Adapting Corporate Governance: The Legal Transplant of Independent Directors in China

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Abstract

This thesis investigates the transplantation and operational effectiveness of the independent director system within China's corporate governance framework, drawing comparisons with established models in jurisdictions like the United States and the United Kingdom. The study traces the origins of independent directors, their roles in corporate governance, and their global spread as a mechanism to enhance board oversight and safeguard minority shareholder interests. This thesis adopts a case study approach and comparative analysis to identify the challenges and deficiencies of the independent director system in China, underscore the impacts of concentrated state control, political dynamics, and cultural factors that influence the functionality of this transplanted legal concept.

The thesis begins by outlining the foundational theories and models of corporate governance, setting the stage for an in-depth exploration of legal transplant theory and recent developments in comparative corporate governance reforms. Then traces the historical and legal evolution of corporate governance in China over the past few decades, highlighting the interplay of market-driven growth and potential reforms in a system undergoing significant transformation. The study critically examines the adaptation of independent directors in China, identifying its ineffectiveness and factors that constrain their effectiveness.

Through a comprehensive evaluation of the independent director system as a legal transplant, the thesis argues that the effectiveness of such a system should be assessed not by its conformity with foreign models but by its degree of integration and adaptation to the local context. The findings suggest that despite the formal adoption of the independent director system, its practical role in improving governance outcomes remains limited due to deep-seated structural and cultural barriers. The study emphasizes the need for ongoing legal and institutional reforms tailored to China's specific corporate environment to enhance the efficacy of independent directors.

Ultimately, this thesis contributes to the broader discourse on legal transplants in corporate governance by offering alternative explanations for the persistence of ineffective governance mechanisms in national contexts with unique legal and socio-economic characteristics, thereby enriching our understanding of the complexities involved in such legal and regulatory adaptations.

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Abbreviations

ACGA	Asian Corporate Governance Association
ALI	American Law Institute
CACG	Commonwealth Association for Corporate Governance
CAPCo	China Association for Public Companies
CPC /CCP	Communist Party of China/ Chinese Communist Party
CCCCP/CCCPC	Central Committee of the Chinese Communist Party
CIRC	Chinese Insurance Regulatory Commission
CRS	Contract Responsibility System
DGCL	Delaware General Corporation Law
FCPA	Foreign Corrupt Practices Act
GCGC	German Corporate Governance Code
GLC	Government-Linked Companies
GSCA	German Stock Corporate Act
ICGN	International Corporate Governance Network
IMF	International Monetary Fund
JCGC	Japanese Corporate Governance Code
NGO	non-governmental organization
NPC	National People’s Congress
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-operation and Development
PAP	People’s Action Party

PBC	private benefits of control
PPCCs/CPPCC	People’s Political Consultative Conferences
PRC	People's Republic of China
PSC	Standing Committee of the Politburo
RMB	renminbi
RPT	Related-Party Transactions
ROA	Return on Assets
ROS	Return on Sales
SCGC	Singapore Corporate Governance Code
SMF	Singapore’s Ministry of Finance
SEC	Securities and Exchange Commission
SETC	State Economic and Trade Commission
SOA	Sarbanes-Oxley Act
SOE	State-Owned Enterprise
SPA	Special Provisions Act
SPC	Supreme People’s Court
SASAC	State-Owned Assets Supervision and Administration Commission
SUM	Society for Establishing Useful Manufacture
TSE	Tokyo Stock Exchange
USSR	Union of Soviet Socialist Republic
WTO	World Trade Organization

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Introduction

Research Background

Over the past decades, corporate governance has emerged as a focus of research in business, economics, and law, driven by substantial changes in global economic, institutional, and regulatory environments. In the broadest sense, corporate governance refers to the systems, rules, and processes by which corporations are managed and controlled, addressing how responsibilities and powers are distributed among various stakeholders.

Corporate governance scholarship has evolved through two main stages. The first wave of research was largely U.S.-centric, examining internal mechanisms such as board composition, executive compensation, equity ownership structures, and institutional investors' monitoring roles. Early studies focused primarily on how these internal governance structures affected firm performance, executive behavior, and managerial decision-making. However, this initial phase often overlooked the broader legal and institutional contexts shaping corporate governance globally.

The second wave of research, which started in the 1990s, greatly expanded its analytical scope to include comparative and international perspectives. This comparative research underscored the critical understanding that governance mechanisms cannot be universally transplanted without considering the receiving jurisdictions' unique institutional and cultural contexts.

A landmark contribution to this comparative perspective came from scholars such as La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV), who highlighted how legal origin—whether common law or civil law—affects corporate governance structures, investor protection levels, and economic development. Their influential "law and finance" theory demonstrated that strong legal protections correlate with dispersed ownership, active capital markets, and improved economic performance. Conversely, weak legal protections typically correspond to concentrated ownership and less effective corporate governance. This insight has significantly shaped discussions around legal transplants and their efficacy in corporate governance reforms.

Legal transplant theory itself, notably articulated by Alan Watson, views the adoption of laws and governance mechanisms from one jurisdiction to another as a primary mode of legal evolution. Watson argued that laws could be transplanted relatively easily, often without major modifications, due to their inherent adaptability. However, this perspective has been contested by scholars such as Gunther Teubner and Pierre Legrand, who emphasize the deep embedding of legal rules within specific socio-legal contexts. These scholars argue that effective transplantation requires more than mere textual adoption; it necessitates compatibility with the receiving jurisdiction's legal culture, institutional environment, and societal norms.

Based on these theoretical understandings, the transplantation of the independent director system into China represents a highly informative example. independent directors originally developed within the Anglo-American corporate governance framework to mitigate conflicts of interest and enhance board accountability and have been globally recognized as a benchmark for sound governance practices. China's adoption of independent directors, initiated through regulatory measures such as the China Securities Regulatory Commission's 2001 guidelines, aimed to signal conformity with international governance standards, attract foreign investment, and modernize its corporate sector amid broader economic reforms.

Yet, the effectiveness of independent directors in China remains controversial. Although formally integrated into China's governance structures, their practical effectiveness is significantly constrained by the local institutional environment, including concentrated state ownership, pervasive influence of the Communist Party, and limited regulatory enforcement capacities. Consequently, independent directors in China often fail to achieve the genuine independence and oversight intended by the original governance model.

Empirical evidence on the effectiveness of independent directors in China has been mixed. While some studies show modest improvements in reducing related-party transactions and enhancing financial reporting quality, overall impacts on corporate governance remain limited. Such outcomes reflect broader criticisms of legal transplants—that adopting formal rules does not automatically guarantee their effective operation in practice.

Against this background, the thesis critically evaluates why China adopted the independent director system and why it persists despite apparent ineffectiveness. It seeks to contribute to legal transplant theory by analyzing how governance mechanisms function within China's unique institutional context, exploring the conditions under which such transplants succeed or fail. This inquiry has important implications not only for China but also for policymakers and international development agencies promoting corporate governance reforms globally.

Research Question and Objectives

This thesis aims to explore the alternative explanations for why the independent director system was transplanted to China and has persisted despite its ineffectiveness. To address this core research aim, the thesis is structured around a series of interrelated research objectives. Each objective is addressed in one or more chapters, contributing cumulatively to answering the central research question. To find the answer to the question, the objectives of this research are:

(1) To review and critically analyze theories relevant to corporate governance and legal transplants and explore how they apply within China's institutional context. The theoretical foundation provides the conceptual tools to evaluate whether, and how foreign governance mechanisms like independent directors can function effectively when transplanted into China's distinct legal and political environment.

(2) To identify the socio-political background of the evolution of independent director system in its original country and assess its diffusion to how governance structure shapes the adaption of this model.

(3) To identify the entrenched practices that undermine genuine director independence in China and the systemic barriers, then compare the independent director in China with that of the U.S. The comparison helps to illustrate the different outcomes produced by one legal institution.

(4) To explore the underlying reasons why China's regulatory reforms have not improved and system's effectiveness; and examine the interaction of different parties under Chinese political system and how it shapes the transplant effects in China.

Together, these objectives together create a multi-layered explanation of why the independent director system was introduced in China as part of the global legal transplantation trend, and why it continues to exist in largely ineffective form. The research objectives ensure the thesis can offer insights into the legal transplantation and the political economy of corporate governance in China.

Contribution

The thesis provides a comprehensive analysis of why China's independent director system continues to struggle with achieving substantive independence despite ongoing revisions. By exploring the persistent systemic and cultural barriers, the thesis highlights the disconnect between formal regulatory frameworks and actual corporate governance practices in China.

The research contributes to legal transplant theory by applying and testing various theoretical frameworks, within the context of China's adoption of independent directors. It explores how local adaptations, socio-legal environments, and the substantive versus label dynamics impact the success of legal transplants, offering a more refined and practical lens through which to evaluate similar initiatives in other developing or civil-law countries.

The findings have broader implications for international development agencies and policymakers in developing countries who are often advised to adopt Western-style corporate governance models. The thesis cautions against a one-size-fits-all approach to legal transplants and emphasizes the importance of adapting governance models to fit local contexts to avoid ineffective reforms and wasted resources.

