Law (including those established pursuant to the Standard Opinion and the Limited Liability Company Standard Opinion) will be brought into conformity with it: "those companies not completely satisfying the requirements of this Law shall meet the requirements of this Law within the specified time limit."⁸⁴ It was subsequently rumored that the time period for such conforming was to be one year: i.e., to 1 July 1995. However, the State Council has, as of yet, not promulgated any relevant rules. While the initiative is a good one, given the need to conform the great universe of corporate forms in existence throughout the PRC, it puts the Chinese regulatory authorities under tremendous pressure with respect to such compliance, especially with regard to corporate entities which have effectively been formed through "private placements" but which have been granted no legal basis in the new law.⁸⁵ To date the majority of PRC companies formed since corporate

80. *Id.* arts. 43(5), 55(6), 55(12).

81. *See* Company Law, *supra* note 2, art. 112.

82. *Id.* art. 103.

83. Article 103(9) does state that the shareholders, acting in a general meeting, may exercise the power to decide upon the company's issuance of "bonds" (*Zhaiquan*), which are specifically addressed in Chapter V of the Company Law, *supra* note 2.

84. *Id.* art. 229.

85. *See* Section III.B.xiii below.

experiments began have not conformed, and there is of course a difficult issue as to how exactly they can be made to conform in a society where the attention and resources dedicated to enforcement are scanty.

- xiv. Failure to Promulgate Detailed Implementing Rules and Designate An Authoritative Interpreter of the Law. As of this writing, other than fairly insignificant provisions on registered capital,⁸⁶ China has not yet promulgated "detailed implementing rules" or regulations which could help explain and clarify many of the more vague or contradictory provisions of the Company Law (many highlighted in this article).⁸⁷ In theory, at least, it is the Standing Committee of the National People's Congress which is empowered to promulgate such urgently required rules – as they did for the Overseas Listing Rules (at the behest of the CSRC and other reformist elements). This situation (not unprecedented in Chinese legislative practice)⁸⁸ would not be so disturbing, if the drafters of the Company Law had at least seen fit to appoint a body as the governing authority or authoritative interpreter of the Law, or even a body which is in charge of promulgating detailed implementing rules. Conversely, the Standard Opinion and the Addendum made very clear designations of the party responsible for interpreting them (CRES),⁸⁹ as did the Issuance and Trading Regulations (the State Council Securities Commission, acting through

86. Tentative Provisions on the Administration of Registration of Company Registered Capital (Dec. 18, 1995 by the State Administration of Industry and Commerce, effective March, 1, 1996).

87. It is understood that there remains a vigorous dispute over which bureau will be permitted to draft such implementing rules among the Standing Committee of the National People's Congress, CRES, the Ministry of Finance, and the CSRC.

88. For instance, although the Law on Sino-foreign Co-operative Joint Ventures was promulgated on Apr. 13, 1988, implementing rules were only forthcoming in 1996. Similarly, there was a gap of almost twelve years between the promulgation of measures for the registration of foreign representative offices in China and their detailed implementing measures. And, notwithstanding the creation of two functioning stock exchanges in China, and markets in all sorts of securities, there is still no Securities Law in China.

89. See Standard Opinion, *supra* note 30, art. 119; see Addendum, *supra* note 33, art. 23.

the CSRC.)⁹⁰ The difficult result may be competing interpretations of the Law and its provisions, and patchwork implementation. Worse, at present, parties looking for authoritative rulings on the Company Law are uncertain which organ they must approach: CRES, the State Council, the CSRC, the Ministry of Finance, the State-Owned Assets Bureau, etc.

- xv. Status of "Foreign-Invested" Unlisted Companies Limited by Shares. The Company Law, by its terms, seems to provide a legal basis for foreign-invested "limited liability companies" but not for unlisted foreign-invested "companies limited by shares."⁹¹ In the earliest days of "B" share issuances, such foreign-invested (B-issuing and unlisted) companies were governed "by analogy" by the Sino-foreign equity joint venture law. The Standard Opinion explicitly recognized such vehicles (both "B" share issuers, and unlisted companies that sold share capital to foreign investors in private transactions), and clearly ceded approval power over them to the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC").⁹² Thus, as with foreign share offerings and "B" shares, the noticeable silence in the Company Law regarding foreign-invested companies limited by shares (and the rights of any other government authority to administer the same) seemingly eliminated a legal basis for them, and detracted from the completeness and seriousness of the Company Law itself, requiring a "small company law" to fill in an important gap. Subsequently, MOFTEC has promulgated such an additional special-use "little company law" specifically applicable to foreign-invested companies limited by shares: "Provisional

90. See Issuance and Trading Regulations, *supra* note 39, art. 83.

91. See Company Law, *supra* note 2, art. 18. The Article uses the term in Chinese for "limited liability companies" (*Youxian Zeren Gongsi*), rather than that for "companies limited by shares" (*Gufen Youxian Gongsi*) or the defined term for both (from art. 2 of the Company Law), merely "company" (*Gongsi*). See *supra* Sections II. A and B for a general description of these corporate forms and the various interests that a foreign investor may obtain in them.

92. See Standard Opinion, *supra* note 30, arts. 12 (para. 3), 13(5), 24(4). See also Issuance and Trading Regulations, *supra* note 39, art. 6.

