

Protection of minority shareholders in Hong Kong and China: do culture and institutional design make any difference?

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Abstract

The corporate governance system in Hong Kong and mainland China was transplanted from Western countries. However, the latest ranking in corporate governance in Asia shows that Hong Kong moved to the top of the 2007 ranking above 11 other Asian countries while China was not even included.² How can such a huge difference be explained? This article compares and discusses the reasons for the difference in corporate governance in Hong Kong and China. In particular, it focuses on discussing local cultural influences and institutional design on the implementation of the system of protection of minority shareholders in Hong Kong and China.

Introduction

Corporate governance is promoted by many people³ as an all-embracing concept to fix corporate ills and failures because it establishes a system of checks and balances to ensure that decision makers are accountable to various stakeholders.⁴ Protection of minority shareholders (PMS) is one of the important elements of corporate governance. Each country has its own PMS mechanism embedded in its company law.⁵ The effects of PMS rules that appear similar may not be the same due to different cultural environments. The fact that a system of PMS works well in certain countries does not ensure that it will work successfully in other countries or regions.

1 I would like to express deep appreciation to Professor Christopher L. Ryan from City University London for his guidance and invaluable comments.

2 According to the news reported by Dow Jones International News, “Hong Kong’s corporate governance is ranked as the strongest out of 11 major Asian economies, the first time Hong Kong has held the top position since the study began in 2000. Singapore slipped to second.” The ranking was conducted by the Asian Corporate Governance Association in 2007. For details, see <http://www.acga-asia.org/public/files/HK%20Has%20Asia%27s%20Best%20Corporate%20GovernanceSingapore%20Slips-Study%20DJ%2026%20Sep%2007.pdf> (last accessed July 2009).

3 S S M Ho, *Corporate Governance in Hong Kong: Key problems and prospects* (Hong Kong: Centre for Accounting Disclosure and Corporate Governance, School of Accountancy, Chinese University of Hong Kong 2003), p. 3.

4 C Xi, “In search of an effective monitoring board model: board reforms and the political economy of corporate law in China” (2006) 22 *Connecticut Journal of International Law* 1.

5 H Cai, “Bonding, law enforcement and corporate governance in China” (2007) 13 *Stanford Journal of Law, Business and Finance* 18. At common law, initial protection was provided by the judiciary but in recent years the protections have become statutory. See the UK Company Act 2006, ss 260 and 994, for example.

There is a large amount of literature on corporate governance and PMS worldwide. La Porta et al.⁶ for example, hold the opinion that “common law countries afford the best legal protections to shareholders and French civil law countries afford the worst” after examining legal rules covering protection of corporate shareholders and creditors, the origin of these rules and the quality of their enforcement in 49 countries. They also argue that highly concentrated ownership has a close connection with poor investor protection. The conclusion they draw is “good accounting standards, rule of law, and shareholder protection measures are highly negatively correlated with the concentration of ownership”.⁷

Stijn Claessens and his co-authors have drawn a similar conclusion after analysing the relevant data of 1301 publicly traded corporations in eight East Asian countries.⁸ They point out that more than two-thirds of East Asian firms are controlled by a single shareholder and separation of management from ownership control is rare.⁹ They also argue “as ownership gets beyond a certain point, large owners gain nearly full control of the company and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders”.¹⁰

When comparing corporate structures in Hong Kong with those in China based on the above scholars’ arguments, it is easy to conclude that PMS in the two places should be more or less the same because a majority of private companies in Hong Kong and a large number of limited liability companies in China are controlled by a single or a few majority shareholders. Therefore, shareholders’ interests may not be as well protected as their counterparts in common law countries.

But the latest ranking in corporate governance in Asian countries shows that Hong Kong moved to the top of the 2007 ranking above 11 other Asian countries while China was not included.¹¹ Despite so much resemblance in ownership structure, culture and management of companies, what causes such divergence in corporate governance and PMS between Hong Kong and China? Does culture and institutional design make the difference?

Both Hong Kong and China are Chinese-dominated societies with the same Confucius-influenced cultural background which affects people’s way of thinking, behaviour and doing business. To understand the interrelationship between these three characteristics, it is necessary to see how scholars discuss the interconnection. There is a large body of literature examining the relationship between philosophy, culture and law. Hahm says that the law is a reflection of the culture’s norms and values and, in order for law to be effective or valid, it must accurately reflect those norms and values.¹² Kim and Markus examined the values of uniqueness or conformity among people in different countries and found that Americans preferred uniqueness while Chinese and other East Asians preferred

6 The four authors are Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W Vishny and the title of their article is “Law and finance”, Working Paper 5661 (Cambridge, Mass: National Bureau of Economic Research, July 1996).

7 Ibid.

8 The eight East Asian economies are Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

9 S Claessens, S Djankov, J Fan and L Lang, “Expropriation of minority shareholders in East Asia” Working Paper 2000-4 (Tokyo: Center for Economic Institutions, Institute of Economic Research, Hitotsubashi University 2000), downloadable from <http://ideas.repec.org/p/hit/hitcei/2000-4.html> (last accessed July 2009).

10 Ibid.

11 The ranking was conducted by the Asian Corporate Governance Association in 2007. See n. 2 above.

12 C Hahm, “Law, culture, and the politics of Confucianism” (2003) 16(2) *Columbia Journal of Asian Law* 254–301.

conformity.¹³ Amir Licht further discusses the possibilities of neatly “plugging-in” foreign legal elements to an existing corporate governance system. He says that, to ensure foreign legal elements are workable, one must assess the difference or distance between the source and target system.¹⁴

In order to find out the reasons for Hong Kong’s placement at the top of corporate governance ranking in Asia and China’s non-appearance, this article intends to compare PMS in Hong Kong and China from four aspects: first, cultural influence on company management in Hong Kong and China; second, the property ownership structures of private companies in Hong Kong and limited liability companies in China (because a company’s property ownership structure, to a large extent, decides the company’s management style); third, the relevant laws and regulations guiding PMS and the corporate governance systems in the two places; and, fourth, the differences in institutional design and culture between Hong Kong and China.

1 Cultural influence on company management

Cultural differences exist between Western and Asian countries. In Western countries, in America, in particular, cultural values such as freedom and individual rights are strongly emphasised. By the American Constitution and especially the Bill of Rights, people repeatedly hear messages about their responsibility for their own fate. They should follow their own conscience, be true to themselves and make their own choices. It is also believed that individual persons’ attitudes, feelings and behaviours should be determined by the self without being controlled by any external cause.¹⁵ On the other hand, the East Asian cultural context emphasises harmony and conformity.¹⁶ One of the most important virtues stressed throughout Chinese history is the notion of centeredness and harmony which refers to keeping balance and harmony within the group.¹⁷ Individuals’ interests are subordinate to those of a group.¹⁸ Keeping balance and harmony among extremes without being skewed or biased has been respected as one of the highest virtues in Chinese culture.¹⁹

PROPERTY OWNERSHIP STRUCTURE

(a) the role of the paternalistic figure in a Hong Kong company

Because individuals are required to put the group interests ahead of their own (based on Confucian teaching), a paternalistic figure within the group therefore plays a very important role. Chinese believe a country is like an extended family with the emperor or monarch at the top.²⁰ Within a Chinese family, the relationships between father and son and husband and wife are superior–inferior in character with a general duty of obedience owed by the inferior to the superior and a reciprocal duty of caring, support and guidance owed by the superior to the inferior.²¹ A private company in Hong Kong is like an extended family with

13 H Kim and H R Markus, “Deviance or uniqueness, harmony or conformity? A cultural analysis” (1999) 77(4) *Journal of Personality and Social Psychology* 785–800.

14 A N Licht, “Legal plug-ins: cultural distance, cross-listing, and corporate governance reform” (2004) 22 *Berkeley Journal of International Law* 195.

15 D A Jopling and U Neisser, *The Conceptual Self in Context: Culture, experience, self-understanding* (New York: Cambridge UP 1997), vol. 7.

16 Kim and Markus, “Deviance”, n. 13 above.

17 Hahm, “Law, culture, and politics”, n. 12 above.

18 Kim and Markus, “Deviance”, n. 13 above.

19 Ibid.

20 S B Lubman, *Bird in a Cage: Legal reform in China after Mao* (Palo Alto, CA: Stanford UP 1999), pp. 3–8.

21 D C K Chow, *The Legal System of the People’s Republic of China in a Nutshell* (St Paul, MN: Thomson/West 2003).

an enterprise founder (EF) acting as a paternalistic figure in control of the company. Its employees show their utmost respect and loyalty to their EF, despite the fact that professional company managers are being widely employed nowadays. The vertical management structure used has the features of paternalism, hierarchy, responsibility, mutual obligation, family atmosphere, personalism and protectionism.²² Conformity and harmony are much emphasised.

People in Asia are taught from their childhood to be obedient to elders, tradition and social norms. Employees should have the virtue of being responsive to standards of proper behaviour without emphasising their personal interests. Thus, it is not easy for employees and minority shareholders to stand up and express their objection to decisions which are not in their favour. In particular, employees must understand that even if their patriarch is wrong, confronting the patriarch directly in public will cause loss of “face”, and losing face could seriously undermine the legitimacy of the patriarch’s position in the company. In addition even if one person is brave enough to stand up and speak frankly, a cherished quality in Western countries, that person may not receive positive support from his or her colleagues, instead, the employee might be punished for disloyalty. The other employees and colleagues may even consider that the person making the complaint or allegation has become disconnected from the group. A person’s desire for independence is believed to be a sign of immaturity.²³

Apart from the extremely rare superior and inferior confrontation between a patriarch and an employee, serious face-to-face confrontation between two directors, in general, will not happen in a boardroom in Hong Kong, China or any other Asian country. As Child describes,²⁴ the chair of the board of directors (BOD) at a board meeting aims to establish a climate of consensus around general principles or the direction of policy rather than to raise specific issues. A compromise will be reached or a decision made prior to the meeting in order to avoid an open loss of face. Disagreements are normally voiced only in private. In Chinese eyes, expressing an objection against a BOD chair may label that person as a personal rival of the chair or chief executive officer (CEO). If people declare their position and even if their view proves correct, it does not mean they come out on top, indeed, it may actually put them in a difficult position in the company. That explains why fewer minority shareholders in China, Hong Kong and other Asian countries file cases against their majority shareholders or the company compared to similar situations in Western countries.²⁵

The advantage of this vertical management structure is to have fewer transaction and agency costs. When an important decision is to be made by a BOD of a company in a Western country, it is often necessary to consult with advisors and receive the approval of the board and shareholders. All these procedures will inevitably cause delay.²⁶ In Hong Kong and China, when the same important decision needs to be made by a BOD, such a decision could possibly be made at a cocktail party or a dinner. If a paternalistic figure is wise, experienced in management and well-connected, the company may benefit. If the patriarch is not as smart as people expected, the one-person decision-making process could

22 P Lawton, “Berle and Means, corporate governance and the Chinese family firm.” (1996) 6 *Australian Journal of Corporate Law* 348.