Methodology and Research Design

This thesis adopts a comparative legal analytical approach to investigate the transplantation and performance of the independent director in China. The research is designed to explore how this mechanism originating in Anglo-American corporate governance systems have been formally adopted, adapted, and ultimately function within China's distinct institutional and political environment. To do so, the study relies on a systematic comparison between the Chinese implementation of independent directors and their operation in jurisdictions where the system originated.

(1) Comparative Legal Analysis

This thesis examines legal rules, institutions, and their enforcement across different jurisdictions to identify similarities, differences, and explanatory factors for variation. In this thesis, the comparative legal firstly analysis helps trace the origin, rationale, and function of independent director in jurisdictions with diverse corporate governance models and legal families. Second, it allows for an evaluation of how. China has adapted the independent director in its own legal political and economic environment. Third, by comparison, it provides an analytical framework for understanding why certain transplantation succeed or fail, by highlighting the contextual compatibility or incompatibility of the legal rules.

This thesis does not assume that adopting foreign governance mechanism leads to convergence across legal systems. Instead, the comparative analysis is used to demonstrate that success of legal transplants depends heavily on domestic institutional contexts.

Although the thesis draws on multiple jurisdictions for comparison, it still primarily focused on China as the main site of investigation. China’s legal transplantation experience is examined to critically assess the interaction between imported legal rules and domestic institutions. This allows to test broader theoretical claims about the limits of legal transplantation in corporate governance reform.

(2) Sources and Analytical Materials

The research uses wide range of primary legal documents and secondary literature

The study closely examines key primary legal documents, including the Company Law of China, the Securities Law, guidelines from the China Securities Regulatory Commission (CSRC), and other relevant regulations that outline the roles, responsibilities, and expectations of independent directors. Besides, the thesis will also analyse relevant laws and regulations regarding independent directors of the U.S., and the other legal jurisdictions. These documents establish the formal legal frameworks governing board independence in these jurisdictions. The analysis provides a foundation for assessing the degree of alignment between legal provisions and their practical implementation, particularly in the context of legal transplantation.

The research draws on an extensive body of secondary materials, including academic articles, government reports, empirical studies, and other scholarly literature. These sources offer insights into the historical development, theoretical foundations, and practical challenges of the independent director system in China. The secondary data also provide comparative perspectives from other jurisdictions, enabling a critical analysis of the similarities and differences in the adoption and functioning of independent directors across different legal and cultural contexts.

The methodology employed in this thesis provides a robust framework for evaluating the transplant of the independent director system into China. By integrating theoretical perspectives on legal transplants with empirical analysis of the Chinese corporate governance landscape, the research aims to contribute to a deeper understanding of the complexities involved in adapting foreign governance mechanisms to local contexts. The findings will not only shed light on the specific case of independent directors in China but also offer broader insights into the challenges and potential of legal transplants in corporate governance reform.

Thesis Structure

The thesis is structured into five chapters, systematically organized to address the central research question.

Chapter 1 establishes the foundational concepts of corporate governance. It provides a comprehensive review of key theoretical frameworks, including agency theory, stakeholder theory, and stewardship theory, and discusses internal and external governance mechanisms that influence corporate accountability and transparency. It addresses governance challenges such as principal-agent conflicts and issues unique to state-owned enterprises, laying the foundation for understanding governance dynamics relevant to China.

Chapter 2 critically analyses legal transplant theory, emphasizing debates around the adaptability of legal rules across jurisdictions. The chapter evaluates different perspectives—from Watson's optimism about legal adaptability to the cautious views of scholars like Teubner and Legrand—highlighting the importance of local contexts and institutional compatibility for successful transplants. This theoretical discussion sets the analytical framework for examining the transplantation of independent directors in subsequent chapters.

Chapter 3 explores the origins, functions, and global diffusion of independent directors, with detailed comparative analyses of the U.S., U.K., Germany, Japan, and Singapore. Each jurisdiction provides distinct insights into how institutional structures, legal origins, ownership concentrations, and local governance cultures shape the effectiveness of independent directors. This comparative analysis establishes an essential context for understanding China's adaptation of the independent director system.

Chapter 4 closely examines the evolution and implementation of the independent director system in China. It traces historical developments from China's early economic reforms to recent regulatory frameworks and assesses how unique institutional factors—including concentrated state ownership, Party control, and regulatory enforcement practices—impact the actual functioning of independent directors. This chapter explicitly addresses the systemic barriers that have undermined genuine director independence in China.

Chapter 5 provides a detailed evaluative analysis, synthesizing the theoretical and comparative insights from previous chapters to explain the limited effectiveness of independent directors in China. Through a structured comparison with the United States, it identifies critical gaps between formal legal structures and practical outcomes, exploring reasons behind the persistence of superficial governance reforms. This chapter also outlines normative recommendations to better align governance transplants with China's institutional realities.

The concluding chapter summarizes key findings, explicitly clarifying how each research objective has been achieved and how they collectively contribute to addressing the central research question. The conclusion also reflects on broader implications for legal transplant theory and international corporate governance reforms, offering guidance for policymakers in similar institutional contexts.

Chapter 1 Corporate Governance

Introduction

Chapter 1 explores the foundational concept of corporate governance, providing a comprehensive overview of different theoretical framework, principles, and issues that shape how corporations are managed and controlled. This chapter starts with defining the concept of corporate governance in the broad and narrow sense, distinguishing between the shareholder-centric and stakeholder-inclusive approaches. Section 1.2 examines the theoretical underpinnings of corporate governance, including agency theory, transaction-cost economics, stakeholder theory, stewardship theory, and resource dependence theory. These theories provide various lenses through which to understand the motivations and actions of corporate actors, thereby illuminating the complexities inherent in governance structures.

Furthermore, section 1.3 compares different models of corporate governance, focusing on the shareholder-oriented model predominant in Anglo-American countries and the stakeholder-oriented model more common in Continental Europe and Asia. Section 1.4 examines the array of internal and external governance mechanisms, including boards of directors, ownership structures, executive compensation, the market for corporate control, and the legal and regulatory frameworks designed to uphold corporate accountability and transparency.

Section 1.5 addresses common challenges in corporate governance, such as principal-agent and principal-principal conflicts, shedding light on issues like managerial entrenchment, excessive perquisite consumption, and the expropriation of minority shareholders. Additionally, it explores the specific governance challenges faced by state-owned enterprises (SOEs), such as political interference and the complications arising from the state's dual role as both regulator and controlling shareholder.

1.1 Definition of Corporate Governance

Definitions of 'corporate governance' vary greatly.[1] Due to the differences in understanding across different economies, a variety of institutions, interest groups, and individuals -- each with their unique viewpoints – have developed varying diverse definitions instead of agreeing upon a single, all-encompassing definition.[2] Corporate governance, in general, refers to the frameworks and procedures put in place by business enterprises to ensure appropriate accountability, adherence to the law, integrity, and transparency in an organization's operations. At its core, corporate governance is built on principles like transparency, accountability, fairness, and responsibility, all predicated on full disclosure. This is meant to foster the trust and confidence of the shareholders. Organizations typically operate within the boundaries established by their national legal systems and regulations, their economic objectives, and the

[1] Christine A Mallin, *Corporate Governance*, vol 14 (4th edn, 2013).

[2] Stijn Claessens, 'Corporate Governance and Development' (2006) 21 The World Bank Research Observer 91 <https://doi.org/10.1093/wbro/lkj004>.

expectations of their stakeholders.[3] The difference in governance practices from one place to another can often be attributed to various factors, including governmental inflexibility and the legal and cultural context of each location.[4]

Since 1992, heterogeneous definitions have been focusing on creating standards for the management and control of firms. The aim is to direct company activities in a way that assures investors of the efficient and profitable management of the resources they have invested.[5] Although definitions of corporate governance vary greatly, scholars often categorise them into 'narrow' or 'broad' types.[6] This classification hinges on whether the governance system is primarily concerned with fulfilling the specific interests of shareholders or addressing the broader concerns of various societal stakeholders.

From the ‘narrowest’ perspective, corporate governance emphasizes capital market regulations pertaining to publicly traded companies' equity investments. This encompasses standards for company listings, insider trading regulations, disclosure and accounting stipulations, and safeguarding minority shareholders' interests. Specifically, the definition would focus on how external investors shield themselves from the misappropriation of assets by company insiders, which includes upholding minority rights and reinforcing creditor rights, the composition and powers of executive directors, and the capacity to initiate class action litigation. Shleifer and Vishny, for example, define corporate governance as ‘how suppliers of finance to corporation assure themselves of getting as return on their investment’.[7] Accordingly, corporate governance can address other problems of the ‘finance supplier’, including resolving collective action problems among dispersed investors and mediating disputes between various stakeholders.

A broader perspective views corporate governance as mechanisms operating when ownership and management are separate. Sir Adrian Cadbury defines corporate governance in ‘The Report of the Committee on the Financial Aspects of Corporate Governance’ (‘Cadbury Report’) as ‘corporate governance is the system by which companies are directed and controlled.’ The Cadbury Report emphasizes three key corporate governance structures of the corporation: a general assembly of shareholders, the board of directors, and the executive management, whose power within the corporation is allocated as follows:

‘Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint directors and auditors and to satisfy themselves with an

[3] Antoine Rebérioux, ‘The End of History in Corporate Governance? A Critical Appraisal’, *Amsterdam Research Centre for Corporate Governance Regulation, Inaugural Workshop* (2004).

[4] ibid.