Regulations on Several Issues Concerning the Establishment of Foreign-Invested Companies Limited by Shares” (the “Provisional Regulations”).⁹³ These Provisional Regulations make clear that the Company Law governs such companies only with respect to matters not covered in the Provisional Regulations and the Overseas Listing Rules,⁹⁴ and does not address which will have precedence in the event of conflict. (“B” share issuing companies were long regulated by “B” share regulations promulgated by the Shanghai and Shenzhen Exchanges and, after the promulgation of the Company Law, by a national law, “Provisions of the State Council on Domestically Listed Foreign Capital Shares of Companies Limited by Shares.”)⁹⁵

- xvi. Foreign Share Offerings. Although the Company Law allows (vaguely) for foreign issuances and listings of PRC share capital,⁹⁶ in general the Law applies only to domestically-issued share capital. The failure to address foreign issuances, and set forth some basic regulatory framework therefore, immediately subjected the “great” Company Law approved by the “national” legislature to the suspicion that it is in fact empty, thereby attacking the legitimacy and seriousness of the Law. The omission also caused the PRC securities regulatory authorities immediately to formulate and publish a “small company law,” which in fact contravened a great deal of the content

93. Promulgated by MOFTEC on Jan. 10, 1995.

94. See Provisional Regulations, *id.* art. 25.

95. Provisions of the State Council on Domestically Listed Foreign Capital Shares of Companies Limited by Shares (adopted on Nov. 2, 1995 by the Thirty-Seventh Session of the Standing Committee of the State Council and issued for implementation on Dec. 25, 1995 by Premier Li Peng pursuant to Order No. 189 of the State Council of the PRC) [hereinafter B Share Provisions].

96. See Company Law, *supra* note 2, arts. 85, 155 (which specifically contemplate additional rule-making by the State Council). The Issuance and Trading Regulations, promulgated almost eight months before the Company Law, also contemplate “direct and indirect” issuances abroad of the share capital of PRC enterprises. See Issuance and Trading Regulations, *supra* note 39, art. 6. The Addendum of course specifically authorized “H” shares: shares with a renminbi par value, purchased and traded in foreign currency and listed on the Hong Kong Stock Exchange. See Addendum, *supra* note 33, art. 4.

of the Company Law, further devaluing the Company Law before it had been in effect for even a month. This "small company law" was in fact produced for the specific purpose of establishing PRC issuers suitable to issue stock abroad, and is the "Overseas Listing Rules."⁹⁷

xvii. No Allowance for "B" Shares. The Standard Opinion (and the Issuance and Trading Regulations) originally contemplated – and thus specifically authorized – the creation and issuance of share capital to be listed on PRC stock exchanges but traded in foreign currencies among foreign holders: i.e., "B" shares.⁹⁸ The Company Law does not address such share capital. Thus, "B" share issuances, prior to the promulgation of the B Share Provisions,⁹⁹ had to either be conducted pursuant to existing Shenzhen and Shanghai regulations of local application, or await the issuance of national regulations promulgated under the authority of the Company Law with respect to such shares. This requirement of further, special-application legislation contributes to the sense alluded to above that the Company Law is empty or fails to address key issues involved in China's corporatization process.

xviii. Conflict with China's New Securities Regime. There are multiple ways in which the Company Law, as promulgated, conflicts with, preempts or skews jurisdictions associated with the substantive laws and institutions arising from China's new securities law regime (including the Issuance and Trading Regulations and the yet-to-be promulgated "Securities Law"). It will suffice to point out just a few of these areas:

First, the Company Law purports to identify the documentation required to be submitted to the "securities

97. See Overseas Listing Rules, *supra* note 36, art. 3, which provides a statutory basis for foreign-listed shares, or "foreign-listed foreign funded shares."

98. See Standard Opinion, *supra* note 30, arts. 24(4), 29; See Issuance and Trading Regulations, *supra* note 39, art. 6, para. 1.

99. See B Share Provisions, *supra* note 95.

administration authorities of the State Council" in connection with the public offer of shares to the public by promoters [sic].¹⁰⁰ The documents listed in the Company Law are far fewer than those currently requested by the CSRC¹⁰¹ in connection with such offers for sale¹⁰², and the Company Law does not even allow the normal Chinese catch-all: "and such other documents, etc. as such authorities shall request." The Company Law goes on to confer approval powers regarding "offering applications" to the securities administrative authorities¹⁰³, while simultaneously setting forth the very minimal – in comparison with the CSRC's announced requirements – content of an offering prospectus. Finally, the Company Law allows for administrative rehearing or administrative litigation (presumably against the CSRC) for the failure to grant an approval with respect to an offering application that "meets the requirements of this [the Company] Law¹⁰⁴, and – more ominously – "administrative sanctions" and (in serious cases) criminal liability for personnel who have direct responsibility for the approval of share and bond offerings, listings, etc. which do not meet such requirements.¹⁰⁵ This structure borders on the absurd, given the fact that "this Law" – the Company Law as promulgated – contains so narrow a list of required documentary and informational submissions, and that China's securities regulators have no competence, and should have no responsibility, for weighing the merits, or truth, of an offering or listing application.¹⁰⁶

100. See Company Law, *supra* note 2, art. 84.

101. See Issuance and Trading Regulations, *supra* note 39, art. 15, items 1-16.

102. One of the documents listed however, an "operating budget" (*Jingying_Gusuanshu*), is seemingly an *additional* document, of uncertain identity.