23 R D Friedman and J F Yates, “The triangle of culture, inference, and litigation system” (2003) 2(6) *Law, Probability and Risk* 137–50.

24 J Child, *Management in China during the Age of Reform* (Cambridge: CUP 1994), vol. 23, p. 333.

25 P Lawton, “Modeling the Chinese family firm and minority shareholder protection – the Hong Kong experience 1980–1995” (2007) 49(5/6) *Managerial Law* 249–71.

26 *Ibid.*

lead to a decision being made either improperly or based on inadequate information so as to destroy the company's competitive quality or damage its finances and its reputation.

(b) The number one person (*yi bashou*) of a company in China

Due to the political climate in China, in addition to these common cultural features of conformity and loyalty to a company “ruler” and the hierarchical management structure described above, the number one person's (NOP) power is reinforced. During the second half of the twentieth century, people in China were constantly taught that the Communist Party headed by Chairman Mao Zedong embodied absolute leadership and authority. Nobody dared to challenge his authority during his lifetime.²⁷ This culture of worshipping the “emperor” was deeply rooted in China for many thousands of years,²⁸ so when a former state owned enterprise (SOE) director is reappointed as a CEO or a BOD chair of a corporatised enterprise, that director also aspires to build up a private empire and be worshiped as a leader by the company employees. Hofstede describes now in such cultures the powerful are entitled to privileges and are expected to use their power to increase their wealth. Their status is enhanced by symbolic behaviour which makes them look as powerful as possible.²⁹ Unlike the EF in a private Hong Kong company, a BOD chair or CEO in a Chinese company is only an agent (due to the property ownership structure of Chinese companies which will be discussed later). These agents expect obedience from people below them (more so than would a Hong Kong EF) because they know an agent's fortune is in the hands of his or her principal. Everyone could lose their jobs and powers if the principal (i.e. the government) decides to remove the agent. So power/money exchange is significant.³⁰ In order to strengthen their power, these agents are expected to be appointed as both chair of a BOD and CEO³¹ so that they can make and execute their decisions without delay. From the government's point of view, it is easier to control the company; from an agent's point of view, it is perhaps an opportunity to make a fortune occurring only once in his or her lifetime. In July 2009, Chen Tonghai (Communist Party of China (CPC) secretary and chair of the BOD and managing director of SinoPec)³² was sentenced to death with a two-year suspension for bribery and corruption. The money Chen received in the previous nine years (1999–2007) reached RMB200m (*renminbi* (people's money), equivalent to US\$29m).³³ People say Chen was destroyed by the “culture of *yi bashou*”. He considered himself king of SinoPec and would not allow anyone in SinoPec to challenge his authority. He made a unilateral decision to invest RMB200m on behalf of the company after talking to someone for only 40 minutes. To him, the board of directors and the shareholders' meeting were for ornamental purposes only.³⁴

Chen Tonghai's case has highlighted the difference between an EF of a Hong Kong company and a *yi bashou* in a Chinese company in so far as decision making is concerned. It is almost impossible for an EF in Hong Kong to make such a hasty decision without careful

27 In the 1950s and 1960s many intellectuals were labelled rightists or counter-revolutionaries and were sent for exile because they criticised the CPC when Mao encouraged them to give suggestions and advice to the government on economic development.

28 Chow, *The Legal System*, n. 21 above.

29 G Hofstede, *Cultures and Organizations – Software of the mind* (London: McGraw Hill 1991), p. 38.

30 Cai, “Bonding”, n. 5 above.

31 In some Western systems of corporate governance this is unacceptable, for example, in the UK, the City's Combined Code requires the offices of chair and of CEO to be held by different people.

32 SinoPec is the second largest corporate group in China.

33 For details, see, <http://hk.news.yahoo.com/article/090715/4/d7av.html> (last accessed 15 July 2009).

34 For details, see, http://news.xinhuanet.com/comments/2008-01/30/content_7524535.htm (last accessed 15 July 2009).

consideration and consultation. Only an agent of a Chinese company would make such a “courageous” decision to invest that amount of money without getting permission from the principal. The reasons for the difference lie in the cultural anomalies discussed below.

(c) *Guanxi* network

When discussing differences in culture, Hofstede remarks that in the collectivist society personal relationships prevail over the task and should be established first; while in the individualist society the task is supposed to prevail over any personal relationships.³⁵ In a collectivist society, such as Hong Kong or China, company managers or CEOs prefer to manage their business by relying on “*guanxi*” networks. The interpretation of the concept of “wealth” in Western and oriental culture is different. People consider a successful person “wealthy” in the Western tradition while the equivalent in China is “well connected”.³⁶ *Guanxi* in Chinese society refers to a set of interpersonal connections that facilitate exchange of favours between people.³⁷ *Guanxi* brings people together and encourages the exchange of valued materials or ideas. *Guanxi* also means trustworthiness. Two persons having *guanxi* mean they have long-time interactions and the opportunity to develop future relationships. *Guanxi* also means mutual obligation. In a corporation, a boss has an obligation to look after the company’s employees and employees have the duty to be loyal and dedicate themselves to the corporation. If an employee, at whatever level, denies his or her obligations, the ultimate price might be the loss of connections.³⁸

Guanxi culture also influences a company’s style of dealing with its partners or outside affiliates. People believe *guanxi* has the function of “glue” that holds Chinese society together.³⁹ Company managers both in Hong Kong and China therefore tend to personalise communications and relationships when doing business. BOD chairs and CEOs need to build up their personal *guanxi* networks for exchanging informal favours and maintaining harmony in order to be successful in their own business or their company’s business. After all, in Chinese society, *guanxi* is deemed as a dominant mechanism for establishing trust. Unlike CEOs in Western countries, Chinese managers prefer to solve daily management-related problems not through formal meetings but through informal personal contacts.⁴⁰ So, a considerable amount of Chinese managers’ time is spent on informal personal connections.⁴¹ When a person does someone a favour because of *guanxi*, that person wins “face” from others and also puts the beneficiary in debt. The beneficiary is then obligated to return a favour when it is requested. So, a Chinese manager believes that, provided a strong *guanxi* network has been established, should a problem arise, a helping hand will easily be found somewhere.

This is particularly true in China where laws and regulations are not well implemented, so people rely on *guanxi* to solve their problems. If there is a problem or a disagreement between a government department and a company or between two companies which needs to be solved through a legal or administrative procedure, paperwork needs to be completed and an agenda of a scheduled meeting needs to be communicated to the relevant personnel.

35 Hofstede, *Cultures*, n. 29 above, p. 67.

36 J E Garten, “Opening the doors for business in China” (1998) 76 *Harvard Business Review* 167.

37 K-K Hwang, “Face and favor: the Chinese power game” (1987) 92 *American Journal of Sociology* 944–74.

38 T W Dunfee and D E Warren, “Is *guanxi* ethical? A normative analysis of doing business in China” (2001) 32 *Journal of Business Ethics* 191–204.

39 L-F Chou, B-S Cheng, M-P Huang and H-Y Cheng, “*Guanxi* networks and members’ effectiveness in Chinese work teams: mediating effects of trust networks” (2006) 9 *Asian Journal of Social Psychology* 79–95.

40 Lawton, “Berle and Means”, n. 22 above.

41 *Ibid.*

When a solution is reached, the execution of the solution needs to be checked and the feedback needs to be reported to the relevant government department. To avoid all this bureaucracy, people believe it is better to solve the problem through an informal channel by using a manager's *guanxi* (personal contacts) or influence.

Apart from the common features of *guanxi* in Hong Kong and China, *guanxi* can also be established more blatantly in China. Stuffing a large amount of money into a "red envelope" (*hongbao*) by an entrepreneur to give to a government official without explicit demand for a return is the most popular way of establishing *guanxi*. The official having received the money certainly knows he or she is obliged to reciprocate by using status, power or position.

The second method of establishing *guanxi* in China is called "*renqing*" meaning an entrepreneur tries to make a connection to a government official as a "brother", "cousin" or a "godfather". This kind of connection can be claimed to be non-material or non-commercial, therefore, it can avoid being classified as the offering or receiving of bribes. Unlike giving a red envelope, which is regarded as an entrepreneur's response to a cadre's hinted demands, *renqing* depends on the entrepreneur's shrewd observation of a cadre's unarticulated needs.⁴² For example, one entrepreneur may introduce his relative, a famous surgeon, to perform an operation on and take special care of a cadre's sick mother. In return, the cadre introduces colleagues and friends to the entrepreneur to enhance connectivity. Such investment may not receive an immediate return but will be really helpful when assistance is needed.

The third method of establishing *guanxi* is to provide the sexual equivalent of the red envelope, with the added possible leverage of bribery. Important business proposals and contracts nowadays are often completed with what those involved see as ideal results in karaoke bars, dance halls, nightclubs, saunas, karaoke TV suites, restaurants, hotels and massage parlours. This form of *guanxi* is preferred by some businesspeople and government officials. There is a common saying that "giving women's bodies and sexual services as gifts will cement *guanxi* better".⁴³

Another observation is that small and medium-sized companies in China are more keen on establishing *guanxi* networks than large companies. Those companies located at a lower position on the administrative ladder may not easily obtain necessary resources like loans and tax concessions. According to Fan et al.'s empirical studies of corruption cases in China, a firm's access to debt finance, in particular, long-term debt provided by corrupt bureaucrats, is vital to many firms' competitiveness.⁴⁴ Local leading companies, especially those converted from SOEs, have already experienced the upper levels of the administrative hierarchy. This is because of their natural connections with administrative organs in urban industry and leads to their receiving generous support from the local government. As a result, they have less need to go out of their way to pull strings through connections. While small and medium-sized companies, on the other hand, in order to survive in the market economy, have to use all possible means to build up a *guanxi* network.⁴⁵

42 D L Wank, "The institutional process of market clientelism: *guanxi* and private business in a South China City" (1996) *The China Quarterly* 830–38.

43 M M Yang, "The resilience of *guanxi* and its new developments: a critique of some new *guanxi* scholarship" 2002 *The China Quarterly* 459–76.