[5] Manuel Alfonso Garzón Castrillón, ‘The Concept of Corporate Governance’ (2021) 25 Visión de Futuro (Vision of the Future) 178, 180.

[6] Elaine Sternberg, ‘Corporate Governance: Accountability in the Marketplace’ [2004] Available at SSRN 4350610 39.

[7] Andrei Shleifer and Robert W Vishny, ‘A Survey of Corporate Governance’ (1997) 52 The Journal of Finance 737, 737 <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.1997.tb04820.x>.

appropriate governance structure. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations, and the shareholders in general meeting.' [8]

The Cadbury Report's definition of corporate governance expanded the focus beyond regulations to include the interaction of internal governance mechanisms with the objective of maximizing shareholder value.

The even broader perspective of corporate governance focuses on the interaction between all stakeholders, including creditors, consumers, employees, suppliers, and the local community, among others. It strongly emphasizes the distribution of generated profits among all stakeholders, aiming to maximise firms' overall economic contribution.[9]

In the foreword to the World Bank Report of 1999, Sir Adrian Cadbury offered a more expansive view of corporate governance. He described corporate governance. '...concerned with holding the balance between economic and social goals as well as between individual and communal goals...', he defined corporate governance as 'the aim is to align as nearly as possible the interests of individuals, corporations, and society.'

This understanding of corporate governance considers external governance mechanisms and the interests of various stakeholders and goes beyond the basic internal structures of a firm. Typically, internal governance structures comprise the shareholders' assembly, the board of directors, and executive management. On the other hand, the external governance mechanisms are the legal system, markets for executive roles and corporate control, regulatory authorities, and the broader cultural, political, social, and economic contexts in which companies operate. From a wider angle, a corporation is perceived as a social entity with responsibilities extending to diverse stakeholders, such as shareholders, creditors, suppliers, customers, employees, management, government, and the local community. The overarching goal of corporate governance is to ensure the efficient use of resources, minimising fraud and mismanagement while balancing the interests of sometimes-divergent stakeholders. In essence, this 'broad' concept of corporate governance, as opposed to the 'narrow' view, emphasizes the management of both internal and external governance institutions to enhance the overall value and performance of the firm, which benefits potential stakeholders as well as shareholders.

In China, there are various definitions of corporate governance. Under Chinese Company Law, 'corporate governance', which refers to internal corporate governance and the distribution of corporate powers, is replaced by the term 'corporate organizational structure', which focuses

[8] 'Report of the Committee On the Financial Aspects of Corporate Governance' para 2.5 <http://www.ecgi.org/codes/documents/cadbury.pdf> accessed 2 November 2017.

[9] Zingales Luigi, *Corporate Governance, The New Palgrave Dictionary of Economics and Law.* (MacMillan,London).

on internal corporate governance.[10] Abstractly speaking, Chinese definitions of corporate governance often refer to the systems that regulate the interactions between all parties with a stake in a business entity, typically highlighting shareholders as an especially significant group.[11] The reform of corporate law and institutions was primarily designed to address the problem associated with state-sector, where the state is the major shareholder of super-sized corporations; thus, protecting the state's interests and property was the primary consideration when drafting the company law.[12]

1.2 Theoretical Basis of Corporate Governance

Corporate governance has recently gained significant attention in business, with the term becoming commonplace in financial journalism during the past three decades. Nevertheless, the principles that form the foundation of corporate governance predate this period, drawing from multiple fields such as finance, economics, accounting, law, management, and organizational studies.

It is recognised that corporate governance is an international phenomenon with inherent complexities, encompassing variations in legal systems, cultural norms, ownership structures, and other factors. Consequently, specific theories may be more applicable or pertinent to particular nations or at specific times, depending on the economic, corporate, or ownership progression within those countries or regions. The stage of development of corporate governance could be related to economic growth, corporate frameworks, or ownership patterns, each influencing the direction and integration of corporate governance within a particular national context. Critically, a key element in this is whether a corporation operates under a shareholder model, prioritising shareholder value above all, or adopts a broader stakeholder approach, which considers the well-being of different groups such as employees, creditors, suppliers, customers, and local communities.

This section will cover the main theories that form the basis of corporate governance development.

1.2.1 Separation of Ownership and Control

Adam Smith, in the 18th century, observed that in joint-stock companies where the ownership and control were separated, corporate directors manage funds that belong to others rather than their own, are less likely to oversee the funds with the same level of care and attention.[13] Berle

[10] Company Law 2005 Art.76.

[11] Donald C Clarke, 'Corporate Governance in China: An Overview' (2003) 14 SSRN Electronic Journal 494, 494 <https://papers.ssrn.com/abstract=424885> accessed 20 September 2021.

[12] Donald C Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125, 131.

[13] Adam Smith, *The Wealth of Nations* (Xist Publishing 1776) <http://books.google.com/books?hl=en&lr=&id=rBiqT86BGQEC&pgis=1>.

and Means provide further explanation of the investor and corporation relationship in their seminal work until 1932.[14] They observed that with industrialisation and market development, the entities owning and those controlling corporations diverged, particularly in the U.S. and the U.K., whose legal frameworks offer solid protections for minority shareholders, encouraging a broader distribution of shareholders.[15]

However, many countries, particularly those with civil law traditions, have less effective legal infrastructure for minority shareholder protection. Therefore, civil law countries do not have the soil to cultivate dispersed ownership structures. Common law emerged in England during the 11th century, contrasting with civil law rooted in Roman law.[16] In jurisdictions with a common-law tradition, such as the United States, British Commonwealth countries and other former British colonies, the legal system depends on judges and juries that operate independently, and the laws are often developed further by decisions made in past cases, offering a degree of flexibility. Conversely, in nations that follow civil law, including many countries in Continental Europe and Latin America, judges are typically expert clerks or civil servants who apply detailed regulations, which may restrict their capacity to adapt to new circumstances.[17] Thus, civil law frameworks have a greater degree of written laws but have less shareholder protection than common law countries, further discouraging investment.

La Porta *et al.* supported this viewpoint in their influential work in 1999.[18] The corporation model of the separation of ownership and management, as observed by Berle and Means, predominantly pertains to common-law countries like the US and the UK but does not hold as true for numerous other countries. La Porta et al.'s study found that the predominant ownership models are family-controlled enterprises or dominant shareholders (e.g. the State) rather than dispersed shareholder structures.[19] This is a clear departure from Berle and Means's concept of ownership in contemporary corporations in common-law jurisdictions. Nevertheless, Berle and Means's seminal work has significantly impacted how corporate structure is understood, influencing the perceptions of ownership, management, and governance in corporations, particularly within the U.S. and the UK. Throughout the twentieth century, there has been a gradual decentralisation of share ownership, leading to the current situation in institutions and

[14] Adolf A Berle and Gardiner C Means, The Modern Corporation and Private Property (Taylor and Francis 1933).

[15] ibid Book II and III.

[16] Caslav Pejovic, 'Civil Law and Common Law: Two Different Paths Leading to the Same Goal' (2001) 155 Poredbeno Pomorsko Pravo 7, 8–10.

[17] Seon Bong Yu, 'The Role of the Judge in the Common Law and Civil Law Systems: The Cases of the United States and European Countries' (1999) 2 International Area Review 35, 37.

[18] Rafael La Porta and others, 'Corporate Ownership around the World' (1999) 54 The journal of finance 471 <https://onlinelibrary.wiley.com/doi/full/10.1111/0022-1082.00115>.

[19] ibid.

a broad array of individual investors holding shares, resulting in the actual '*ownership'* that lacks substantial influence.[20]

In recent years, numerous corporate misgovernance and malfeasance were exposed to the public, including the perceived excessive compensation of executives relative to their performance, high-profile corporate failures, and scandals. As a result, corporate pension funds have been severely decimated, and shareholders have suffered significant losses. Therefore, shareholders, especially institutional shareholders, have encountered increasing pressure to embrace a more active role with their ownership rather than being passive shareholders. Also, the corporate governance code requires enhanced transparency and disclosure and is expected to rectify the current disparity in information between the investor and management, thereby granting investors more insight into the operational undertakings and strategic plans of the company.

When shareholders start to engage with their investments as genuine owners, they will wield more substantial control over corporate entities and their governing bodies, enhancing the accountability of these boards. Consequently, the essence of ownership will be restored to the actual shareholders.

1.2.2 Agency Theory

Agency theory has a long history within the domain of management and economics. It explores the problems within organizations due to the division between ownership and management and focuses on strategies to mitigate these issues. This theoretical framework helps to deploy various governance mechanisms designed to regulate agents' actions within joint-held companies. The evolution of agency theory is a profound narrative that traces back to Adam Smith in 1776. Smith is credited for identifying the possibility of agency problems in his work 'The Wealth of Nations.' Smith hypothesised that management by non-owners could lead to misalignment of incentives if the managers did not prioritise owner benefits. In the 1930s, Berle and Means later observed the separation of ownership and management of US companies. They argued that in joint-stock companies, the owners were distinguished by their position to oversee or delegate the administration of the enterprise, and to receive any resulting profits and benefits. The managers were primarily characterized by their role in operating an enterprise, presumably for the benefits of the owners.'[21]

Ownership in joint-stock companies is distributed among individuals or groups holding shares, who then entrust the operational authority to managers (agents). These agents are tasked with

[20] John C Coffee, 'Dispersed Ownership: The Theories, the Evidence, and the Enduring Tension Between'Lumpers' and'Splitters'' [2010] Columbia Law and Economics Working Paper 60–61.