103. See Company Law, *supra* note 2, art. 86, para. 1.

104. *Id.* art. 227.

105. *Id.* art. 221.

106. The provision also runs directly counter to the spirit of the legend which must, pursuant to Article 16 of the Issuance and Trading Regulations, *supra* note 39, be on the front of any prospectus, reading (in part):

NO DECISION MADE BY THE GOVERNMENT OR ANY STATE SECURITIES REGULATORY DEPARTMENT CONCERNING THIS ISSUANCE INDICATES THAT SUCH BODIES HAVE SUBSTANTIVELY PASSED UPON OR WARRANTED THE

Second, the Company Law also asserts its authority in the matter of new share issuances, prescribing certain qualifications for companies that wish to increase their capital and issue new shares, including: (i) full subscription of a previous issuance (which must have been at least one year beforehand); (ii) continuous profits and payments of dividends for the three previous years; (iii) no false statement in a company's financial statements over the three previous years; and (iv) that the "projected profit" of the issuer exceeds the bank deposit interest rate.¹⁰⁷ The list is apparently exclusive, and thus in conflict with the Issuing and Trading Regulations,¹⁰³ and preempting any future Securities Law. The final requirement, the implicit promise that investors will do better investing in the issuer's stock than in depositing funds in a bank, is inappropriate and forces initial public offering issuers to tout immediate income over long-term capital appreciation.

Third, the Company Law rather clearly over-reaches its competence in purporting to set forth requirements for companies that seek to list on stock exchanges.¹⁰⁹ Such provisions would have been far better left to the CSRC, the forthcoming national Securities Law or the regulations promulgated by China's stock exchanges. Perhaps most extraordinary, and unprecedented in any local listing regulations or the Issuing and Trading Regulations, is the provision allowing for temporary de-listing of an issuer upon such entity experiencing losses for three straight years.¹¹⁰

VALUE OF THE SHARES BEING OFFERED BY THE ISSUER OR ANY POTENTIAL GAIN TO THE INVESTORS.

107. See Company Law, *supra* note 2, art. 138. Item (ii) does not apply to companies issuing stock in connection with a stock dividend.

108. See Issuance and Trading Regulations, *supra* note 39, arts. 10 (capital increase), 11 (increase of private placement).

109. See Company Law, *supra* note 2, arts. 151-158.

110. *Id.* art. 157(4). The Issuance and Trading Regulations, echoing art. 138 of the Company Law, address the problem from the opposite side: such that a company may list only after it has demonstrated three years of profits. See Issuance and Trading Regulations, *supra* note 39, art. 30(4). In Article 70, the Issuance and Trading Regulations allow for companies only to be prohibited from *issuing* shares in the event of serious misbehavior, but not de-listing. *Id.* art. 70.

B. *The Establishment of Viable Securities Issuers*

- i. Failure to Define Accepted Share Classifications. The Standard Opinion¹¹¹ distinguished between four kinds of share capital: (i) state shares, (ii) legal person shares, (iii) individual shares, and (iv) foreign shares, according to the identity of the holder of such shares. The Company Law does not address such distinctions. These distinctions are important, especially with respect to "state shares" and "legal person shares" and the oft-encountered hybrid, "state-owned legal person shares," the common name or concept for share capital of newly-transformed state enterprises held by representatives of the state.¹¹² The Standard Opinion, other items of legislation and various pronouncements by relevant departments have made clear that "state shares" and "legal person shares" may not be freely transferred.¹¹³ Thus, the failure of the Company Law even to address such different categories (coupled with the silence in the Overseas Listing Rules¹¹⁴ on the same subject) throws into doubt the very legal basis for such distinctions, and increases widespread confusion as to the limitations and uses of such share capital.

- ii. Failure to Provide a Legal Basis for Preferred Shares or Different "Classes" of Shares. The Company Law does not provide an explicit basis for preferred shares, different classes of shares (with different values or different voting rights, terms and conditions) or convertible shares; it merely allows for further State Council regulations on

111. See Standard Opinion, *supra* note 30, art. 24.

112. Which share classification was recognized in the Provisional Regulations on the Administration of State Equity in Companies Limited by Shares (promulgated by CRES and the PRC State-owned Assets Bureau on Nov. 3, 1994, almost a year, and a full five months, after the promulgation and coming into effect, respectively, of the Company Law).

113. See, e.g., the Provisional Regulations on the Administration of State Equity in Companies Limited by Shares, *id.* It is rumored that one of the major obstacles involved in the final formulation of a national "Securities Law" for China is the thorny issue of transferability of "state shares" and "legal person shares" and related implications for continuing "state ownership on behalf of the people."

114. The Overseas Listing Rules, *supra* note 36, make only a distinction between "foreign listed shares" and "domestic shares."

"the issue of different types of share certificates [sic] not covered by this law."¹¹⁵ The Standard Opinion addressed preferred shares in some detail,¹¹⁶ and seemed to imply the existence of different classes of the same shares of ordinary share capital.¹¹⁷

With respect to the creation of capital stock with different valuations, the Company Law seems to indicate the opposite, with the simple statement that: "the capital of a company limited by shares is divided into shares; each share shall be of equal value."¹¹⁸ This not only represents a step back from the Standard Opinion, which specifically authorized preferred shares, but makes exceedingly difficult the issuance of stock of PRC issuers on different markets – for instance, "A" shares in Shanghai and "N" shares in New York – where mid-range per share valuations differ. In the U.S. context this problem has been solved by effectively "bundling" together PRC share capital into appropriately priced "American Depositary Shares" (i.e., 50 ordinary shares of a PRC issuer being represented by one American Depositary Share), even in anticipation of subsequent "A" share issuances which will effectively unbundle such shares to achieve a more rational initial public offering price in China.