44 J P H Fan, O M Rui and M Zhao, "Rent seeking and corporate finance: evidence from corruption cases" (2008) 36(3) *Journal of Comparative Economics*, available from the Social Science Research Network http://papers.ssrn.com/sol3/papers.cfm?abstract_id=877627 (accessed in July 2009).

45 Yang, "Resilience", n. 43 above.

It is interesting to look at the reasons why Chinese businesspeople are more enthusiastic than their counterparts in Hong Kong in establishing *guanxi* networks. Unlike Hong Kong, where the rule of law is well established, laws written on a piece of paper and laws implemented are sometimes two different matters in China. In other words, “unspoken rules” are still popular in China. Local protectionism, departmental protectionism and difficulties in law enforcement occur from time to time. Some government officials take bribes and bend the law, abuse their power when executing the law, and may even substitute their own word for the law. Therefore, businesspeople can anticipate potential problems they may face such as sudden policy changes or administrative harassment.⁴⁶ If they know someone in the government who has more discretionary control over a wider range of public resources and most importantly is willing to protect them, entrepreneurs are happy to invest in the *guanxi* network and treat that government official as *kaushan* (supporter). From the perspective of the government official, having *guanxi* with local entrepreneurs may institutionalise new sources of revenue to cope with decline in state-allocated resources.⁴⁷ In fact, a *guanxi* network may benefit both sides. Therefore, people perceive *guanxi* as a double-edged sword, it can be beneficial but it can easily be interpreted as bribery and corruption. *Guanxi* is also considered as fertile soil for corruption to flourish.⁴⁸ Many Chinese government officials, company directors and CEOs have been punished for corruption or bribery by misusing their *guanxi* networks.⁴⁹

2 Different ownership structures

(A) OWNERSHIP STRUCTURE OF HONG KONG PRIVATE COMPANIES

Why is the *yi bashou* management style so popular both in Hong Kong and China? More than 50 per cent of Hong Kong private companies are controlled by a few majority shareholders so the EF is able to play a crucial role in a private company. According to Doe’s research, “fifty-three per cent . . . of all listed companies had one shareholder or a family shareholder group owning 50 per cent or more of the voting shares . . . Eighty-eight per cent . . . had one shareholder or family shareholder group owning 25 per cent or more.”⁵⁰

Hong Kong private companies or family firms normally undergo four stages: emergent, centralised, segmented and disintegrative.⁵¹ At the emergent stage, the EF together with other business partners work hard to start their business. In order to survive in the market, they have to show their ultimate mutual trust and confidence. Ownership and management of a firm is normally not separated. At the second stage, the firm has established its business well and the EF may have also have reached retirement. But it is not easy for EFs to hand over the power that they have fought for almost all of their lives to the next generation so succession becomes a major issue. At the third stage, the second generation

46 For example, if a bureaucrat from an environment protection bureau wanted a local company to reimburse his or her personal expenses but the request was turned down, the bureaucrat could harass the company by finding an excuse to order the company to pay an extra penalty for not reaching certain environmental protection standards. In China, it is not surprising that some local companies have to pay extra money to a local environmental protection bureau in order to allow them to continue their production without spending money on purchasing proper equipment to purify their wasted water or polluted air. As the company has not done the right thing, it is easy to blackmail it.

47 Yang, “Resilience”, n. 43 above.

48 Chou et al., “Guanxi networks”, n. 39 above.

49 U C Braendle, T Gasser and J Noll, “Corporate governance in China – is economic growth potential hindered by *guanxi*?” (2005) 110(4) *Business and Society Review* 389–405.

50 J Doe, “Corporate governance in Hong Kong” (1998) 9(10) *International Company and Commercial Law Review* 281–90.

51 Lawton, “Modeling the Chinese family firm”, n. 25 above.

may have control of the family business but equal inheritance of the family business and assets becomes a problem among siblings which may put the business in danger and vulnerable to outside market competition. So it is wise to move the family firm back to the centralised stage in order to pull all the strength and resources together to survive in the market with one sibling controlling the business and helping the other siblings to establish their own firms.⁵² The capability and experience of a paternalistic figure in a company is crucial to the success of a family business. Since most Chinese family firms or private companies have undergone this lifecycle, the strengths and problems are all linked to the structure of ownership and control. As far as minority shareholders' interests in these companies are concerned, Ho and Chueng both point out that the main problem is not the agency problem but the problems between the majority and minority shareholders.⁵³

(B) OWNERSHIP STRUCTURE OF CHINESE LIMITED LIABILITY COMPANIES

An NOP in a Chinese limited liability company (LLC) expects everyone in the company to understand that he or she is the only person who can make decisions for the company. To explain the reasons why these NOPs are so reluctant to give up any managerial power, it is necessary to examine the ownership structure of the LLC in China. Most LLCs were converted from SOEs and many former SOE directors were reappointed by the government as BOD chairs and CEOs. SOEs had a long history of misusing or wasting state assets due to the public ownership structure and lack of supervision mechanisms, so, when a former SOE director is reappointed as a BOD chair or CEO of an LLC, the post is changed but the bad habit of misusing state assets cannot be corrected overnight. Besides, converted companies have a split share structure with more than half of the shares belonging to the state and legal person companies. These shares are non-transferable. Only the remaining (minority) shares can be traded on the stock market.

State shareholders in Table 1 are mainly local state assets bureaux responsible for investing and managing state assets in companies. Legal person shareholders include state-owned companies, private companies, state institutions (*shiyè danwèi*) or social organisations (*shèhuì tuántǐ*).⁵⁴ If a company happens to be a listed company, more than half of its shares are not allowed to be traded on the stock exchange for the reason that state shares should remain in the hands of the government according to the regulations promulgated at that

Table: 1 Ownership and control⁵⁵

Shareholders	Ownership	Control (in board of directors)
State shareholders	24%	21%
Legal person shareholders	44%	48%
Staff shareholders	2%	3%
Individual shareholders	30%	4%
Total	100%	76%

52 Lawton, "Modeling the Chinese family firm", n. 25 above.

53 R Cheung, "The statutory minority remedies of unfair prejudice and just and equitable winding up: the English Law Commission's recommendations as models for reform in Hong Kong" (2008) 19(5) *International Company and Commercial Law Review* 156–64; Ho, *Corporate Governance*, n. 3 above.

54 Legal person shareholders are mainly those LLCs converted from SOEs. In order to expand their production, these companies may invest in another company and become a legal person shareholder. So, technically speaking, a large amount of assets of these companies invested in by legal persons are also state assets.

55 The table is copied from Z. Guanghai and C. Guofu, *The Government and Enterprises – Their interrelationship in the transitional period* (in Chinese) (Beijing: Beijing University Publisher 2005), p. 109.

time.⁵⁶ It was believed that if a large amount of state shares or legal person shares became tradable, the stock market could open up a channel for misappropriation or depreciation of state assets.⁵⁷ The immediate problem of such an unbalanced share structure is that the price of a listed company does not reflect its performance and the problem of “insider control” is serious. Controlling shareholders of these companies, either representatives from the State Assets Management Bureau (SAMB)⁵⁸ or a legal person company, have less motivation to care about changes in the values of share prices of the listed companies in the market. They are more interested in raising funds from the stock market. Therefore, they are frequently engaging in benefit transfer through misappropriation of funds or related-party transactions to expropriate listed companies and infringe upon the interest of minority shareholders.⁵⁹ That explains why so many minority shareholders in China complain that they were misled by companies’ fabricated annual reports and have suffered great loss by purchasing shares in those companies.

The combination of all the above factors indicates that the interests of minority shareholders both in Hong Kong private companies and in Chinese LLCs will not be effectively protected. Scholars in Hong Kong have pointed out that the concentrated Chinese ownership structure can lower agency costs between the managers (agent) and shareholders (principal) but they give rise to a second dimension of the agency problem – the one between controlling and minority shareholders.⁶⁰ In Chinese LLCs, the problem of expropriating minority shareholders’ interests is even worse. But it would be premature or hasty to conclude that the law and methods of PMS in Hong Kong and China are more or less identical in providing inadequate protection. The legal and regulatory framework and cultural factors affect how PMS operates in each jurisdiction.

3 Relevant legislation on PMS in Hong Kong and China

Hong Kong was a colony of the UK for over 150 years, so its company law (the Company Ordinance)⁶¹ is largely based on the UK’s Company Act 1948 and its amendments. China, on the other hand, is still a socialist country implementing a civil law system and its Company Law has characteristics of civil law countries, such as Germany and Japan.

56 For example, the Ministry of Finance published “Circular on Issues Relating to Reduction of State-owned Shares held by Financial Assets Management Companies and State-owned Banks” in 2004. The circular clarifies that: “when companies go public, the shares held by the wholly state-owned banks and financial assets management companies which are converted from credit assets may not be reduced, and the contribution to the social security fund corresponding to such shares shall be exempted”.

57 By April 2005, as many as 1102 listed companies started issuing A shares on the stock exchanges. Among these companies, 890 companies had unbalanced share structures with one majority shareholder holding more than 50 per cent of the total. Sixty-three companies had powerful majority shareholders holding 75 per cent of a company’s shares. W Junhui, “Some thoughts about accumulative voting rights” (in Chinese) (2007) 19(3) *Journal of Henan Textile College* 37–40.

58 In order to manage state assets in corporatised SOEs efficiently, the state-owned SASAC was established at the central government level in 2003 and SAMBs at local government level in 2003 or 2004. Their major responsibilities include supervision of the preservation and increment of the value of state-owned assets in enterprises under their supervision and enhancement of the management of state-owned assets and to advance the establishment of modern enterprise systems in SOEs. For details of their rights and liabilities, see <http://www.sasac.gov.cn/n2963340/n2963393/2965120.html> (accessed December 2008)

59 Z. J. Lin, L. M. Liu, X. Zhang, “The development of corporate governance in China” (2007) 28(7) *Company Lawyer* 195–203.

60 Cheung “Statutory minority remedies”, n. 53 above; H Goo and R H Weber, “The expropriation game: minority shareholders’ protection” (2003) *Hong Kong Law Journal* 71–98.