[21] Berle and Means (n 17); Ronald Harry Coase, 'The Nature of the Firm' (1937) 4 Economica 386; Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 The Journal of Law & Economics 301 <http://www.jstor.org/stable/725104> accessed 2 November 2017; Eugene F Fama and Michael C Jensen, 'Agency Problems and Residual Claims' (1983) 26 The journal of law and Economics 327.

operating the enterprise on behalf of the shareholders (principals), raising critical questions about whether the managers act in the owners' best interests or serve their own ends.

This discourse was further expanded as economic studies explored agency problems through risk-sharing among different organizational stakeholders.[22] They noted that individuals and groups within a firm exhibit varying risk tolerance, influencing their decisions and actions. This disparity in risk preference between the capital-investing principals and the risk-averse agents who manage the firm creates a fundamental agency conflict as outlined in agency theory.

Alchian, Demsetz, Jensen and Meckling integrated elements from agency theory, property rights, and finance and applied them to modern corporations.[23] They described the firm as a nexus of contracts among production factors, emphasizing its nature as a legal fiction defined by its internal contractual relationships. They viewed the agency relationship as a contract in which principals and agents pursue self-interest, potentially leading to conflicts. This framework emphasizes the importance of monitoring mechanisms, incentive structures, labour market dynamics, and information asymmetry in shaping ownership structures and mitigating agency costs.

Jensen and Meckling highlighted the value maximization and profitability of the firm, suggesting that wealth maximization results from effective team production among involved parties.[24] Nevertheless, due to differing interests, conflicts may arise, addressable only through managerial ownership and control. These self-interested parties recognize that their interests are fulfilled only if the firm continues to exist, thus motivating their performance for its survival. Similarly, Fama also held that competition from other firms forced the development of mechanisms within companies to effectively monitor the performance of both the entire team and individual members.[25]

Fama and Jensen's research reveals that while separating ownership and control can introduce agency costs, these can be effectively managed through appropriate governance structures tailored to the organization's specific needs.[26] For complex corporations, they emphasize the role of corporate boards and external market mechanisms, like the stock market and takeover markets, which serve as checks on managerial decisions. These mechanisms ensure that managers' decisions align with shareholder interests by providing oversight and potentially

[22] Michael C Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems; The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems', vol XLVIII (1993); Robert Wilson, 'The Theory of Syndicates' [1968] Econometrica: journal of the Econometric Society 119.

[23] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305, 308 <https://www.sciencedirect.com/science/article/pii/0304405X7690026X> accessed 3 July 2018. Also see: Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 Journal of Political Economy 288.

[24] Jensen and Meckling (n 26).

[25] Fama (n 26).

[26] Fama and Jensen, 'Separation of Ownership and Control' (n 24).

replacing underperforming managers. In non-profit organizations, where profit maximisation isn't the objective, governance structures are designed to ensure that operations align with organizational missions and that resources are used efficiently without personal gains by the managers. Governance often involves boards composed of stakeholders who closely monitor management to prevent the misuse of funds and to ensure fidelity to the organization's goals. The effectiveness of these governance mechanisms in mitigating agency problems hinges on their ability to align the interests of controllers (managers) with those of the owners (shareholders or stakeholders), thereby reducing potential conflicts and improving overall organizational efficiency. This alignment is crucial for maintaining trust and accountability within the organization, which are foundational for the survival of the organization.

Grossman and Hart critique the conventional analysis of the principal-agent problem, which typically assumes that the principal design an incentive scheme to maximise expected utility, assuming the agent's utility is stable. They referred to significant literature of Mirrlees, which points out that this standard approach is generally flawed. Instead, Grossman and Hart propose an alternative method.[27] They suggest that if the agent's preferences regarding income lotteries do not change based on their actions, the best way to ensure an agent's compliance through incentives can be determined by solving a convex programming problem. This method allows them to define the optimal incentive plan that considers the agents' risk attitudes and the quality of information available to principals. It suggests that no incentive issues would occur if agents were risk-neutral.[28]

Eisenhardt developed agency theory on the basis of Jensen and Meckling’s theory of the firm. He classified the agency model into two categories: the positivist agency model and the principal-agent model, noting that while both are based on the contractual relationships between principals and agents, the principal–agent model is notably more mathematical in nature.[29] This model delineates principals as risk-neutral and focused on profits, whereas agents are characterized as risk-averse and interested in securing their own rents. Positive agency theory elucidates the origins of agency problems and the associated costs, proposing that agents will act in the principal’s interests if incentives are aligned, and that disciplined agent behaviour arises from principals’ informed oversight.

Within the context of corporate governance, agency theory highlights the crucial role of the board of directors in mitigating issues that arise from the principal-agent relationship, where managers (agents) are tasked with acting on behalf of the shareholders (principals). According to Margaret Blair, while managers are appointed to serve the interests of the corporation's

[27] JA Mirrlees, ‘The Theory of Moral Hazard and Unobservable Behaviour: Part I’ (1999) 66 The Review of Economic Studies 3 <https://doi.org/10.1111/1467-937X.00075>; James A Mirrlees, ‘The Optimal Structure of Incentives and Authority within an Organization’ [1976] The Bell Journal of Economics 105.

[28] Sanford J Grossman and Oliver D Hart, ‘An Analysis of the Principal-Agent Problem BT - Foundations of Insurance Economics: Readings in Economics and Finance’ in Georges Dionne and Scott E Harrington (eds) (Springer Netherlands 1992) 7 <https://doi.org/10.1007/978-94-015-7957-5_16>.

[29] Grossman and Hart (n 31).

owners, it is essential to have adequate monitoring systems in place.[30] These systems are designed to prevent managers from abusing their authority, thereby safeguarding the corporation from potential mismanagement. The expenses incurred through such misuse and the costs associated with monitoring and implementing disciplinary measures to prevent such abuses collectively form what is known as ‘agency costs’.[31] These costs are a central concern in agency theory, which suggests that robust governance mechanisms, especially a vigilant board of directors, are essential to reduce these costs and ensure that management acts in the shareholders' best interests.

1.2.3 Transaction-Cost Economics

Transaction-cost economics draws from the work of Coase, who claims that corporations can reduce costs by undertaking activities internally rather than relying solely on external transactions.[32] Williamson developed transaction-cost economics (TCE), a framework that provides insights to governance structures of organizations by examining the costs of transactions in contrast with agency theory’s contractual basis of the firm.[33]

TCE argues that transactions are the fundamental units of analysis in economics. The costs associated with these transactions, including search and information costs, bargaining and enforcement costs, are crucial determinants of organizational efficiency and corporate governance structure.[34] According to transaction-cost economics, firms create governance structures that minimize transaction costs. This perspective contrasts with the neoclassical views of Coase, which emphasize that firms arise due to inefficiencies in the market that make internal coordination of resources preferable to market transactions in certain conditions.[35] The concept of TCE offers a theoretical framework that allows for a comprehensive understanding the boundaries of the firm. It explains why firms choose to internalize certain activities while outsourcing others. The decision is a trade-off, weighting the costs of performing activities internally against the costs of externalizing them.[36]

In corporate governance, TCE explains the conditions under which firms find it more efficient to govern internally (through hierarchies) rather than relying on external governance mechanisms such as contracts and market exchanges.[37] This aspect of TCE helps explain the prevalence of hierarchical structures within firms and the varying levels of vertical integration

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[30] ibid.

[31] Margaret M Blair, ‘Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century’ (1996) 29 Long Range Planning 432; Jensen and Meckling (n 26).

[32] Coase (n 24).

[33] Oliver E Williamson, ‘Corporate Finance and Corporate Governance’ (1988) 43 The journal of finance 567.

[34] Oliver Williamson, ‘Corporate Governance’ (1984) 93 The Yale Law Journal 1197, 1206.

[35] Coase (n 24) 1220.

[36] Williamson, ‘Corporate Governance’ (n 37) 1220–1226.

[37] Oliver E Williamson, ‘Markets and Hierarchies: Some Elementary Considerations’ (1973) 63 The American Economic Review 316 <http://www.jstor.org/stable/1817092>.

across different industries. It posits that internalising governance can be more cost-effective when transaction costs in the market are high, typically due to high uncertainty, frequency, and asset specificity.[38]

TCE significantly contributes to corporate governance by providing a clear understanding of how contracts are structured and enforced. TCE assumes bounded rationality and opportunistic behaviour; contracts between parties are often incomplete and cannot foresee all future contingencies.[39] Thus, governance mechanisms are necessary to fill these gaps and enforce agreements effectively. This insight helps organizations design better contractual relationships that are adaptive and equipped to handle unforeseen circumstances.[40]

TCE underscores the significance of both formal and informal institutions in reducing transaction costs associated with governance. For example, the legal framework, regulatory oversight, and even cultural norms can significantly influence the efficiency of governance structures by minimising the costs and complexities involved in transactional relationships. These institutions provide the necessary backdrop against which economic exchanges occur, ensuring a level of predictability and order essential for reducing transaction costs.

In summary, TCE has fundamentally shaped our understanding of corporate governance by emphasizing the importance of internal governance structures, the critical role of comprehensive contractual frameworks, and the overarching influence of institutions in fostering efficient economic exchanges. It is crucial for firms looking to optimize their governance strategies in response to inherent transactional challenges.