With respect to different classes of the same share capital enjoying different voting rights, the Company Law does not present an advance on the Standard Opinion,

115. "...*Faxing Benfa Guidingde Gupiao Yiwaide Qita Zhongleide Gupiao*". See Company Law, *supra* note 2, art. 135. Article 138 of the Company Law also alludes to the idea of different types of shares, mandating that when shareholders vote upon the issuance of new shares they must specifically address the "type" (*Zhonglei*) of such shares. *Id.* art. 138.

116. See Standard Opinion, *supra* note 30, arts. 23 (which allows for cumulative preferred and a liquidation preference), 39, para. 3 (which prohibits any voting rights for preferred shares), 102(1) (liquidation preference). Note also that the relevant accounting provisions for companies limited by shares – still in effect – make provision for preferred share capital.

117. See *id.* art. 27, which mandates that "the issue price of the same type (*Tongzhong Leibie*) of shares during the same issue by a company must be uniform," which seems to imply the existence of different "types" — and arguably different classes — of share capital; and art. 83(5), which uses the same Chinese word (*Leibie*) in requiring amendment of the company's articles of association to "add new types of shares" (*Zengshi Xinde Gufen Leibie*).

118. See Company Law, *supra* note 2, art. 129.

both of which seem to enshrine the principle of "one share, one vote."¹¹⁹ The Chinese phraseology in the Company Law is more limiting than that evident in the Standard Opinion: Article 130 of the Company Law declares that "the same stock (tonggu) enjoys the same rights (tongquan)¹²⁰ and the same benefits (tongli)," whereas the Standard Opinion refers in several places to the same (tongzhong)¹²¹ or new (xinde)¹²² "types" (leibie) of share capital (gufen).

The failure to acknowledge different classes of shares, and different rights attaching to such classes, will both stymie efforts to provide sophisticated financing strategies for investors in PRC issuers and cause certain difficulties in attempting to protect minority rights. If the Company Law does not address different classes of stock, then investors will have to settle for the same rights as all other shareholders and it will be difficult to establish a basis upon which minority holders or investors giving different value can be recognized and protected. The CSRC has recognized at least the latter problem with respect to PRC issuers accessing foreign capital markets by providing in the Overseas Mandatory Articles for "class shareholders" (leibie gudong), "class shareholder meetings" and a full listing of issues affecting a specific class, upon which such class must pass upon by a supermajority (two-thirds).¹²³ These concepts will be used

119. See Standard Opinion, *supra* note 30, art. 39, para. 2, and art. 49 (but see also paragraph 3 of the same article, which prohibits any voting rights being attached to preferred shares). CRES confirmed, in its letter to the Hong Kong Stock Exchange of 10 June 1993 (CRES Hong Kong Stock Exchange Letter, *supra* note 48) that the division in law among state, legal person, individual and foreign shares did not affect the principle of "one share, one vote", or "same rights for the same shares." See *id.* item 1. For the Company Law iteration, see Company Law, *supra* note 2, art. 106, para. 1, and art. 130, para. 1: "the same shares enjoy the same rights and benefits" (*Tonggu Tongquan, Tonggu Tongli*).

120. This concept has already resulted in one disastrous decision by a local PRC court, which has allowed that employee-owned shares – previously subject to restrictions on transfer pursuant to Article 24(3) etc. of the Standard Opinion, *supra* note 30 – must be freely transferrable as "the same stock enjoys the same rights," *i.e.*, the same liquidity.

121. See Standard Opinion, *id.* art. 27.

122. *Id.* art. 83(5).

123. See Overseas Mandatory Articles, *supra* note 38, arts. 72,78,80, 82.

to protect "H" and "N" (or other foreign shareholders) as an identified minority. A better solution would have been to provide for different classes of stock in general, and the protection of class rights in accordance with the practice of UK (and Hong Kong) law.

- iii. Pre-emptive Rights and Anti-dilution Protection. The Company Law provides for statutory pre-emptive rights with respect to "limited liability companies"¹²⁴ but only allows for a shareholder's vote at companies limited by shares in the event of a proposed increase in capital¹²⁵ or issue of new shares¹²⁶ – and only at general meetings, not apparently at special meetings.¹²⁷ If an increase in the registered capital of a company limited by shares will cause an amendment of the company's articles of association, then implicitly shareholders must approve by a supermajority (two-thirds) any increase in capital that would preview an issuance of capital by the company.¹²⁸ However, the Company Law falls short of offering existing shareholders pre-emptive rights to purchase shares in any offering of new shares, thereby protecting themselves against dilution. Statutory pre-emptive rights (with provisions for waivers of such rights subject to time and volume limitations) are a feature of corporate law regimes which are closest to the UK model. Whatever the merits of such rights for certain kinds of minority shareholders, it seems clear that they could not be offered in the PRC, as existing state legal person shareholders simply do not now have the cash to participate in such purchases, and thus would necessarily suffer dilution to existing non-state shareholders.