61 The latest amendment to Hong Kong Company Ordinance was made on 14 December 2007.

(A) HONG KONG LEGAL AND REGULATORY FRAMEWORK

Hong Kong has an effective legal system to protect minority shareholders. For example, s. 168A of the Hong Kong Company Ordinance allows any shareholder to petition the court for an appropriate order if the affairs of the company have been conducted in a manner which is unfairly prejudicial to the interests of that shareholder or shareholders generally. Section 177(1)(f) permits shareholders to apply for a just and equitable winding up if they feel that they have been unfairly treated. Shareholders in Hong Kong can also claim their interests in the court based on an exception to the rule in *Foss v Harbottle*.⁶² A recent amendment (ss 168BA–BK) to the Company Ordinance⁶³ has strengthened the position of minority shareholders in companies. It establishes a procedure allowing a member of a company to bring a derivative action or intervene in any proceedings in the event of misfeasance.⁶⁴ In fact, the Hong Kong legislation permits coexistence of the common law and statutory derivative actions. Judge Rogers VP confirmed in the case of *Waddington Ltd v Chan Chun Hoo & others* (2006) that the creation of a new statutory procedure would not affect the common law right to bring a derivative action.⁶⁵

Apart from the Company Ordinance, there are several other laws regulating companies in Hong Kong:

- The Securities Disclosure of Interests Ordinance (Cap 396) which requires substantial shareholders to disclose interests in shares of listed companies. Directors and chief executives of a listed company are also required to disclose interests in shares and debentures of the listed company and its associated companies.⁶⁶
- The Hong Kong Code on Takeovers and Mergers requires companies to disclose timely and adequate information to enable shareholders to make an informed decision as to the merits of the offer and to ensure that there is a fair and informed market in the shares of companies affected by takeover and merger transactions.⁶⁷
- The Listing Rules require a listed company to keep the market informed of all sensitive information, such as connected transactions, with its subsidiary or a connected person (including a director, chief executive, or substantial shareholder of the company or its subsidiaries, or associate of any of these). These transactions are subject to disclosure to the stock exchange and shareholder approval in the general meeting. Interested parties are prevented from voting.⁶⁸

62 V Stott, *Hong Kong Company Law* 12th edn (Hong Kong: Pearson Longman 2008), p. 186.

63 The amended Company Ordinance came into effect on 15 July 2005.

64 Stott, *Hong Kong Company Law*, n. 62 above, p. 188.

65 This is a double derivative action in which minority shareholders sue majority shareholders and other relevant parties in relation to certain steps taken by majority shareholders in a number of complex commercial transactions which are alleged to be to the ultimate disadvantage of the company, and consequently the minority shareholders, and the ultimate benefit of the majority shareholders, the first and second defendants. For details, see http://legalref.judiciary.gov.hk/lrs/common/ju/ju_body.jsp?DIS=56913&AH=&QS=&FN=&currpage= (last accessed August 2009). See also Stott, *Hong Kong Company Law*, n. 62 above, p. 189, and *Waddington Ltd v Chan Chun Hoo & others* in Court of Appeal, Civil Appeal No. 220 of 2005 Hong Kong, p. 905.

66 For details, see <http://sdinotice.hkex.com.hk/di/NSSrchMethod.aspx?src=MAIN&lang=EN&in=1> (last accessed December 2008).

67 For details, see http://www.mallesons.com/publications/Corporate_Finance_Briefing/6630265W.htm (last accessed December 2008).

68 For details, see http://www.hkex.com.hk/rule/mbrule/mb_ruleupdate.htm. See also Ho, *Corporate Governance*, n. 3 above, p. 13.

With the exception of the relevant ordinances and regulations to control companies in Hong Kong, a three-tier market regulatory system is also well established by the Hong Kong government. The Securities and Futures Commission (SFC) and the stock exchange (HKEx) work together to monitor listed companies and the securities and futures market in Hong Kong. Among the regulatory institutions, the Hong Kong government is the overall policymaker. The SFC as the statutory regulator of listed companies enforces the new Securities Futures Ordinance and the Takeover Code. HKEx, as the non-statutory frontline regulator of listed companies, enforces the Listing Rules.⁶⁹ Except for commercial secrets, SFC encourages all firms to increase transparency by more voluntary disclosure.⁷⁰

(B) CHINA'S LEGAL AND REGULATORY FRAMEWORK

China's system for regulating companies, although started in the 1990s, has been greatly improved in the past 10 years. Its first Company Law, promulgated in 1994, was a hybrid produced by copying company laws from both common law countries and civil law countries (including Hong Kong's Company Ordinance), plus local elements.⁷¹ China's Company Law was further amended in 2006. In order better to protect minority shareholders' interests in companies, the amended Company Law provides shareholders with cumulative voting rights,⁷² the right of requesting the company to repurchase their shares at a reasonable price⁷³ and the right of viewing important company documents.⁷⁴ Most importantly, considering the weakness of 1994 Company Law with no relevant article permitting shareholders to initiate derivative actions, the amended Company Law has inserted one article (Article 152) which provides details on how shareholders may bring proceedings against company wrongdoers.

China's Securities Law was proclaimed in 1998 and amended in 2005. It has strict and detailed rules on issuance of securities, trading of securities, guidelines for stock exchanges and clear legal liabilities that companies and the relevant personnel shall carry if they violate it. In addition to these laws, and specifically to counter the serious problem of making

69 Ho, *Corporate Governance*, n. 3 above.

70 See <http://www.sfc.hk/sfc/html/EN/aboutsfc/disclosure/policy.html> (last accessed December 2008).

71 Local elements here refer to some provisions in the 1994 Company Law which emphasised the importance of the CPC and the state. For example, Article 17 highlighted that "the grass-root organization of the Communist Party of China in a company shall carry out its activities in accordance with the Charter of the Communist Party of China". As the 1994 Company Law failed to clarify the relationship between the CPC organisation, a shareholders' meeting and a board of directors in a company, when the 1994 Company Law was implemented, it was difficult to avoid problems between the CPC organisation, the shareholders' meeting and the board of directors in the company. Article 4(3) emphasised that "the state assets of a company belong to the State". This provision has received many criticisms because an LLC is an independent legal person. When a company is required to consider "the state assets of a company belong to the State", it is difficult for the company to be truly independent and be responsible for its own profits and losses.

72 Article 106 of 2006 Company Law states "when shareholders elect directors or supervisors, each share has the voting rights equal to the number of the directors or supervisors to be elected, and concentrated use of the voting rights held by a shareholder is permitted". It means shareholders may bundle their shares up with other minority shareholders in order to reach a minimum amount of ownership that may give them enough power to express their views at a shareholders' meeting. Buckley et al. further describe how the cumulative voting system operates: "A shareholder may allocate all of the votes that he would be entitled to cast for the election of all directors (the number of shares owned times number of directors to be elected, assuming one vote per share) among the different candidates in any manner he wishes." For details, see F H Buckley, M Gillen and R Robert, *Corporations, Principles and Policies* 3rd edn (Toronto: Emond Montgomery 1995), p. 427.

73 For details of how shareholders can request the company to repurchase their shares and the relevant conditions, see Article 75 of 2006 Company Law.

74 Article 34 of 2006 Company Law states "shareholders shall have the right to check and make copies of the articles of association, minutes of shareholders' meetings, resolutions of the board of directors and board of supervisors and financial reports of the company".

fraudulent misrepresentations by listed companies to trap unsophisticated investors, the Supreme People's Court in 2002 issued a Notice on the Relevant Issues Concerning the Acceptance of Civil Tort Dispute Cases Caused by False Statements in the Securities Market.⁷⁵

Apart from a series of laws and regulations which apply to companies and the securities market, China has also set up a supervision system with two major institutions playing important roles. One is the China Securities Regulatory Commission (CSRC) responsible for the supervision of securities and futures business; stock and futures exchange markets; listed companies; and other securities-related business.⁷⁶ The other is the state-owned Assets Supervision and Administration Commission of the State Council: SASAC at the central government level and SAMBs at local government level. Their major responsibility, as state investor, is to supervise the preservation and increment of the value of state assets in SOE-converted companies under their supervision.⁷⁷

(C) PROTECTION OF MINORITY SHAREHOLDERS: PRACTICE IN HONG KONG

How comparable is the enforcement of the relevant laws and regulations in these two places? Data relating to cases filed by minority shareholders against companies and majority shareholders in Hong Kong is not readily available, so discussion of the practice of PMS in Hong Kong is mainly based on different scholars' research and in particular the data (1980–1995) collected by Lawton.⁷⁸

Doe stated that “fifty-three per cent . . . of all listed companies in Hong Kong had one shareholder or a family shareholder group owning 50 per cent or more of the voting shares”.⁷⁹ As a result of such shareholding, the interests of minority shareholders in these companies will inevitably be affected. First, when a private company becomes a listed company with its shares floated on the stock exchange, the EF of that company may still consider the company as family property. Minority shareholders, having contributed their capital, are seen as merely fund providers, not as shareholders or co-owners deserving of equal treatment.⁸⁰ Secondly, when directors of the company need to be appointed, as the management of the company is in the hands of the EF and controlling shareholders, the procedure of nominating and appointing directors is ultimately controlled by them. Minority shareholders have almost no chance to vote for a director who could represent them on the board.⁸¹ Thirdly, when a company enters into a contract with a related party, as a general rule, controlling shareholders who are also directors must not approve a contract in which they are interested.⁸² But, in reality, as shareholders do not owe any fiduciary duty to each other, it is perfectly acceptable for them to put their personal interests before those of the company when they vote at the general meeting.⁸³ The

75 For details, see <http://www.lawinfochina.com/law/displayModeTwo.asp?id=4699&keyword=> (last accessed 30 October 2008).

76 For details of the functions of the CSRC, see <http://www.csrc.gov.cn/n575458/n4001948/n4004898/n4026463/index.html> (last accessed November 2008).

77 For details of the SASAC, see <http://www.sasac.gov.cn/n2963340/n2963393/2965120.html> (last accessed November 2008).

78 The data relating to minority shareholder petitions in Hong Kong (1980–1995) is collected by Lawton “Modeling”, n. 25 above.

79 Doe, “Corporate governance”, n. 50 above.

80 Goo and Weber “The expropriation game”, n. 60 above.

81 *Ibid.*

82 Lord Greene MR said in *Regal (Hastings) Ltd v Gulliver* [1942] 1 ALL ER 378: “The general rule of equity is that no one who has duties of a fiduciary nature to perform is allowed to enter into engagements in which he has or can have a personal interest conflicting with the interests of those whom he is bound to protect.”