1.2.4 Stakeholder Theory

Freeman (1984) has substantially impacted corporate governance by promoting a comprehensive perspective on accountability and corporate responsibility through the introduction and development of stakeholder theory. It is a paradigm shift from a conventional shareholder-centric model to promote a governance structure where the interests of all stakeholders, including employees, customers, suppliers, and the community, are integrated into corporate decision-making.

The stakeholder theory originated from Freeman's classical work published in 1984, which provides a strategic approach to organizational management to achieve better corporate

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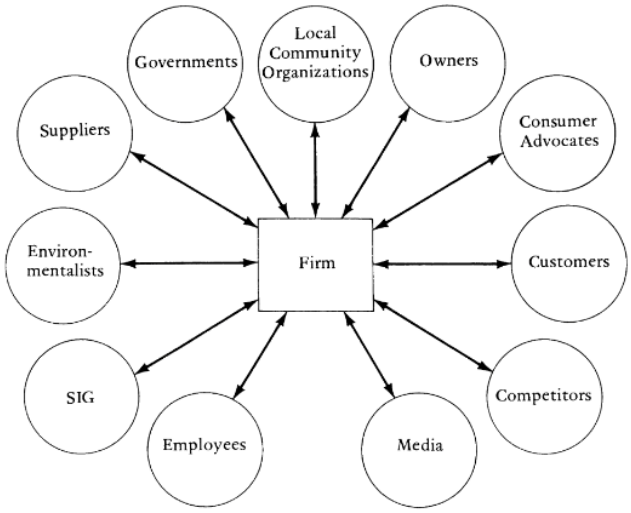
[38] ibid.

[39] Oliver E Williamson, 'Markets and Hierarchies: Analysis and Antitrust Implications: A Study in the Economics of Internal Organization' [1975] University of Illinois at Urbana-Champaign's Academy for Entrepreneurial Leadership Historical Research Reference in Entrepreneurship.

[40] See: Williamson, 'Corporate Finance and Corporate Governance' (n 36) 569–573; Philip Stiles, *Boards at Work [Electronic Resource] : How Directors View Their Roles and Responsibilities* (Bernard Taylor ed, Oxford : Oxford University Press, 2002 2002).

performance.[41] Freeman defined stakeholders as 'any group or individual who can affect, or is affected by, the accomplishment of the corporate purpose' and identified the stakeholders as follows:[42]

Figure 1-1 Stakeholder View of the Firm



Stakeholder theory was initially proposed as the alternative to the shareholder theory of the organization because business organizations reported moral and ethical misconducts and their negative impact on the external environment.[43] According to the stakeholder theory, the firm is a multilateral agreement between the firm and diverse interest groups who contribute firm-specific value and well-being; companies are not supposed only to fulfil the interests of one party, i.e., the shareholder, but to create value for all stakeholders. Freeman argued that a good firm-stakeholder relationship can have an impact on the corporate operation. Thus, the management should have a sense of value in the process of decision-making.[44]

Shareholder and stakeholder theory have distinct views on corporate governance structures and monitoring mechanisms. However, theory and empirical studies frequently fail to determine which corporate governance structure would be most efficient definitively.[45] There is a notable contrast in corporate governance structures as influenced by stakeholder theory, particularly

[41] R Edward Freeman, Strategic Management: A Stakeholder Approach (Cambridge University Press 1984).

[42] R Edward Freeman, 'The Politics of Stakeholder Theory: Some Future Directions' (1994) 4 Business Ethics Quarterly 409; Freeman (n 44) 24–25.

[43] Santosh Pande and Valeed Ahmad Ansari, 'A Theoretical Framework for Corporate Governance': (2014) 7 Indian Journal of Corporate Governance 56, 58 <https://journals.sagepub.com/doi/abs/10.1177/0974686220140104?journalCode=ijca> accessed 7 July 2021.

[44] Freeman (n 44).

[45] Lucian Arye Bebchuk and Mark J Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (2000) 52 Stanford Law Review 170.

when comparing the Anglo-American model with the German model.[46] The Anglo-American model is characterised by its focus on shareholder value, with a board comprised of executive and non-executive directors elected by shareholders. In contrast, the German model legally provides the rights of stakeholders, such as employees, to participate in governance through representation on the supervisory board, highlighting a more stakeholder-inclusive approach.

The choice between these governance structures also extends to monitoring mechanisms. In the Anglo-American model, the emphasis is on aligning executive actions with shareholder interests through market mechanisms like takeovers and performance-based compensation. On the other hand, the German model employs codetermination and labour representation as additional monitoring layers to balance stakeholders' diverse interests.[47]

Jensen proposed enlightened value maximisation to avoid the shareholder or stakeholder value maximisation dichotomy.[48] Enlightened value maximisation incorporates substantial elements of stakeholder theory. Yet, it prioritises maximising the firm’s long-term value as the benchmark for executing necessary trade-offs among its stakeholders.[49] This approach effectively resolves the difficulties associated with multiple objectives, typically present in traditional stakeholder theory.

1.2.5 Stewardship Theory

Stewardship theory, contrasting with agency theory, focuses on managerial motivation as an alternative approach to corporate governance. Agency theory argues that the separation of incumbency of roles of board chair and CEO would help protect shareholders' interests. Conversely, stewardship theory suggests that managers will act as stewards of the assets they manage, giving priority to organizational goals rather than their personal interests.[50] Therefore, the duality of the board chair and CEO is believed to maximise shareholder interests by ensuring that company leadership is deeply aligned with the firm's success.[51] According to Dalton and Kesner’s empirical study, eighty per cent of U.S. industrial corporations have CEO

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[46] Collins G Ntim, ‘Defining Corporate Governance: Shareholder versus Stakeholder Models’ [2018] Ntim, CG (2018). Defining Corporate Governance: Shareholder versus Stakeholder Models’, in ‘Global Encyclopedia of Public Administration, Public Policy and Governance’, Springer, USA; Shabir Ahmad and Rosmini Omar, ‘Basic Corporate Governance Models: A Systematic Review’ (2016) 58 International Journal of Law and Management 73 <https://doi.org/10.1108/IJLMA-10-2014-0057>.

[47] Ntim (n 49) 10.

[48] Michael Jensen, ‘Value Maximisation, Stakeholder Theory, and the Corporate Objective Function’ (2001) 7 European financial management 297.

[49] ibid 303.

[50] Lex Donaldson and James H Davis, ‘Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns’ (1991) 16 Australian Journal of management 49, 51.

[51] Donaldson and Davis (n 53).

duality, which was higher than that in Japan.[52] The practice of CEO duality in the U.S. has faced significant criticism, leading to demands for the separation of the roles of CEO and board chair to improve industrial performance and shareholder returns.[53]

Stewardship theory holds that executives are not opportunistic but committed to effective and efficient management and to being reliable stewards of the company's resources. This approach suggests that managerial motives are inherently aligned with the organization's objectives, benefiting principals through increased share prices and returns.

In contrast to agency theory, which often depicts managers as self-serving at the owners' expense, stewardship theory views managers as self-actualizing individuals focused on higher-order needs such as achievement and self-actualisation. Stewards are described as involvement-oriented and trustworthy, placing the firm's priorities above their gains. This theory assumes a low-power distance culture where managers integrate their identities with the firm's prestige, treating themselves as integral members of the organization rather than external employees.

In corporate governance, stewardship theory advocates for clear, unambiguous managerial roles and an organizational structure that empowers managers with appropriate authority and respect. It posits a unified, collective stewardship team encompassing the board and management, supporting and aiding the CEO and management to foster firm growth and shareholder well-being. This theoretical framework offers a contrasting view to agency theory, emphasising that top management is expected to act altruistically, advancing the firm's interests ahead of personal gains.

1.2.6 Resource Dependence Theory

Resource Dependency Theory (RDT), which incorporates insights from both sociology and management,[54] explores how external resources influence organizational behaviour and adopts a strategic perspective on corporate governance.[55] It underscores the importance of acquiring external resources for any organization's strategic management, acknowledging that all corporations rely on these resources. RDT recognises that the board of directors is 'lynchpin between a company and the resources it needs to achieve its objectives'[56]

Resources originating from the external environment and often controlled by other firms establish a dependency between firms that exchange these resources. This interdependence

[52] Dan R Dalton and Idalene F Kesner, 'Composition and CEO Duality in Boards of Directors: An International Perspective' (1987) 18 Journal of International Business Studies 33; Idalene F Kesner and Dan R Dalton, 'Boards of Directors and the Checks and (Im) Balances of Corporate Governance' (1986) 29 Business Horizons 17.

[53] Dalton and Kesner (n 55).

[54] A Pettigrew, 'On Studying Managerial Elites. Strategic Management Journal, 13 (S2): 163-182.'

[55] Dalton and Kesner (n 55).