124. See Company Law, *supra* note 2, art. 33.

125. Which the board may only propose, but which must be approved by the shareholders. *Id.* art. 112(6).

126. *Id.* art. 138.

127. *Id.* arts. 103(8, 11), 104.

128. *Id.* art. 107, requiring a two-thirds majority of the voting rights *present at the meeting* – again with no quorum requirement apparent.

- iv. Derivative Forms and Convertible Stock. The Company Law does not acknowledge the existence of derivative instruments¹²⁹ and convertible stock. (The Company Law does, however, specifically envision the issuance of bonds that are convertible into stock.)¹³⁰ The Overseas Listing Rules correct this, for PRC issuers listing stock abroad, by allowing for depositary receipts "and other forms of derivative instruments." Some authoritative sources in the CSRC have previously indicated that the Overseas Listing Rules thus also authorize convertible stock, although the legal basis for this assertion is far from clear.

- v. Authorized but Unissued Capital and Over-allotment Option or "Greenshoe." Like the Standard Opinion, the Company Law does not provide a legal basis for any difference between a company's authorized and issued share capital.¹³¹ Instead, the Company Law anticipates that the value of all shares authorized for issuance (the "registered capital") will be fully paid.¹³² This limits the flexibility of issuers in the distribution of newly authorized capital, and negates the possibility of a common U.S. underwriting practice (associated with "book building") which allows for an "over-allotment option," i.e., an extra portion of stock that may be dipped into to cover extra demand in an IPO, and demonstrate the keen demand for an IPO stock. The Overseas Listing Rules allow for such over-allotment options, but only in an amount up to 15% of the total number of foreign-listed

129. *Id.* arts. 129-135. Note however that Article 135 allows that the State Council may issue further regulations governing the issuance of "other forms of share certificates [sic]."

130. *Id.* arts. 172, 173.

131. For "H" share issuers, the Addendum allowed for an "authorized" but unissued share capital concept, such that all of a company's authorized shares could be issued over a fifteen month period after the issuer's establishment. It also allowed for over-allotment options, and subsequent issuances of already authorized capital without further shareholder approval. *See* Addendum, *supra* note 33, art. 5.

132. *See* Company Law, *supra* note 2, arts. 25, 26, 78 ("the registered capital of a company limited by shares is the total share capital which has been registered with the company registration authority and which has been actually received"), 91.

foreign funded shares, and with the approval of the CSRC.¹³³

- vi. Investment Company Restrictions. Perhaps one of the most troublesome, and unclear, provisions of the Company Law is the ceiling on external investment permitted by companies:

Except for investment companies and holding companies specified by the State Council, where a company invests in other limited liability companies or companies limited by shares, the aggregate amount of investment may not exceed fifty percent of the net assets of the company...¹³⁴

(This ceiling echoes a similar ceiling in the Standard Opinion,¹³⁵ which differed from the Company Law only in requiring approval from "authorized departments." The Addendum eliminated the restriction altogether with respect to "H" share issuers¹³⁶.) First, the provision clearly restricts the establishment of holding company structures, so crucial to the creation of viable and attractive capital markets issuers. Second, the concept articulated in this provision is exceptionally unclear, as it seems to neglect investment by PRC companies into forms other than "limited liability companies or companies limited by shares" (i.e., partnerships, sole proprietorships, Sino-foreign equity and co-operative joint ventures) and gives no guidance how the value of "net assets" or investments in other companies is to be calculated, and when. There were high hopes that — after the Addendum — this provision would be altered in the Overseas Listing Rules. This hope, sadly, was not fulfilled.

- vii. Formation of Companies Limited by Shares and Initial Public Offers. The Company Law provides for two

133. See Overseas Listing Rules, *supra* note 36, art. 11.

134. See Company Law, *supra* note 2, art. 12, para. 2.

135. See Standard Opinion, *supra* note 30, art. 4.

136. See Addendum, *supra* note 33, art. 7.

methods of forming a company limited by shares: "offer" and "promotion."

Establishment by the "offer" method means "subscription by the promoters of part of the shares to be issued by a company (not less than 35%) and a public offer of the remaining part of the shares" prior to formal establishment,"¹³⁷ i.e., the raising of funds from the public even before the company has been established.¹³⁸ (The provisions of the Standard Opinion resulted in the same anomaly.¹³⁹) Few overseas jurisdictions allow the public offer of shares of a company that is not yet formed; it is highly unlikely that investors in China will, as the domestic capital market matures, engage in such risky purchases (even though the Company Law provides for a full refund of the public subscribers' payments – with bank interest – in the event a founding meeting is not held, the public shares have not been fully subscribed, or a resolution not to establish the company is adopted at the founding meeting).¹⁴⁰

Establishment by the "promoter" method contemplates the subscription by the promoters of all initial shares issued by the company¹⁴¹ (while subsequent

137. See Company Law, *supra* note 2, art. 74. This provision represents a narrowing of options, as compared with the Standard Opinion, which described two kinds of "offers": (a) a public offer much like that described in Article 74 of the Company Law, and (b) a "directed share offer," allowing for subscription by the promoters, and non-public issuances to other legal persons and, subject to approval, employees (a kind of pre-establishment private placement). See Standard Opinion, *supra* note 30, art. 7, para. 3.