83 *Northwest Transportation Co. Ltd v Beatty* [1887] 12 App Cas 589.

consequence of controlling shareholders' misconduct through related party transactions is that minority shareholders' interests are compromised. Therefore, minority shareholders' complaints (according to Lawton's research on 275 minority shareholder petitions in the High Court of Hong Kong from 1980 to 1995 inclusive) are mainly in the following categories: exclusion from management 73.1 per cent; loss of confidence 58.9 per cent; failure to follow regulations 51.3 per cent; diversion of funds/assets 30.1 per cent; no dividend paid 12.7 per cent; and dilution of shareholding 12.7 per cent. The grounds of petition may vary depending on the cause of action used. In some cases, the grounds of petition overlap, for example, exclusion from management and loss of confidence might be the grounds of the same petition.⁸⁴

(D) PROTECTION OF MINORITY SHAREHOLDERS: PRACTICE IN CHINA

Collecting the relevant data relating to PMS in China is even more difficult because China is a civil law country: legal cases do not carry the force of precedent compared to the practice in a common law country. It is not a mandatory requirement for all courts in China to report cases. A court may select and publish some important cases if it wishes. Before the amended Company Law became effective, only a few high-profile and influential cases were reported. I have managed to collect 26 (26=100%) PMS-related cases from different sources.⁸⁵ Of these, 11 cases (42%) were decided in accordance with the 2006 Company Law and another 11 (42%) were decided on the basis of the 1994 Company Law. Four cases (16%) were first turned down by the court due to lack of guidance in the 1994 Company Law but reopened for trial after the amended Company Law became effective and minority shareholders filed the cases again.⁸⁶ Although 26 cases are insufficient to make meaningful comments on whether the relevant PMS provisions in the new Company Law are proper and effective, at least, through these cases, we have a better view of how minority shareholders fight for their interests in companies and how courts in China handle these cases.

In general, minority shareholders' status in Chinese companies is comparatively similar to their counterparts in Hong Kong. Due to the split shareholding structure, minority shareholders in China are mainly excluded from management. Therefore, the grounds of complaint by minority shareholders in China are similar to the complaints by minority shareholders in Hong Kong.

First, minority shareholders complain that they are not consulted when the company's articles of association are altered (three cases (12%)).⁸⁷ Secondly, directors or controlling shareholders of a listed company transfer the company property to a third party or use the company property to provide a guarantee for a third party without either a decision reached by the BOD or informing minority shareholders. They also treat a listed company within a corporate group as a cash machine (11 cases = 43%). Thirdly, company directors and

84 The grounds of complaint listed by Lawton were based on analysis of 275 minority shareholder petitions in the High Court of Hong Kong between the years 1980 and 1995 inclusive. Although the data (1980–1995) collected by Lawton is outdated, the grounds of complaint listed are still applicable because these grounds match other scholars' findings. Also see, A Lau, J Nowland and A Young, "In search of good governance for Asian family listed companies: a case study on Hong Kong" (2007) 28(10) *Company Lawyer* 306–11. Doe, "Corporate governance", n. 50 above.

85 Different sources here refer to Chinalawinfo.com; Infobank; Isinolaw; LawinfoChina; Lawyee.net; Lexis.com and also relevant websites of local courts.

86 As 1994 Company Law had no provision guiding derivative action, when minority shareholders initiated a lawsuit on behalf of the company, the court had no choice but to turn down their request. When the Company Law was amended, a new article (Article 152) guiding derivative action was included. The former shareholders are therefore permitted to file their case again.

87 The calculation is based on 26 cases collected. Note that all percentages are rounded up.

controlling shareholders release untrue information in prospectuses and annual reports to mislead/cheat investors (nine cases = 35%). Fourth, minority shareholders are not given dividends (one case = 4%). Fifth, company directors or controlling shareholders sell state assets at an undervalue (two cases = 8%) which results in a drop in the minority shareholders' share value.

Close examination of the grounds of complaint by minority shareholders in Hong Kong and China reveal differences. First, although the minority shareholders in both places complain that controlling shareholders and directors exclude them from the decision-making process, at least in Hong Kong company directors cannot carry out notifiable transactions or connected transactions without timely disclosure in accordance with the Listing Rules.⁸⁸ If the stock exchange and the SFC discover that they are not accurately informed of any price-sensitive information that may have an effect on the market, the stock exchange may use its powers to suspend trading in the shares of the company until such information enters the public domain.⁸⁹ Because of effective supervision and accounting systems, company directors or controlling shareholders find it difficult to diversify company assets without proper disclosure. In China, minority shareholders (nine cases (35%)) complain that controlling shareholders or company directors transfer the company assets to its parent company or use the company assets to provide guarantee for a third party without a decision made by the BOD or informing minority shareholders. The difference here is that assets of a private company in Hong Kong belong to either the EF or the shareholders. It is unlikely that they will transfer or use their own property as a guarantee to save another company without any benefit. In China, majority shareholders in many companies are agents from the SAMBs. Their personal interests may conflict with that of the company and, therefore, they might generously transfer the company assets to save another company.⁹⁰ Even if these shareholders and directors do not benefit directly from the transfer, they will benefit later from an enhanced *guanxi* network that has been established through the transaction.

Secondly, there is also a difference in the issuing of company prospectuses and annual reports. The practice in Hong Kong in this respect is very strict. When a company plans to issue a prospectus, the requirement of the Company Ordinance is that, if the prospectus contains an untrue statement, the persons who subscribe for any shares or debentures on the faith of the prospectus and who suffer loss or damage by reason of that statement will be entitled to be compensated.⁹¹ The requirement to make an annual report⁹² by company directors states that failure to take all reasonable steps to secure compliance is an offence.⁹³ So it is more difficult for company directors in Hong Kong to make fraudulent misrepresentation through either their annual report or their company prospectus. In nine cases (34%) out of the 26 Chinese cases, minority shareholders complained that the company directors and majority shareholders fabricated their monthly or annual reports.

88 Modifiable transactions refer to details of significant acquisitions or dispositions of assets that have to be disclosed when the value of the transaction relative to the value of the issued share capital of the company exceeds a specified percentage. See Ho, *Corporate Governance*, n. 3 above, p. 13.

89 Ibid.

90 For details of how company directors use the company assets as a guarantee to save another company without a decision reached by the BOD, see <http://www.people.com.cn/GB/jinji/20021127/875535.html> (last accessed December 2008).

91 Stott, *Hong Kong Company Law*, n. 62 above, pp. 7 and 9.

92 An annual report made by the directors normally deals with the profit or loss of the company for the financial year. The report must be approved by the BOD and signed on its behalf either by the chair of the meeting at which it was approved or by the secretary of the company: Hong Kong Company Ordinance, s. 129D(2).

93 Hong Kong Company Ordinance, s. 129F.

Although both the 2006 Company Law and the Securities Law in China emphasise directors' duties and the severe punishment that they may receive if they make misrepresentations,⁹⁴ in reality, it is difficult for minority shareholders who are not professionals with knowledge of accountancy and law to collect crucial evidence to prove that the statements issued by the company are fictitious.⁹⁵ It also indicates that the supervision and accounting systems in China are not as efficient as their counterparts in Hong Kong. In addition, it means agency problems are still serious although the new Company Law has set up stricter rules to punish those who breach directors' fiduciary duties and duties of care and skill.⁹⁶

4 Institutional design differences

(A) DO CULTURE AND INSTITUTIONAL DESIGN MAKE ANY DIFFERENCE?

Cultural influence produces some differences in corporate governance and PMS between Hong Kong and China, but the difference is not huge. So, why is Hong Kong at the top of the corporate governance ranking of Asian countries but China is not? Is there any other reason that causes such huge difference? Does it lie in a difference in culture and institutional design?

(B) INSTITUTIONAL DESIGN IN HONG KONG

Although Chinese-dominated societies emphasise harmony and conformity, Chinese culture is an evolutionary process developing from a pluralist platform to include subcultures and hybrids.⁹⁷ This is particularly true in Hong Kong. Apart from the influence of Confucianism, Hong Kong is an international business hub with a modern outlook, free

94 Regarding issuing new shares in China, Article 137(3) of the 2006 Company Law requires a company not to have "false reporting in the financial and accounting documents of the company during the last three years". Article 152(5) allows a company to issue new shares with the condition that "the company has not committed any significant illegal acts and there are no false records in the financial accounting statements for the last three years". With regards to the liabilities of misrepresentation, Article 212 states "if a company is found to have provided false financial and accounting reports or to have concealed important facts in reports to shareholders or the public, the principal personnel directly responsible and other personnel directly responsible shall have a fine imposed of RMB10,000 to RMB100,000 Yuan. If a case is serious enough to constitute a crime, criminal liability shall be pursued in accordance with the law." The Securities Law also has similar requirements, such as Articles 20, 31, 69, 151 and 192.

95 In one case, 476 minority shareholders sued Ying Guanxia (YGX), a gigantic listed company. YGX fabricated its annual report to impress potential investors and many minority shareholders living in different provinces. Because of the report, these shareholders suffered a great loss. The disputable capital reached RMB181m. As many as 476 investors registered as plaintiffs to claim for compensation. As the minority shareholders filed the case in 2001, the case was turned down for a reason that no judgment could be made without proper guidance. After the amended Company Law became effective in 2006, the shareholders filed the case again. The case dragged on until, eventually, shareholders were offered 2.2 shares for each RMB10 Yuan by YGX. Considering the losses minority shareholders had suffered, the offer was very unfair. For details, see <http://0-www.chinainfobank.com.lib.cityu.edu.hk/IrisBin/Test.dll?db=hk> (last accessed September 2008).

96 For example, Article 148(2) states "Directors, supervisors and senior management personnel shall not abuse their duties and rights to receive bribes or other illegal income and shall not convert company assets." Article 203 states "where a company made false records or concealed important facts on financial accounting reports etc provided to the relevant authorities as required by the law, the person-in-charge and other personnel who are directly responsible shall be imposed a fine ranging from RMB30,000 to RMB300,000 by the relevant authorities". For details of how this law punishes those who breach a director's fiduciary duties and duties of care and skill, see China Company Law Chapter XII: Legal Liability.

97 A Young, "Rethinking the fundamentals of corporate governance: the relevance of culture in the global age" (2008) 29(6) *Company Lawyer* 168-74.

markets and technological innovation and a culture which is increasingly a mix of traditional and Western influences.

The sovereignty of Hong Kong was handed over to China in 1997. Since then separation of power has been adhered to based upon the principle of “one country and two systems” and the Basic Law of the Hong Kong Special Administrative Region (HKSAR).⁹⁸ A three-tier system is exercised with the Chief Executive holding the power of the executive and the powers of judiciary and legislature being exercised by the courts and legislative council. The three-tier system aims to provide a check and balance function with each element monitoring the performance of the others.