[56] Robert Ian Tricker, *Corporate Governance: Principles, Policies, and Practices* (Oxford University Press, USA 2015).

is critical because resources are valuable, costly to imitate, rare, and irreplaceable, making them a fundamental market power source.[57] Consequently, firms possessing these resources are considered more powerful than their competitors without such access. This dependency on external resources typically impacts a firm's productivity, with resource scarcity introducing uncertainty. To secure their long-term survival, firms continuously strive to leverage these resources. Resource Dependency Theory also examines how connections between directors and various aspects of organizational performance or behaviour interrelate.[58]

1.2.7 Summarizing Main Corporate Governance Theories

The development of corporate governance has been enriched by contributions from various disciplines, leading to a diverse array of underlying theories. Here's the summary of the critical theories introduced above and commonly associated with the evolution of corporate governance:

Table 1- 1 Key Theories Affecting Corporate Governance Development

Theory	Basic Argument
Agency Theory	Agency theory defines an agency relationship as one where one party (known as the principal) delegates tasks to another party (referred to as the agent). Within the framework of a corporation, the principals are the owners, and the agents are the directors.
Transaction-Cost Economics	Transaction Cost Economics considers the firm as a governance structure in its own right. Selecting the right governance structure is crucial for aligning the interests of directors with those of shareholders.
Stakeholder Theory	Stakeholder theory recognizes a broader array of constituents beyond just shareholders, emphasizing the inclusion of multiple stakeholder groups. In scenarios where stakeholders are emphasized, the company's governance structure might be designed to allow direct representation from these diverse stakeholder groups.
Stewardship Theory	Directors are seen as stewards of the company's assets, naturally inclined to act in the best interests of the shareholders.
Resource Dependency Theory	Directors play a crucial role in linking the company to the external resources necessary to achieve its corporate objectives.

[57] A Michael and Ireland Hitt, *Strategic Management Cases: Competitiveness and Globalization* (South Western Educational Publishin 2012).

[58] Jeffrey Pfeffer and Gerald Salancik, 'External Control of Organizations—Resource Dependence Perspective', *Organizational behavior 2* (Routledge 2015).

1.3 Corporate Governance Model

Corporate governance models in the majority of countries around the world are either shareholder-oriented (Anglo-American) or stakeholder-oriented (Continental European), or a combination of both known as a hybrid model. This section discusses these two leading corporate governance models within the extant literature.

1.3.1 Shareholder Model of Corporate Governance

The shareholder corporate governance model is primarily prevalent in the U.S, UK and other commonwealth nations (also called the 'Anglo-American model'), which emphasizes the doctrine of shareholder value and importance. This model operates under the principle that a firm's primary function is to serve the interests of its owners, reflecting the separation of ownership from management as seen in the Anglo-American system. In this framework, the capital providers or shareholders delegate the everyday management of the company to a unitary board of directors and executive management, who typically do not own shares in the company themselves.

Under the shareholder model, the ownership tends to be dispersed among numerous shareholders.[59] The widespread dispersion of ownership results in diminished shareholder power to directly influence their business management.[60] This separation introduces significant agency problems, which are central to the theoretical foundation of this discussion. Agency theory assumes that managers are both opportunistic and rational, leading them to often favour their self-interests over those of the shareholders. Thus, it proposes that as shareholders (principals) must entrust the management of their company to directors and managers (agents), there arises an inherent risk that these directors and managers will prioritise their personal interests over those of the shareholders.[61]

Ownership structures have also transformed over time, deviating from the widespread ownership model identified initially by Berle and Means. Currently, ownership in most corporations is highly concentrated in the hands of a few major individual shareholders or institutions.[62] There has been a trend toward convergence in corporate governance models, predominantly aligning with the Anglo-Saxon model, which is increasingly regarded as the dominant and most extensively adopted corporate governance model. Many scholars argue

[59] Berle AA and Means GC, *The Modern Corporation and Private Property* (Taylor and Francis 1933)

[60] Berle and Means (n 17).

[61] Smith, *The Wealth of Nations* (n 16); Jensen and Meckling (n 26).

[62] Olusola A Akinpelu, 'Corporate Governance Framework in Nigeria: An International Review' 147–50.

that there is a global shift toward a unified corporate governance model, with other systems gradually aligning with the Anglo-American model.[63]

The shareholder model proposes several approaches to address agency problems. Initially, it advocates for eliminating restrictions on factor markets to boost competition.[64] Additionally, it promotes the adoption of a voluntary corporate governance code of ethics and conduct, rooted in the fundamental business principles of accountability, discipline, fairness, independence, responsibility, and transparency, aimed at guiding the behaviour of directors and managers.[65] It also suggests enhancing managerial incentive schemes by linking executive compensation to performance, thereby better aligning the interests of shareholders and managers.[66]. Furthermore, it views the efficient contract between the management and shareholder and the managerial labour market as the effective method to monitor managerial behaviour and protect shareholders' interests.[67]

Conversely, the shareholder model opposes external interference and additional mandates on corporations by governmental and central authorities, arguing that such interventions could distort the operations of free markets.[68] As a rational economic model, it presumes the efficiency of factor markets, encompassing capital, managerial labour, and corporate control. Self-regulation, supported by supplementary voluntary mechanisms like a voluntary corporate governance code, proves to be more efficient in restraining managers' diverging activities.[69]

This model's rejection of external regulatory interventions and its strong endorsement of market-driven regulation stems from the underlying belief that the primary source of corporate financing is equity, not debt. It assumes that equity capital is predominantly sourced from efficiently functioning capital markets, where capital naturally flows to investments yielding the highest risk-adjusted returns.[70]

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[63] Marina Martynova and Luc Renneboog, 'Evidence on the International Evolution and Convergence of Corporate Governance Regulations' (2011) 17 Journal of Corporate Finance 1531, 1544–51 <https://www.sciencedirect.com/science/article/pii/S0929119911000988>.

[64] Steve Letza, Xiuping Sun and James Kirkbride, 'Shareholding versus Stakeholding: A Critical Review of Corporate Governance' (2004) 12 Corporate Governance: An International Review 242, 247.

[65] 'Report of the Committee On the Financial Aspects of Corporate Governance' (n 11).

[66] Jeroen Weimer and Joost Pape, 'A Taxonomy of Systems of Corporate Governance' (1999) 7 Corporate governance: An international review 152, 153–54.

[67] Letza, Sun and Kirkbride (n 67) 249.

[68] Friedrich Hayek, 'The Corporation in a Democratic Society: In Whose Interest Ought It and Will It Be Run?' in M Anshen and GL Bach (eds), *Management and Corporations* (New York: McGraw-Hill 1985); Milton Friedman, '61. Capitalism and Freedom' in Ricardo Blaug and John Schwarzmantel (eds), *Democracy: A Reader* (Columbia University Press) 344–49 <https://doi.org/10.7312/blau17412-074>.

[69] Letza, Sun and Kirkbride (n 67) 249.

[70] Milton Friedman, 'The Social Responsibility of Business Is to Increase Its Profits' [2007] Corporate Social Responsibility 173 <https://link.springer.com/chapter/10.1007/978-3-540-70818-6_14> accessed 20 September 2021.

In the shareholder corporate governance model, the board typically operates under a single-tier system, mainly consisting of non-executive directors elected by the shareholders. The board of directors represents the shareholders, protecting shareholders' interests. However, some boards within this model may include executive and non-executive directors. This structure is noted for maintaining a formal and unbiased relationship between the board (representing the corporation) and the investors (shareholders).[71]

While generally consistent, the shareholder model exhibits notable differences between different countries. For example, the US corporate governance traditionally has CEO duality (the same person holds the positions of both the CEO and the board Chairman). The random sample of large U.S. firms in the 1980s revealed that 82 per cent exhibited CEO duality.[72] However, the number of S&P 500 companies with CEO duality has declined from 65 per cent in 2007 to fewer than 50 per cent in 2017.[73] In contrast, the UK corporate governance recommends that the role of Chairman and CEO should be separated and not occupied by the same individual.[74] Regarding takeovers and defensive mechanisms regulations, Delaware jurisprudence grants the board the authority to reject hostile takeover bids, albeit under enhanced judicial scrutiny. Meanwhile, the UK corporate governance code completely prohibits takeover defences.[75]

Despite its widespread adoption as a predominant corporate structure, the shareholding model is not without significant criticisms. These criticisms primarily focus on the limited shareholder power, the inefficiency of the board of directors and short-termism.[76]

The shareholding model operates on the principle of shareholder primacy, which assumes that corporations should primarily serve shareholder interests. This premise theoretically grants shareholders residual power to elect operational leaders and engage in significant corporate decisions, such as appointing and dismissing directors at shareholder general meetings. However, shareholders often find their ability to exert meaningful control severely constrained by the procedures governing shareholder general meetings and corporate elections.[77] Typically, directors, not shareholders, set the shareholder general meetings agenda, thereby

[71] Julian Franks and Colin Mayer, '12. Corporate Ownership and Control in the U.K., Germany, and France' in Donald H Chew and Stuart L Gillan (eds), *Global Corporate Governance* (Columbia University Press 2009) <https://doi.org/10.7312/chew14854-012>.

[72] Dalton and Kesner (n 55) 39.

[73] Spencer Stuart U.S. Board Index, 'S&P 500 Boards: Trends Over One, Five and 10 Years' (2017) <https://www.spencerstuart.com/~/media/ssbi2017/ssbi_2017_final-trendsonly.pdf?la=en#page=2.00>.

[74] 'Report of the Committee On the Financial Aspects of Corporate Governance' (n 11).

[75] City Code on Takeovers and Mergers (The Takeover Code) 2016 Rule 21.