138. See Company Law, *supra* note 2, arts. 91- 95 which mandate a founding meeting within 40 days of payment in full by the public subscribers, adoption of the issuer's articles of association at that meeting, submission of a company registration within 30 days of the founders' meeting, and a decision by the registration authority regarding formation of the company thirty days *after that*. See also *id.* art. 136, which indicates that share certificates may not be issued prior to the registration and establishment of a company, and art. 142, which requires that, in connection with an issuance of new shares, all money be paid in before shares are issued, and re-registration is effected.

139. See Standard Opinion, *supra* note 30, arts. 19, 20, which contemplate a founding meeting forty days *after* payment for company shares is received in full, and formal registration and establishment of the company thirty days *after that*.

140. See Company Law, *supra* note 2, arts. 91 (para. 2), 93.

141. *Id.* arts. 74, 82.

issuances are restricted within any twelve-month period following).¹⁴²

Thus, an initial public offering using the first technique seems unpalatable, while the second seems impossible.

The Company Law further requires that companies limited by shares must have at least five promoters (more than half of which must be domiciled in China),¹⁴³ but that state-owned enterprises being re-organized into companies limited by shares may have fewer than five promoters, but only if they are established through the "offer" method.¹⁴⁴ Thus, the Company Law provision also represents a step back from the Standard Opinion, which allowed that "large scale" state enterprises being transformed into companies could, subject to approval, have only one promoter if the "offer" method was used.¹⁴⁵

The combined implications of each of these provisions makes for very difficult promotion, establishment and initial public offering procedures. While the problem remains for wholly domestic companies, the CSRC provided a remedy in the Overseas Listing Rules. Pursuant to those Rules, a state-owned enterprise (i) may be converted into a company limited by shares by the promotion method with fewer than five promoters, and (ii) may issue new shares immediately after its formal establishment.¹⁴⁶ (The Standard Opinion¹⁴⁷, the Issuance and Trading Regulations¹⁴⁸ and the Company Law all provide for certain restrictions on increases in capital and public flotations within a year of

142. As with the offer method of establishment, companies formed by promoters are established only after all promoters shares have been fully paid. *Id.* art. 82, para. 2.

143. The Standard Opinion, *supra* note 30, required a minimum of three promoters.

144. *See* Company Law, *supra* note 2, art. 75.

145. *See* Standard Opinion, *supra* note 30, art. 9, para. 1. The Addendum was even more favorable in such situations, allowing for one promoter, formal establishment and an immediate increase in capital followed by a public offer. *See* Addendum, *supra* note 33, art. 6.

146. *See* Overseas Listing Rules, *supra* note 36, art. 6.

147. *See* Standard Opinion, *supra* note 30, art. 7 (para. 3), 36.

148. *See* Issuance and Trading Regulations, *supra* note 39, art. 11(2) (concerning private placements).

formation or any previous increase.¹⁴⁹) The Overseas Listing Rules provide even greater flexibility for companies engaging in transformation and initial public offering by stating that "a company may increase its capital through an issuance of foreign-listed foreign-funded shares even when the issuance is within a period of less than twelve (12) months of a previous share issuance."¹⁵⁰ This offers the best of both worlds: formation by promoters and formal legal establishment of an issuer, followed by an increase in capital, and an initial public offering — i.e., the "offer" method, but with the legal establishment of the company sensibly coming after the promotion and before the offer.

- viii. No Pricing Differential for Simultaneous Issuances. The Company Law states very clearly: "For share certificates [sic] issued at the same time (tongci faxing de gupiao), each share shall have the same issue terms and price; the share price for each share purchased by any organization or individual must be the same."¹⁵¹ This makes very difficult the previously accepted practice of simultaneous issuances of either (i) "A" and "H" (or "N"¹⁵²) shares or (ii) "A" and "B" shares, at different issue prices, and explicitly overrules the very finely-drawn Article 27 (paragraph 3) of the Standard Opinion, which states only that: "the issue price of the same type of shares during the same issue by a company must be uniform (emphasis added)." This form of language allowed "A," "B" and "H" shares to be offered at different issue prices, based upon their characterization as different "types" of shares.

149. In the Standard Opinion, *supra* note 30, the twelve month blackout restriction is applicable to: companies formed by the promoters method, and by the "directed share offer" method (described herein as the analogue to private placements), and any company that wishes to issue new share capital after establishment. The Addendum eliminated this restriction for "H" share issuers; see Addendum *supra* note 33, art. 8.

150. See Overseas Listing Rules, *supra* note 36, art. 10, para. 2, which follows the lead of the Addendum, *supra* note 33, art. 8.

151. See Company Law, *supra* note 2, art. 130, para. 2.

152. The CSRC does not recognize a distinction between "H" and "N" shares; the different designations are merely a market idiom.