In addition to the implementation of this check and balance system, one Hong Kong institution that plays an irreplaceable role in keeping Hong Kong clean, fair and transparent is the Independent Commission Against Corruption (ICAC) which is considered the community watchdog.⁹⁹ The Hong Kong ICAC does not confine its activities to enforcement. It is responsible directly to the Chief Executive of the HKSAR. The ICAC’s strategy of fighting corruption is three-pronged, namely investigation,¹⁰⁰ prevention¹⁰¹ and education.¹⁰² Because of its outstanding performance, the ICAC has significantly changed the business cultural climate in Hong Kong. Previously, corruption was widespread and now it is largely rejected,¹⁰³ According to the Transparency International 2008 Corruption Perceptions Index, Hong Kong is ranked 12th with Austria and the UK 16th and the USA 18th worldwide.¹⁰⁴

Media supervision is another powerful weapon that watches over government and helps to maintain a clean Hong Kong. Under the notions of press freedom and social responsibility, government intervention with the press in Hong Kong is minimal. As no government censorship of news is allowed, people are free to criticise the administration. For example, Antony Leung Kam-chung, the former Financial Secretary of the HKSAR, resigned after the media disclosed that he had bought a car for HK\$790,000 (US\$101,282) just weeks before he raised the tax on new vehicles in his March budget. In view of the public outcry, he tried to

98 Article 2 of the Basic Law.

99 The ICAC was established on 15 February 1974 with the enactment of the Independent Commission Against Corruption Ordinance. Being a statutory body, it was given an independent status in that the commissioner has the statutory responsibility to fight corruption through investigation, prevention and education. R Wong Sai-chiu, “The Hong Kong anti-corruption model” (paper presented at Opening Ceremony of the Centre of Anti-Corruption Studies and seminar, 3 April 2009).

100 Investigation here includes compelling a suspect or a third person to provide information under certain conditions. In recognition of the difficulty in bringing the corrupt to justice and to ensure public confidence in the ICAC, there are provisions which include legal presumptions and protection of confidentiality including the identity of a subject of investigation and the details of the investigation. *Ibid.*

101 Prevention here means the Corruption Prevention Department within the ICAC which seeks to tackle corruption at source by proactively engaging government departments and the commercial sector to review procedures and practices conducive to corruption. They make recommendations, in the form of corruption prevention assignment reports, to plug corruption loopholes which are usually identified during the course of corruption investigation. *Ibid.*

102 Education here means the Community Relations Department within the ICAC which is tasked with the promoting of the image of ICAC as an independent and determined anti-corruption body and to ostracise the corrupt by instilling a culture of integrity in the community. They achieve this through various programmes that educate the public against the evils of corruption and by fostering the enlisting of their support in reporting corruption. *Ibid.*

103 M J Skidmore “The future of Hong Kong: Hong Kong institutions: promise and peril in combating corruption: Hong Kong’s ICAC” (1996) 547(118) *The Annals of the American Academy of Political and Social Science* 24–36.

104 Lord Martin Thomas of Gresford, “The rule of law v the national interest” (paper presented at Opening Ceremony of the Centre of Anti-Corruption Studies and seminar, 2 April 2009).

defuse the controversy by donating the money to the Community Chest, a local charity,¹⁰⁵ but the Hong Kong people were not satisfied till he announced his resignation. A search of several influential newspapers in Hong Kong in the past few years discloses other such reports. For example, in 2003, the media reported that a judge was investigated for claiming reimbursement for an air ticket after receiving the same ticket from his daughter as a gift. Such indiscretions, however, are minor if compared with what corrupt government officials have done in mainland China.¹⁰⁶ Because of powerful media supervision and the Hong Kong people's high expectations of their government, Hong Kong retained its top ranking together with Singapore as the region's least corrupt economies in 2009.¹⁰⁷

(C) LEGAL CULTURE IN HONG KONG

In Hong Kong, due to Western cultural influence, rules and systems are well respected and operated impartially. The concept of the rule of law is deeply rooted in Hong Kong. A law professor¹⁰⁸ from mainland China once described the legal culture difference between Hong Kong and China. He said that wherever he went in Hong Kong people, including police, salespeople, government officials and almost everyone he contacted behaved according to "written rules". These rules can be easily learnt through the government's websites or from different pamphlets available at government departments and offices. Therefore, these rules are transparent, comprehensive and easy to follow.¹⁰⁹ Because people can predict the results of following the written rules, it is easy for them to make a decision either to follow the rules or to reject them and risk the consequences. They also know that Hong Kong enforcement mechanisms are efficient and effective.

Therefore, minority shareholders in Hong Kong feel less restraint about filing cases in court against the company and its directors if they discover that their interests in companies have been unfairly treated. Shareholders normally feel confident of winning the case if they have enough evidence to prove their claim because of the judicial system of Hong Kong. According to Lawton's research, there were 286 actions issued in the High Court of Hong Kong during the period of 1990–1995 alone.¹¹⁰ Of course, minority shareholders in Hong

105 For details, see http://www.knowledgerush.com/kr/encyclopedia/Antony_Leung_Kam-chung/ (last accessed 8 February 2010).

106 Chen Tonghai, former chair of the BOD of China Petrochemical Corporation, was sentenced to the death penalty with a two-year suspension for corruption and bribery on 15 July 2009. The amount of money he received over 10 years reached RMB200m. For details, see http://news.ifeng.com/opinion/200803/0309_23_432067.shtml (last accessed July 2009).

107 For details, see <http://business.inquirer.net/money/breakingnews/view/20090408-198573/RP-no-longer-most-corrupt-in-ranking> (last accessed July 2009).

108 The law professor is from the Law School, Yunnan University, China. He wrote his impression of Hong Kong in June 2007 under the pen name Fa Dou after he completed his work as a visiting fellow at the Law School, City University of Hong Kong. For details, see <http://www.jcrb.com/n1/jcrb1340/ca615721.htm> (last accessed July 2009).

109 Y Fan, "Chong Wen Hua Jiaodu Lijie XiangGang" ("To understand Hong Kong from a cultural perspective"), see <http://www.lunwenda.com/fangan200804/31775-2/> (accessed in July 2009).

110 Lawton "Berle and Means", n. 22 above.

Kong face similar problems of paying huge litigation fees as shareholders do in other countries¹¹¹ but, that aside, they have confidence in the legal system.

(D) INSTITUTIONAL DESIGN IN CHINA

China has been absorbing Western traditions since the policy of economic reform and opening to the outside world started in 1979. Legislative, administrative and judicial functions in China have made great advances. If looking at corporate governance-related legislation, China's Company Law and Securities Law regulating the stock exchange and corporate governance have been amended and implemented. Two powerful supervision systems (CSRC and SASAC)¹¹² have also been established. Its judicial system has undergone tremendous reform to try to combat long-standing problems, such as its close relationship with local government.¹¹³ Higher courts, instead of local government or party officials, now have more decisive power in court appointments and promotion. In order to prevent judges being involved in corruption, an internal monitoring system has been set up in all courts, especially those located in provincial capital cities. Judges' salary adjustment and promotion are closely linked with the quality of cases they have handled. Directors of lower-level courts and division directors of higher courts are required to rotate from time to time.¹¹⁴ This may give an impression that there is now not much difference between Hong Kong and China in terms of legislation and the role of the judiciary.

But careful study of China's constitution shows that there are differences in institutional design. Article 3 of the constitution states: "All administrative, judicial, and procuratorial bodies of the state are created by the National People's Congress (NPC) and they are

111 Minority shareholders in Hong Kong also have problems paying huge litigation fees. In Hong Kong, there is no strict rule on how much a solicitor should charge his/her client. In practice, a partner in a city firm charges approximately HK\$8000 per hour. An associate charges roughly HK\$6000 per hour. If a barrister is needed for a case, the client needs to pay the barrister's fee on top of the fee which has to be paid to the solicitor based on the agreement. Fortunately, according to s. 168BI of the Hong Kong Company Ordinance, "the court may, at any time (including on granting leave under section 168BC(3)), make any order it considers appropriate about the costs incurred or to be incurred by the following persons in relation to an application for leave made under section 168BC(3) or any proceedings brought or intervened in, or to be brought or intervened in, under section 168C (1) a) the member; b) the specified corporation; and c) any other parties to the application or proceedings". In the case of *Chung Sau Ling & others v Asia Women's League Ltd & others* [2001] 3 HKC 410, the court of first instance adjudicated the test for the exercise of discretion as to costs in a minority shareholder's derivative action on behalf of a company. It was held that the court had the discretion to make a prospective pre-emptive costs order in favour of minority shareholders in terms of ordering the company to indemnify the plaintiffs against the costs incurred in the action. For details, see *Butterworths Hong Kong Company Law Handbook* 8th edn (Hong Kong: Butterworths Asia 1999), pp. 724–5.

112 CSRC refers to the China Securities Regulatory Commission. It is the main securities regulator of the PRC. The CSRC oversees China's nationwide centralised securities supervisory system, with the power to regulate and supervise securities issuers, as well as to investigate, and impose penalties for, "illegal activities related to securities and futures". The CSRC is empowered to issue Opinions or Guideline Opinions, non-legally binding guidance for publicly traded corporations. SASAC refers to the State-owned Assets Supervision and Administration Commission of the State Council. Its main responsibilities are to supervise state assets management nationwide.

113 Chinese courts have a close relationship with local governments because courts are financed by local governments. This sponsorship system has caused a lot of problems. Before the reform of the judiciary system, local government officials or the local CPC party members would send notes or phone a judge handling a high profile or a politically sensitive case for certain confidential information which greatly affected the judge's ability to make a fair judgment. For details, see X He "Routinization of divorce law practice in China: how institutional constraints influence judicial behavior" (2009) *International Journal of Law, Policy and the Family* 83–109.