[76] Letza, Sun and Kirkbride (n 67) 244–46.

[77] Sternberg (n 9) 80–84.

controlling the issues up for a vote. It has been noted that shareholders face considerable difficulty placing binding resolutions on the agenda.[78]

The board of directors, supposed to be the primary guardian of shareholders' interests, shows significant inefficiencies. Executive directors, who are also usually the company's managers, are often reluctant to recognise, critique or correct their mistakes.[79] Meanwhile, non-executive directors in the shareholding model are typically nominated by the CEO or the board, reducing their independence from management and their accountability to shareholders.[80] Thus, the accountability of non-executive directors to shareholders is often undermined by their nomination, appointment, and compensation processes. Nevertheless, the corporate governance code and listing requirements have led to gradual improvements in board appointment processes.[81] Publicly listed companies are mandated to establish independent nomination committees chaired by independent non-executive directors, enhancing board accountability and executive oversight.

Furthermore, another substantial argument against a shareholder approach is its excessive focus on short-term financial performance. The shareholder model primarily relies on the efficient capital market, which pressures managers considerably.[82] Managers under pressure from investors and competitors have a powerful incentive to pursue short-term profits rather than the company's wellbeing in the long run.[83]

Finally, the shareholder model is criticised for only emphasising the interest of shareholders, which is considered ineffective in supporting good corporate governance.[84] This approach is often viewed as limited because it overlooks the contributions of other stakeholders involved in a company. Many argue that a company's success is not solely due to its shareholders but results from various parties' collective efforts and resources, including investors, employees, creditors, suppliers, and customers.[85] Additionally, the credibility of a shareholder-centric model has been increasingly questioned following high-profile corporate scandals and global

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[78] ibid.

[79] ibid 85.

[80] ibid 87.

[81] NYSE Listed Company Manual 2016; Financial Reporting Council, 'The UK Corporate Governance Code' [2014] Financial Reporting Council 1.

[82] Letza, Sun and Kirkbride (n 67) 249.

[83] Fabian Brandt and Konstantinos Georgiou, 'Shareholders vs Stakeholders Capitalism' [2016] Comparative Corporate Governance and Financial Regulation 58–59.

[84] ATM Adnan and Hilda Tandigalla, 'The Dramatic Shift in Emphasis from a Shareholder-Dominated Approach to a Stakeholder-Oriented Corporate Governance Model' (2017) 12 European Journal of Business and Economics 3.

[85] Maria Maher and Thomas Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' [2000] Available at SSRN 218490; H Jeff Smith, 'The Shareholders vs. Stakeholders Debate' [2003] *MIT Sloan Management Review*.

crises, such as those involving Enron and WorldCom, which have exposed significant flaws in this approach.[86]

1.3.2 Stakeholder Model of Corporate Governance

In contrast with the shareholder model, the stakeholder model adopts a comprehensive approach, where managers' fiduciary duty extends beyond shareholders to encompass many stakeholders, including employees, customers, suppliers, government, and the broader society. Stakeholders' interests have their intrinsic value instead of being considered for the sake of shareholders.[87] The Stakeholder model views the company as a superordinate entity where various parties hold legitimate vested interests.[88] Under the stakeholder model, the board is responsible for safeguarding the interests of shareholders and stakeholders.

The stakeholder corporate governance model is prevalent in Germany, France, Japan, and other Continental European and Asian countries. The ownership structures, board structure, and the nature of management and control differ from the shareholder model. First is the ownership structure. For continental European public corporations, banks and financial institutions possess significant shareholding, which enables them to have a substantial impact on major corporate business activities and focus on the firm's long-term prosperity.[89] Banks are not prohibited from conducting business in continental European countries. Instead of the equity market, banks become the primary source of capital.[90] Furthermore, the underdeveloped market makes it costly for shareholders to exit the corporation, and investors are provided with low legal protection.[91] To effectively monitor the management, shareholders are incentivised to buy many stocks.[92] The Stakeholder model is characterised by concentrated ownership whose corporate operation is primarily determined by the internal governance mechanism.[93]

The seminal work of La Porta et al. reveals the negative correlation between ownership concentration and investor protection, attributing this relationship to differences in legal

[86] Smith, 'The Shareholders vs. Stakeholders Debate' (n 88).

[87] Thomas Donaldson and Lee E Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20 Academy of management Review 65, 67.

[88] Gregory F Maassen, 'An International Comparison of Corporate Governance Models' [1999] Amsterdam: Spencer Stuart Amsterdam.

[89] Lucian Cernat, 'The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or Still the Century of Diversity?' (2004) 11 Journal of European Public Policy 147, 154 <http://www.tandfonline.com/doi/abs/10.1080/1350176042000164343> accessed 8 July 2017.

[90] ibid.

[91] ibid 154–55; Fabrizio Barca and Marco Becht, *The Control of Corporate Europe* (Oxford University Press Oxford 2001) 4.

[92] Cernat (n 92) 155.

[93] Klaus J. Hopt and Patrick C. Leyens, 'The Structure of the Board of Directors: Boards and Governance Strategies in the US, the UK and Germany', *Comparative Corporate Governance* (Edward Elgar Publishing 2021) 6.

origins.[94] Their findings indicate that Anglo-American countries, which fall under the common law traditions like the UK and US, typically exhibit dispersed ownership alongside stronger investor protections. In contrast, countries influenced by civil and Scandinavian legal traditions, such as France, Germany, and Japan—grouped as Continental-European-Asian countries—display a higher concentration of ownership coupled with less robust investor protection.

Secondly, the governance structure usually consists of a two-tiered board system: an executive board ('Vorstand') comprising company executives and a supervisory board ('Aufsichtsrat') composed of non-executive directors that represent shareholders and employees. The supervisory board is in charge of appointing and supervising management board members, reviewing the major business decision-making and determining corporate compensation strategies.[95]

Thirdly, the stakeholder model promotes prioritising building trust and long-term contractual ties between the firm and its stakeholders. For example, cross-shareholding (mutual shareholding relationship between at least two firms),[96] and co-determination (employee participation in decision-making through the supervisory board). Following the principle of co-determination, the role of labourers/employees is emphasized, with the right to appoint or recommend supervisory board members. In large corporations, the employee representatives fill the seat of the board to ensure employees' interests are in the central place during decision-making, reflecting a more substantial role for employees and their unions in corporate governance compared to other models.[97] Additionally, it encourages enhanced interactions among shareholders, creditors, managers, employees, and suppliers. The approach also supports the integration of business ethics to balance the diverse interests of various stakeholders.

Although the stakeholder model offers a more holistic approach to balancing the interests of more parties, it is not without criticism. Opponents claim the stakeholder model is not compatible with substantive corporate objectives. According to stakeholder theory, firms should be equally responsible to all of their stakeholders. However, 'an organization that is accountable to everyone, is actually accountable to no one: accountability that is diffuse, is effectively non-

[94] La Porta and others, 'Law and Finance' (n 1); Rafael La Porta and others, 'Legal Determinants of External Finance' (1997) 52 The Journal of Finance 1131 <http://doi.wiley.com/10.1111/j.1540-6261.1997.tb02727.x> accessed 25 March 2019.

[95] Klaus J Hopt and Patrick C Leyens, 'Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy' (2004) 1 European Company and Financial Law Review 135, 141 <https://www.degruyter.com/document/doi/10.1515/ecfr.2004.1.2.135/html> accessed 30 May 2021.

[96] Katsuhiko Muramiya and Tomomi Takada, 'How Cross-shareholding Influences Financial Reporting: Evidence from Japan' (2020) 28 Corporate Governance: An International Review 309.

[97] Cernat (n 92) 153; Mark J Roe and Margaret Blair, 'Codetermination and German Securities Markets' [1999] Employees and corporate governance 194.

existent.'[98] This approach contradicts the traditional business aim of investing capital to maximise long-term value.

Moreover, unlike the shareholder model, which gives a clear objective, the stakeholder model strives for multiple goals, which creates confusion, conflict, inefficiency, and competitive failure for the organization.[99] Stakeholder capitalism assesses a corporation's performance across a wide range of metrics, not just by its share performance. However, the identification of who exactly qualifies as a stakeholder is often met with varying interpretations. Freeman broadly defines stakeholders as 'any group or individual who can affect or is affected by the achievements of the firm's objectives.' Nonetheless, there remains a need for further differentiation among stakeholders, given that their interests and their influence on the organization can differ significantly.

1.3.3 Ownership Structure and Corporate Governance Model

The relationship between ownership structure and board structure is a nuanced aspect of corporate governance. The ownership structure is the product of a competitive selection process that weighs various cost-benefit considerations to create an ideal organizational structure for the company.[100] It reflects the distribution of equity stakes between internal management and external investors, shaped by competitive selection processes where shareholders determine the optimal balance between ownership and control to manage their capital effectively and minimize monitoring responsibilities. The ownership structure results from the shareholder's and equity market's choice to adopt a dispersed or concentrated ownership structure.[101]

Whether concentrated or dispersed, the ownership structure is heavily influenced by the profit-maximising objective of shareholders, particularly regarding cash flow and voting rights.[102] The degree of private benefits of control significantly affects the choice of ownership structure. When private benefits of control are high, corporate founders may opt for a concentrated ownership structure to maintain control and prevent external takeovers.[103] In contrast, a dispersed ownership structure might be a favourable choice to increase company efficiency without worrying about losing control when the private benefits of control are minimal.