- ix. Share Subscription Applications. The Company Law mandates that, in making a public offer of shares, promoters must publish a prospectus and prepare a share subscription application (*rengushu*), the latter of which must conform to detailed requirements.¹⁵³ However, this provision seemingly conflicts with accepted practice under the Standard Opinion, which required companies to issue "share subscription certificates" (*gupiao rengouzheng*). Apparently, these share subscription applications are not the same as share subscription certificates, as subscribers submitting the former are obligated to make payment for shares according to the number of shares they have subscribed for pursuant to the share subscription applications,¹⁵⁴ presumably eliminating any allocation among potential subscribers in the event of over-subscription.
- x. Share Certificates. Article 132 of the Company Law — while allowing for "other forms"¹⁵⁵ — seemingly contradicts another command of the Law requiring that company shares take the form of "share certificates" (*gupiao xingshi*)¹⁵⁶ and further stipulates the items that must be included on share certificates, that such certificates must be signed by the chairman of the board of directors and affixed with the company seal, and that promoters' shares must be so labeled. Such stipulations seem to run counter to the desired move towards book-entry shares (specifically authorized in the Issuance and Trading Regulations¹⁵⁷), and leaves a mystery as to how

153. See Company Law, *supra* note 2, art. 88. The requirements are set forth at the Company Law, art. 89.

154. *Id.* art. 88.

155. This represents an improvement from the Standard Opinion, which contemplated the use of only paper share certificates. See Standard Opinion, *supra* note 30, arts. 25, 28.

156. See Company Law, *supra* note 2, art. 129, para. 2.

157. See Issuance and Trading Regulations, *supra* note 39, arts. 53 and 81(2). Note also that the CRES Hong Kong Stock Exchange Letter, *supra* note 48, makes clear that the "printed" signature of the chairman of the board of an issuer on the issuer's share certificate would comply with Article 28 of the Standard Opinion, *supra* note 30, art. 28.

the required notation for promoters will be removed once such shares are properly transferred to non-promoters.

- xi. Intrusive Escrow Arrangements. The Company Law contains the following, apparently exclusive, provision with respect to the handling of money flows in connection with public offerings:

In making a public offer of shares, the promoters [sic] shall enter into an escrow agreement with a bank. The escrow bank shall receive and hold as agent the payments for shares, issue receipts to subscribers making payments, and shall be obliged to issue evidence of receipt of payments to relevant departments.¹⁵⁸

This provision is awkward, as it forces the employment of a bank intermediary, and does not give the issuer (or its promoters), or their appointed underwriter, any other choice as to how to manage the underwriting.

- xii. No Legal Basis for Private Placements. Except with respect to the original subscription of share capital by "promoters,"¹⁵⁹ the Company Law does not contemplate private placements to domestic or foreign investors, sophisticated or not. The Standard Opinion apparently did, in the form of "directed share offers,"¹⁶⁰ which entailed subscription by promoters, coupled with (pre-establishment) non-public distributions to other legal persons and, subject to approval, employees. The Issuance and Trading Regulations went a step further, allowing for private placements (dingxiang muji) even after the completion of the establishment process, with a

158. See Company Law, *supra* note 2, art. 90.

159. Note however that even in the event of establishment by the offer method, a company limited by shares must "make public" its financial statements, which seems to eliminate one of the key benefits – for an issuer – of a private placement. See Company Law, *supra* note 2, art. 176, para. 3.

160. See Standard Opinion, *supra* note 30, art. 7, para. 4.

space of twelve months between each placement.¹⁶¹ This omission from the Company Law is both at variance with the way in which a great deal of "B" share issuances have been effected, along with a smaller portion of "A" share distributions, and it also seems to close off a viable capital raising method for competent PRC issuers that cannot face the approvals (or expense and disclosure) associated with a public offer.

- xiii. Restrictions on Transfers by Sitting Directors. The Company Law contains a blanket prohibition upon "directors, members of the supervisory committee, and managers (jingli)" from transferring their shares while they are in office,¹⁶² a prohibition not apparent from the Standard Opinion or the Shares Issuance and Trading Provisions. In fact, the Standard Opinion contained a much more nuanced and thus workable provision, applicable only to directors and managers, which allows for time and volume limitations and a reporting requirement.¹⁶³ The Company Law provision is drawn too broadly, and may seek to hamper the development of an independent, economically-interested managerial class. A better strategy would have been a narrower prohibition (i.e., prohibiting such transactions within many months or years of purchase, sale or public announcements) and the establishment of a system whereby such persons are obligated to disclose their shareholdings in the companies they control¹⁶⁴ and notify the public or some central authority upon their desire to dispose of or acquire shareholdings.¹⁶⁵

161. See Issuance and Trading Regulations, *supra* note 39, art. 11.

162. See Company Law, *supra* note 2, art. 147, para. 2.

163. See Standard Opinion, *supra* note 30, art. 30(6).

164. Which disclosure requirement already exists: see Company Law, *supra* note 2, art. 147.

165. Note that the Issuance and Trading Regulations adopt another strategy, such that any director, supervisor, senior management or legal person shareholder who owns more than 5% of the voting shares of a company, and who realizes a profit on any stock purchases or sales of the same company, must vest such profits in the company. See Issuance and Trading Regulations, *supra* note 39, art. 38.