114 See news article. "A reshuffle of provincial-level court directors" at <http://www.jcrb.com/gssfgg/> (last accessed 28 August 2008).

responsible to and supervised by the respective congresses.”¹¹⁵ The pyramid structure with the NPC at the top and the judicial and procuratorial institutions at the bottom indicates that the degree of judicial independence in China is different from the real judicial independence in Hong Kong. In addition, in the preamble to the constitution, the leadership of the CPC and the guidance of Marxism–Leninism, Mao Zedong thought, and Deng Xiaoping theory are all emphasised in building China into a prosperous socialist state.¹¹⁶ So, when the rule of law and the party’s leadership are in conflict, it becomes unavoidable that the rule of law, to a certain degree, will be compromised. Wu Bangguo, chair of the NPC Standing Committee, emphatically declared at the annual session of the NPC in March 2009, China “would definitely not adopt a Western-style political system, and would definitely not practise multi-party policies, ‘separation of three powers’ or bicameralism”.¹¹⁷

Potter argues that the role of law in China today remains conflicted. On the one hand, the Chinese government and society at large have accorded significant importance to the role of law in socio-economic relations. But herein lies the rub – fealty to socialism unavoidably qualifies and diminishes the capacity for law to serve as an independent source of restraint on government behaviour.¹¹⁸ Lubman further portrays the systemic and ideological limitations of Communist Party rule as a cage confining the bird of Chinese legal reform.¹¹⁹ So, based on Lubman’s description, China is attempting to build the rule of law within its own boundary which means the rule of law is not unconditional. If it contradicts the party’s leadership or state sovereignty, which one shall prevail? The rule of law or the party’s leadership? The answer is “unspoken”. So the rule of law in China should be understood as “the rule of law with Chinese characteristics” or better, “the rule of law within the political/constitutional context of China”.

In terms of institutional design in anti-corruption, China has similar institutions to the ICAC in Hong Kong, such as an internal anti-corruption bureau within each procuratorate, the National Bureau of Corruption Prevention (NBCP) of the People’s Republic of China¹²⁰ and the Central Commission for Discipline Inspection (CCDI) of the CPC.¹²¹ They are all responsible for punishing corrupt government officials. An advantage of having multiple anti-corruption agencies is to create competition among these institutions. Therefore, from an institutional design point of view, China’s anti-corruption network should be more comprehensive, however, its functions have not reached the ICAC’s standard. The reason for the inefficiency is that these institutions owe their duties only to their own superiors. For example, the CCDI is an internal disciplinary inspection agency of the CPC so it is responsible only to the CPC. The anti-corruption bureau within the

¹¹⁵ Article 3 of China’s Constitution (the Fourth Constitution) amended in 2004.

¹¹⁶ See para. 7 of the Preamble to China’s Constitution.

¹¹⁷ The National People’s Congress Standing Committee’s report to the National People’s Congress in March 2009. See, http://www.npc.gov.cn/npc/xinwen/syxw/2009-03/16/content_1493462_5.htm (last accessed 26 July 2009).

¹¹⁸ P B Potter, “Review essay: legal reform in China: institutions, culture, and selective adaptation” (2004) 29 *Law and Social Inquiry* 465.

¹¹⁹ S B Lubman, *Bird in a Cage*, n. 20 above, pp. 3–8.

¹²⁰ The NBCP was established in September 2007. The new bureau will report directly to the State Council, or China’s cabinet. The main task of the NBCP is to push forward transparency of government information at various levels, in other words, to “prevent corruption at its root”. The NBCP will not step into the investigation of individual cases because it does not have the power. See http://www.chinadaily.com.cn/china/2007-09/13/content_6104202.htm (last accessed July 2009).

¹²¹ For details, see <http://www.sourcejuice.com/1295331/2010/01/13/17th-session-Communist-Party-China-Central-Commission-Discipline-Inspection/> (last accessed 8 February 2010). This website publishes an article discussing the CCDI of the CPC and its Fifth Plenary Session, held 11–13 January 2010 in Beijing.

People's Procuratorate is naturally responsible to the People's Procuratorate. While the NBCP, an anti-corruption institution at the national level, is responsible to the State Council or to the NPC. So lack of mutual communication and co-operation among these institutions is an urgent problem. The consequence of such insufficient teamwork is lack of adequate protection for whistleblowers. The reports against corrupt officials are often transferred back and forth among several relevant institutions, causing leakage of the reporters' identification. Sometimes, certain reports have even been sent to the target government officials. Retaliation against reporters is not uncommon in China.¹²² Most reporters are too scared to put their names to reports. Therefore, many company directors and majority shareholders in China are not afraid of the NBCP, CCDI or the anti-corruption bureau in each procuratorate, although a great number of high profile government officials, company directors and majority shareholders have been punished for corruption because of the excellent work of these agencies.¹²³ It is often said that it is easy for these institutions to kill "flies" but difficult to catch "tigers".¹²⁴

Media supervision is also less effective in China. Journalists are not as lucky as their counterparts in Hong Kong. In China, media is under the tight supervision of the CPC and the government. Some local government officials deliberately make it difficult for journalists to interview local people in order to expose scandals. From time to time, news emerges of journalists being beaten up for disclosing conspiracy between corrupt government officials and businesspeople, violating local people's interests.¹²⁵ For example, in Zhenzhou City, when a journalist was told that several luxurious residential buildings had been erected on a piece of land initially designated by the local government to build flats for people on low incomes, he wanted to interview the government officials responsible for urban land planning. But his requests were repeatedly turned down. Eventually, he got a chance to encounter Mr LuJun, a government official in charge of Zhenzhou Urban Planning and ask for an explanation. To his surprise, LuJun told the journalist not to be a busybody. When the journalist insisted, LuJun gave an explanation, asking the journalist whether the journalist represented the CPC or the ordinary citizens.¹²⁶ To government officials like LuJun, the unspoken rule is that the CPC's and people's interests are different. If the journalist supported the CPC represented by LuJun, he should keep his mouth shut without asking for trouble. Unfortunately, LuJun was unlucky this time. After the journalist exposed the scandal through the internet, millions of people accused LuJun of putting the interests of the CPC above those of the people. LuJun was therefore removed from his urban planning post.¹²⁷ Although the media in China has been playing a more and more important role in monitoring the government, it

122 G Yong, "Historical evolution and future reform of China's Communist Party Discipline Inspection Commission" (paper presented at Opening Ceremony of the Centre of Anti-Corruption Studies and seminar, 3 April 2009).

123 For details, see an anti-corruption website: <http://www.china-fantan.net/?vkxxbqb=40406> (last accessed December 2008).

124 For details, see <http://news.sina.com.cn/c/2004-03-02/14032985447.shtml> (accessed July 2009).

125 For example, in June 2009, the news reported that in Shanghai, a newly completed residential building had collapsed. People are questioning whether there is a conspiracy between corrupt officials and the land developer. Also, when a journalist tried to interview the relevant people, the local government officials asked the journalist to shut up. For details, see <http://shengbuzhang.cctv.com/20090723/102651.shtml> (last accessed July 2009).

126 For details, see http://news.ifeng.com/opinion/politics/200907/0714_6438_1247924_7.shtml (last accessed July 2009).

127 After the journalist exposed the scandal, LuJun was removed from the position and the construction of the luxurious buildings was suspended. *Ibid.*

is interesting to examine why the unspoken rules are so popular with the likes of Lujun and the many corrupt government officials in China.

(E) UNSPOKEN RULES AND LEGAL CULTURE IN CHINA

Compared with Hong Kong, China has a similar cultural background but emphasises more centeredness and harmony. The difference between the two places is that rules and principles are implemented impartially in Hong Kong while in China rules can be interpreted and implemented in various ways.¹²⁸ In other words, there is another set of unspoken rules, so-called “implied rules” working effectively parallel to the officially published rules. The popularity of implied rules can also be considered a kind of cultural phenomenon since culture involves learned patterns of behaviour.¹²⁹ For example, in August 2008, incidents of poisonous dried milk had been widely reported. Some thousands of babies had developed kidney problems from drinking melamine – found in the contaminated dried milk. Surprisingly, lawyers were told by the Heibe provincial government not to take such cases: if such cases are accepted, the details must be reported to the government.¹³⁰ A court in Lanzhou Gansu Province even announced that it would not accept lawsuits over the Sanlu infant dried milk scandal until a guideline for dealing with such cases was issued by the authority (i.e. the CPC).¹³¹ In fact, the Heibe provincial government had noticed the milk powder problem long before the media reported the incident. What the government did was to quietly remove all problematic milk power products from the shelves of all supermarkets within the province, hoping that the problem would quietly go away without being noticed by the people and the media.¹³² The implied rule here is that the local government must control the situation in order not to lose “face” and local companies must not be bankrupted by huge compensation payments. An unspoken rule that local courts follow is that they should not come into conflict with the local government by deciding cases in favour of the complainants. If a local profitable company is bankrupted because of such an incident, the government may lose tax revenue and, most importantly, the relevant officials in the government will have to be removed. The chain reaction is that local courts may therefore not obtain sufficient financial support from the local government and, thus, have to find fiscal sources somewhere else.¹³³ All of these factors may result in a certain degree of compromise in justice and fairness.

Potter’s arguments can be used to explain the reasons why unspoken rules are exercised by the local government and company directors. He says the patrimonialism of Confucianised, Marxism–Leninism, Mao Zedong thought combines with the sovereign

128 For example, according to the relevant rules, children should go to a primary or secondary school close to the residential area where they live. But if the parents of a pupil or student are willing to pay extra money to the best school in that district or the city, the student can go to that particular school without any problem. If someone needing an operation prefers a top surgeon, all the patient needs to do is to pay extra money to that particular doctor. Such things happen all the time in the author’s hometown, Hangzhou, China.

129 J Scott and G Marshall, *Oxford Dictionary of Sociology* (Oxford: OUP 2005), p. 133.

130 According to the report, about 5770 babies in Hebei province have developed kidney problems because of drinking poisonous dried milk. For details, see the news report at <http://www.usqiaobao.com> (last accessed 22 September 2008).

131 News report, “Judge refuses to accept lawsuit until guidelines” and “Sanlu court action put on hold”, *South China Morning Post*, 16 October 2008.

132 See www.takungpao.com/news/09/01/23/sanlu_discuss-1022979.htm (last accessed 23 January 2010).

133 Due to lack of sufficient funding, some local courts encouraged judges to fine more people for violating certain administrative regulations. The extra fines collected by these local courts were considered their additional income should therefore be distributed among all staff in the courts as a kind of welfare. For details, see, Z Wenji, “Chang Sha Kaifu local people’s court collects fees and fines without proper guidelines” (in Chinese) <http://people.rednet.cn/PeopleShow.asp?ID=322796>, 22 April 2009 (last accessed 8 February 2010).

party-state supremacy to establish a powerful modality of governance in the People's Republic of China (PRC). Patrimonial sovereignty is thus a typology by which regulators are accountable only to their bureaucratic and political superiors. Under the dynamic of patrimonial sovereignty, political leaders and administrative agencies have responsibility for society but are not responsible to it.¹³⁴ Potter has pinpointed the core of the problems. As the Chinese government considers the sovereign party-state as supreme, the rule of law has, to a certain degree, been treated as a vehicle by the government to exercise power when convenient or necessary. But such practice is non-spoken, it therefore creates a grey area for unspoken rules to be practised among party members, government officials, entrepreneurs and ordinary citizens. That explains why LuJun, a government official, felt able to use the CPC as a weapon to silence the journalist. In LuJun's mind, the CPC had supreme power and he, as a local representative of the CPC, was entitled to enjoy material satisfaction originated from that supreme power. The "unspoken rule" can also be used to interpret the Hebei provincial government's response to the milk powder scandal. As the local government was accountable only to its bureaucratic and political superior, all it wanted to do was to conceal the scandal so that the local government's image would not be ruined. Once the contaminated milk scandal received international media coverage, the local government changed its attitude. The Ministry of Health has discussed with the relevant departments and companies various proposals for compensating the sick babies.¹³⁵ In the case of the milk powder scandal, it was predictable that the local government would instruct lawyers not to get involved in the sick babies cases. It is likely that the same government would support local important companies at the expense of minority shareholders' interests.

Another reason to explain the popularity of unspoken rules is the imbalance between economic and political reform, with the wheel of economic reform going faster and the wheel of political reform slowing down.¹³⁶ Chinese leaders witnessed the Soviet leader Mikhail Gorbachev's political reforms which caused the collapse of the former Soviet Union. Most Chinese leaders therefore believe that Gorbachev had his priorities wrong – by pursuing political reform before economic reform, he courted disaster and failure.¹³⁷ Chinese leaders are convinced that political reform should be carried out more slowly than economic reform in China. But economic growth will inevitably lead to democratic opening. Intentionally holding back political reform results in the current institutional design becoming incompatible with economic development, which unavoidably forces people to use unspoken rules to solve their problems. In addition, the Chinese economy is in a transition period, from a closed economy to an opening-up economy. Political power becomes much more valuable because political power can now allocate economic resources. That explains why the exchange of "power and money" has become so popular and why the government, in charge of political power, is much less willing to give it up or even allow political reform.

Unspoken rules also apply to companies. Most of the successful companies in China have ambitions of becoming world top-500 companies. Company directors have dreams of

134 Potter "Review essay", n. 118, above.

135 For details, see http://news.bbc.co.uk/chinese/trad/hi/newsid_7770000/newsid_7776300/7776333.stm (last accessed 12 December 2008).

136 L Rui, "A proposal for our country's political reform" (paper presented at 16th National Congress of the CPC and published in Yan Huang Chun Qiu 2003). For details, see <http://personal.nbnet.nb.ca/stao/lirui003.htm> (last accessed December 2008).

137 M Pei, "Political reform in China: leadership difference and convergence", see http://www.carnegicendowment.org/files/Pei_Revised.pdf, 2 November 2005 (last accessed July 2009).

becoming “global champions”. Once this dream comes true, it would not only bring with it the pride of the Chinese people and the government, but, most importantly, the company wins “face” and the directors become national heroes. To reach this goal, some Chinese companies prefer a short cut instead of working hard. For example, Lenovo Group Limited (LGL), mainland China’s largest and the world’s fourth largest personal computer manufacturer,¹³⁸ merged with IBM in 2004. LGL’s plan was to make Lenovo an international brand with the help of IBM’s reputation. But LGL was not well prepared for possible and potential problems, therefore, the merge did not bring LGL the ideal result, instead, its profits dropped 78 per cent two years of the merger.¹³⁹ Another case that demonstrates the “global champion” culture is that of TCL¹⁴⁰ merging with Thomson. In 2003, TCL, the largest TV manufacturer in China, merged with Thomson, a French company, in order to create a TV–DVD giant. Li Dongshen, the CEO of TCL, boldly pledged in 2003 to make profit within two years after the merger. Again, TCL failed to do its homework properly before the merger, all it wanted was to become a world famous company by using Thomson as a ladder. Instead of bringing TCL profit, it brought a nightmare. TCL’s loss in 2006 reached RMB1840m and TTE, a joint venture of TCL and Thomson, also suffered a great loss due to this aggressive strategy. Eventually, TCL had to break up with Thomson to avoid further loss.¹⁴¹

The two gigantic companies’ painful merger experiences demonstrate that when companies make hasty and aggressive decisions under the influence of a “global champion” mentality, they will inevitably ignore necessary measures to improve corporate governance and to protect minority shareholders’ interests in the companies. In addition, from the majority shareholders’ point of view (in particular, where the majority consists of state shareholders), protection of state assets in the company is also their priority. So the unspoken rule here is that if there is a conflict of interest between becoming a “global champion” and the minority shareholders’ benefits (that is between the state and minority shareholders’ interests in the company), then sacrificing the minority shareholders’ interests for the dream of “global champion” or the interests of the state should be considered a patriotic decision. Otherwise, the intention of the decision makers will be questioned. In Chinese culture, an individual’s interests never have an equal status with those of the state or collectives. This was true in ancient times and was also true at the time of the implementation of the planned economic system (1949–1979). The motto “be dedicated to serving the public without any thought of oneself” was used as a standard for choosing a

138 Lenovo produces desktops, laptops, servers, handheld computers, imaging equipment and mobile phone handsets. Lenovo also provides information technology integration and support services, and its QDI unit offers contract manufacturing. It is the world’s fourth largest personal computer manufacturer after Hewlett-Packard and Dell of the USA and Acer of Taiwan. See www.businessweek.com/magazine/content/05_19/b3932113_mz063.htm, 9 May 2005 (last accessed 8 February 2010).

139 For details, see <http://hi.baidu.com/havis2008/blog/item/ad6a772dd7c644e48a1399b9.html> (last accessed July 2009).

140 TCL is China’s largest television manufacturer. TCL teamed with French company Thomson to form the world’s largest television production joint venture in 2003. Li Dongsheng, chair of TCL International, and Charles Dehelly, CEO of Thomson, said at a signature ceremony that the TCL–Thomson company was planning to produce 18 million television sets annually, replacing Sony as the leading global television maker. The two companies planned to combine their TV and DVD businesses, according to the cooperation memorandum. Total assets of the joint venture amounted to €450m, with TCL International holding 67 per cent and Thomson 33 per cent of the shares. For details, see http://www.chinadaily.com.cn/en/doc/2003-11/04/content_278455.htm (last accessed July 2009).

141 For details, see <http://www.shangdog.com/weburl/96938.htm> (last accessed July 2009).

model worker or a national hero for several decades. A government official¹⁴² in Shenzhen expressed a majority shareholder's standpoint when he was interviewed recently.¹⁴³ He stated that:

about 75% of listed companies have one dominant shareholder. This results in the dominant shareholder appointing directors to look after its interests. In terms of shareholder return, if there is a conflict of interest between the dominant shareholder and the minority shareholders, the interests of the dominant shareholder will be looked after first.¹⁴⁴

From the point of view of minority shareholders, due to traditional Confucian influence, sacrificing personal interests for the collective or for society's best interests is considered good virtue and should be well praised. Besides, owing to the long Chinese tradition of mediation and the Confucian preference for mediation and harmony, before minority shareholders manage to enter into a court room, they may have to go through a mediation process. Even after litigation has commenced, mediation will still be conducted by the court according to China's Civil Procedure Law.¹⁴⁵ Considering the exhausting, time and energy-consuming process of mediation which may not result in a favourable outcome for them, minority shareholders may not want to be start a fight with the majority unless absolutely necessary even though they have know that their interests in a company have been compromised. Instead, they may prefer someone else to litigate for them. The Chinese have another expression for such a situation "the nail that sticks up most gets hammered down". In addition, minority shareholders also have problems collecting crucial evidence to support their arguments and are hampered by lack of professional knowledge and experience. They are also subject to expensive litigation fees, in particular, if it is a derivative action, the benefit goes to the company even if minority shareholders win the case. So, minority shareholders in China have little motivation and many disincentives to sue the company and the majority.

Conclusion

Mainland China and Hong Kong are both dominated by rich cultural heritages and both have good legal and regulatory frameworks and comprehensive supervision systems to protect minority shareholders. But Hong Kong was ranked number one in corporate governance in Asia in 2007 and China was not included. Culture and institutional design arguably explain the difference. Hong Kong, due to its British colonial history and the fact that it is now an international business centre, has developed its unique cultural mixture of both Chinese and Western tradition. In addition, the rule of law, separation of power and impartiality of administration are strongly emphasised. Minority shareholders not only have less restraint to sue the majority shareholder or company directors in court but also have confidence in Hong Kong's judicial system because it is independent, predictable, consistent and not arbitrary.

142 In China, when a government official is interviewed by a foreign journalist or a researcher, if possible, that official would prefer his or her name not to be released in the published report in order to avoid unnecessary troubles. In particular, if the report criticises the local government, that government official will be in trouble. It is therefore not easy to find out the name of the government official who was interviewed by the Australian researchers.

143 The interview was carried out by the research team led by Roman Tomasic and Neil Andrews from Victoria University and Jane Fu from Deakin University. The project was sponsored by the Australian Research Council (ARC) under an ARC Discovery Grant. The report they wrote is "Minority shareholder protection in China's top 100 listed companies" 2007 9(1) *Australian Journal of Asian law* 88–119.

144 Ibid.

145 See PRC Civil Procedure Law, Chapter Eight.

In China, the constitution confirms the CPC's position of supreme power. Separation of power is not exercised. Fast economic development should naturally lead to democratic opening but intentionally slowing down political reform makes current institutional design not compatible with economic development which results in the popularity of unspoken rules. The rule of law cannot be fully implemented. Sometimes, unspoken rules prevail against written rules. People pay more attention to unspoken rules because such implied rules can sometimes help get the job done better, more quickly and cheaply.

China can point to the many laws regulating companies and company finances and an apparently comprehensive supervision system as part of its good corporate governance agenda which includes the protection of minority shareholders. But, without a more fundamental culture change, minority protection is only an aspiration. In reality, the unspoken rules (the nepotism, the bribes, the conflicts of interests, the system of reciprocal favours) will have to be eliminated and the culture of willingly subordinating individual interests to those of the state needs to be adjusted. Otherwise China will not reach the standard of corporate governance that has been achieved in Hong Kong. One of the most important prerequisites of good corporate governance in China is the elimination of unspoken rules so that companies are transparently managed. Without improvements in the reality of corporate governance, foreign investment in Chinese companies will not be forthcoming and the development of private equity financing internally will not happen if the potential providers of private equity have a poorly protected minority status.