- xiv. Interim Dividends. Neither the Standard Opinion nor the Company Law provides an explicit legal basis for interim dividend distributions, or empowers the board of a company to declare such an interim dividend, absent the approval of the shareholders acting in general meeting.¹⁶⁶ The requirement that certain allocations be made annually to the statutory common reserve and welfare funds before the profits of the company may be distributed (and the "clawback" of dividends in the case of an under-allocation)¹⁶⁷ ensure that interim dividends will be difficult to effect, if they are not contrary to law. Thus, interim dividends, an important aspect of capital markets transactions in mature markets, and certain to become increasingly desirable to real PRC investors, are seemingly impossible or illegal to effect.
- xv. Return of Mis-allocated Profits. The Company Law mandates that any company must, before distributing its annual after-tax profits, make allocations to the company's "statutory common reserve fund" (10% of after-tax profits) and "statutory common welfare fund" (5-10% of after-tax profits).¹⁶⁸ The provision is subject to a cap once the common reserve fund is funded to a certain level (50% of registered capital), and a carry-over funding obligation in the event of losses. However, the Company Law also contains the following extraordinary provision:
- If a shareholders meeting or the board of directors violates the above provisions and profits are distributed to the shareholders before the company makes up losses or makes allocations to the statutory common reserve fund and

166. See Company Law, *supra* note 2, arts. 103(7), which empowers the shareholders in a general meeting to *approve* (*Pizhun*) the company's profit distribution plan, and 112(5), which allows the board merely to *formulate* (*Zhidong*) such distribution plan. See also the similar provisions in Standard Opinion, *supra* note 30, arts. 42(2), 55(4).

167. See Company Law, *supra* note 2, art. 177. See below, Section III.B.xv.

168. See Company Law, *supra* note 2, art. 177. See also Section III.A.x above.

the statutory common welfare fund,
the profits distributed in violation
of the provisions must be returned
to the company.¹⁶⁹

Not only is this "clawback" mechanism profoundly worrying to shareholders (as it raises the specter of having to disgorge already received and employed dividends), but it is almost impossible to implement in a true market context, where shareholders acquire and dispose of interests continuously. How likely is it that a company could reconstruct its year-end shareholders' list from several years previous, and then contact certain former shareholders (and recipients of wrongfully calculated dividend monies) to cause them to disgorge such monies to the company? The provision is plainly unworkable, and a holdover from a corporate regime that contemplates large, static shareholders: i.e., the state, or long-term foreign investors in joint ventures. It also represents a misconceived departure from the Standard Opinion, which required allocations to make up previous losses, and to the two statutory funds (with no minimum for the welfare fund),¹⁷⁰ before any dividend (or bonus) distributions – and in the event of a breach of such obligations by the company, then the conferring of a right on the company's creditors to request compensation (from the company, not the shareholders) for any losses incurred.¹⁷¹

V. CONCLUSION

The foregoing discussion, which represents a detailed description of some of the flaws in China's Company Law, should not be taken as an outright condemnation of an important item of legislation which took years to produce. Instead, the discussion seeks to highlight certain aspects of the

169. See *Company Law*, *supra* note 2, art. 177, para. 3. See also art. 216 which also commands that in such event the Company must make up (how and to whom?) "the exact amount which should have been allocated."

170. See *Standard Opinion*, *supra* note 30, art. 73, para. 1.

171. *Id.* art. 73, para. 2.

Law which need to be amended or rethought as the government of China, powerful departments and newly-independent economic actors use the legislation (and underlying concepts) in the transition to a mixed economy, albeit with "Chinese characteristics." This task has become only more urgent with the drive to corporatization and diminution of the state's interest in the aftermath of the 15th Congress of the CCP.

The criticisms above should also alert China's government and foreign professionals to the great price paid for the lack of real transparency in China's legislative process. Many of the problems and contradictions noted above could have been addressed had more insightful (or experienced) hands been allowed to participate in the generation of the Company Law. Of course, many of these problems have since been remedied in subsequent rule-makings, waivers, or the promulgation of legislation applicable to certain kinds of entities or situations – for instance, with respect to issuers accessing foreign capital markets. Such *post facto* remedial action, however, actually serves to detract from the prestige and identity of China's first modern national corporate statute, even while it makes crucial corporate concepts more useful or viable in the immediate term. Only in this sense would the promulgation of the Company Law have been better delayed until greater agreement or coherence could be achieved.

The foregoing critique also reveals the temporary result of contending forces in the struggle to transform China from a centralized, state planned economy to some kind of market economy ruled by law. William Kirby has described the history of China's first corporate law (the 1904 law promulgated by the Qing court) as "to some degree, a barometer of the state's assumptions toward the economy over the course of the 20th century."¹⁷² So the retreat implicit in the changes between the Company Law and the Standard Opinions may be seen as the barometer of the state's defense against the onslaught of independent economic action, acting under an increasingly weak central government, and predicated on interactions between economic "strangers" governed by law, all as conjured up by the opening up to the outside world and heady program of economic and industrial reform of the last 15 years. While the Company Law has nettlesome technical problems, it is also replete with inconsistencies and odd concepts which are a direct expression of the state's resistance to what has been advertised as the new system: a market economy employing increasingly private capital. Thus, while on its face the Company Law

172. See Kirby, *supra* note 23, at 44.

promises the creation and organization of a semi-independent group of economic actors, in fact it both expresses and enables continuing state control over the economic and industrial system in China. Certainly this appears to be the reality of corporatization in China to date, where the state is merely changing the form, but not the substance of economic relationships. In this way, law, and specifically the Company Law, has acted not as a bulwark against the state and central control, or as an agent to further competitiveness and independent economic action, but as a vehicle in promoting the state's ascendancy over "private enterprise."¹⁷³ The fascinating question in China is whether or not the true function of the corporation will triumph over the badly compromised form presently described in China's Company Law.

173. This is akin to the development Kirby perceives with respect to the Guomindang "nationalization of the corporation" in the period 1929-45. *Id.* at 51.