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[98] Sternberg (n 9) 135.

[99] Adnan and Tandigalla (n 87) 3.

[100] Harold Demsetz, 'The Structure of Ownership and the Theory of the Firm' (1983) 26 Journal of Law and Economics 375, 384.

[101] Harold Demsetz and Belen Villalonga, 'Ownership Structure and Corporate Performance' (2001) 7 Journal of corporate finance 209, 210.

[102] ibid.

[103] Rafael La Porta and others, 'Investor Protection and Corporate Governance' (2000) 58 Journal of financial economics 3, 13.

The legal protection of investors also plays a crucial role in shaping ownership structures. La Porta et al. have shown the correlation between ownership structure and the level of legal protection of investors.[104] Their empirical evidence suggests that ownership is generally more concentrated in jurisdictions with weaker investor legal protections. This observation leads them to argue that concentrated ownership is a substitute for legal safeguards in environments where legal protections for investors are inadequate. In such scenarios, only large shareholders can effectively secure investment returns due to their significant influence and control over the firm, compensating for the lack of legal mechanisms that would otherwise protect smaller investors. Additionally, legal regulations in the United States make maintaining significant, locked shareholdings costly and complex, contrasting sharply with other countries' practices.[105] Therefore, where legal systems provide vital protection for minority shareholders, a dispersed ownership structure is more viable; however, concentrated ownership tends to dominate in jurisdictions with weaker protections.[106]

The private benefits of control influence the choice between concentrated and dispersed ownership and shape the governance structure, particularly the board's composition. The board's composition, defined by the balance between internal (executive) and external (independent) directors, indicates how independent the board is from management. The ideal board composition involves a delicate balance where insiders are motivated enough to fully understand and disclose their stakes, while outsiders minimise coordination costs and effectively veto inferior decisions.[107] However, personal stakes often lead insiders to prefer less rigorous efforts and secure perks from projects that are not aligned with broader shareholder interests. The private benefits of control, such as access to free cash flow, often prompt insiders to prioritize their own benefits over the company's wealth, resulting in conflicts of interest.[108] When insiders have substantial private benefits, they tend to be less transparent, making it harder for outsiders to coordinate and validate company projects.[109] In other words, the more insiders benefit privately, the less effective the monitoring by outsiders.

The structure of ownership also influences the power dynamics within the boardroom. Companies where insiders hold substantial personal stakes require governance structures that compel insiders to be more transparent, even if this reduces the ability of outsiders to critically assess company projects.[110] Generally, a board's composition positively relates to insiders' private benefits and inversely to monitoring effectiveness. Insiders who hold significant shares

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[104] La Porta and others, 'Law and Finance' (n 1).

[105] Mark J Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1996).

[106] ibid.

[107] Charu G Raheja, 'Determinants of Board Size and Composition: A Theory of Corporate Boards' (2005) 40 The Journal of Financial and Quantitative Analysis 283, 283–84 <http://www.jstor.org/stable/27647198>.

[108] Michael Jensen C., 'Agency Costs of Free Cash Flow , Corporate Finance , and Takeovers Agency Costs of Free Cash Flow , Corporate Finance , and Takeovers' (1986) 76 American Economic Review 323.

[109] Raheja (n 110) 299.

[110] ibid 298.

often reduce the presence of external directors to maintain control and maximise their gains. Nevertheless, incorporating outside directors, typically supported by independent investors, into the board can dilute the management's dominance, impacting both the CEO's tenure and the distribution of voting rights.[111]

This dynamic leads to a negotiation process between the CEO and outside directors, often described as a bargaining game over board composition.[112] The goal of these negotiations is to establish a balanced level of board independence, represented by a fair proportion of independent directors. Achieving this balance typically results in a one-tier board system, prevalent in organizations with dispersed ownership. If this balance isn't achieved, the governance structure may adopt a two-tier board system, which is more common in entities with concentrated ownership. Over time, board structures can change, especially during intense negotiations, potentially leading to a hybrid system that blends features of both board types.

1.4 Corporate Governance Mechanism

Corporate governance includes a set of mechanisms to induce the self-interested controller of the company, who has the power to make optimal decisions for the corporate owners.[113] It refers to 'the structures, process and systems, both formal and informal, by which power is exercised, constrained, monitored and accounted for in the management of a corporation.'[114] The internal governance mechanisms are organizationally based and designed to bring the interests of the managers and shareholders into congruence,[115] refers to the board of directors, ownership structure, and executive compensation. The external governance mechanisms are market-based and are designed to complement/substitute the internal governance mechanism, which refers to the takeover market, legal and regulatory system.[116]

1.4.1 Internal Corporate Governance Mechanism

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111 James S Linck, Jeffry M Netter and Tina Yang, 'The Determinants of Board Structure' (2008) 87 Journal of financial economics 308; Urska Velikonja, 'The Political Economy of Board Independence' (2013) 92 North Carolina Law Review 855 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2352109> accessed 16 August 2018.

112 Renée B Adams, Benjamin E Hermalin and Michael S Weisbach, 'The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey' (2010) 48 Journal of economic literature 58, 65.

113 Diane K Denis and John J McConnell, 'International Corporate Governance' (2003) 38 The Journal of Financial and Quantitative Analysis 1, 2 <https://www.jstor.org/stable/10.2307/4126762?origin=crossref> accessed 27 May 2019.

114 Roman Tomasic, Stephen Bottomley and Rob McQueen, *Corporations Law in Australia* (Federation Press 2002) 262.

115 James P Walsh and James K Seward, 'On the Efficiency of Internal and External Corporate Control Mechanisms' (1990) 15 Academy of Management Review 421, 423 <https://journals.aom.org/doi/abs/10.5465/AMR.1990.4308826> accessed 29 September 2021.

116 Michael C Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48 The Journal of Finance 831, 850.

1.4.1.1 Board of Directors

The board of directors is legally required to develop and implement the internal governance mechanisms in public-held companies. The board of directors are elected by the shareholders in accordance with the corporate charters, whose primary task is to select the CEO, oversee management, establish corporate strategy, vote on major issues like mergers and acquisitions, adjustments in the CEO's compensation, and changes to the company's capital structure, etc., whereas the board hires managers to initiate and execute the decisions.[117] Where the conflict of interests between managers and shareholders arises, the board of directors can check the managerial malfeasance as the internal governance mechanism. However, in firms with dispersed shareholding, the board of directors is more like puppets than monitors. A significant factor contributing to the board's lack of independence is CEOs' considerable influence over the selection of directors. Additionally, CEOs typically possess superior information, consolidating their influence and control over the board.

Board structure (the board size, composition, independence, director's ownership and leadership structure) is carefully considered for the best performance.[118] Board independence, i.e., the number of independent directors and the identity of the directors, is one of the determinants that is assumed to have an impact on the board's monitoring performance. [119] Current regulatory efforts towards the enhancement of board independence, i.e. mandatory certain proportion of independent directors, to diminish the CEO's control over the board and further advocate shareholders' interests.

However, the independent director has its limitations. Outside directors external to the company may not possess sufficient knowledge or information to oversee management effectively. Independent directors relying on the CEO for reappointment and the emerging close ties between senior management and the board of directors have compromised the board's autonomy and ability to monitor and control.[120] For concentrated shareholding companies, independent directors must be independent of corporate insiders and controlling shareholders to protect minorities. Solid empirical evidence supports that board independence has a noticeable effect on improving corporate value and management efficiency.[121]

1.4.1.2 Ownership Structure

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[117] Robert C Clark, *Corporate Law* (Little Brown and Company 1986); Fama and Jensen, 'Agency Problems and Residual Claims' (n 24); Fama and Jensen, 'Separation of Ownership and Control' (n 24).

[118] Benjamin Hermalin and Michael S Weisbach, 'Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature' (National Bureau of Economic Research Cambridge, Mass, USA 2001).

[119] Kose John and Lemma W Senbet, 'Corporate Governance and Board Effectiveness' (1998) 22 Journal of Banking & Finance 371, 373,379.

[120] Walsh and Seward (n 118) 430.

[121] For the detailed discussion on independent directors, see Chapter 2

Ownership structure pertains to the distribution of equity attached to voting rights and capital, as well as the identification of the equity holder. Thus, the ownership structure can be dispersed/concentrated, and the identity of equity holders can be insiders (managers/employees) and outsiders (individuals, financial institutions and states).

Blockholders: The concentration of ownership directly aligns the interest between the management and the owner. As discussed above, when the ownership is widely dispersed, i.e., individual shareholders own a very small fraction of the firm shares, shareholders will lack incentive for the shareholders to monitor and exert their influence on management decision-making.[122] The concentration of control and ownership in the hands of a small number of investors would be an approach to deal with the free-rider problem with dispersed shareholding. Blockholders refer to large shareholders (e.g. families, governments and other corporations) and institutional investors.[123] Concentrated ownership grants the owner the capacity and incentive to monitor and advise, which improves corporate performance.[124]

However, as discussed, the blockholders' alignment of the interests between the management and shareholders has no shortcomings. Large shareholders may be incentivised to pursue their interests at the expense of the minorities.[125] Large shareholders may miss out on diversification benefits due to their substantial stake in one company.[126] Thus, there should be a balance between the costs and benefits of having large shareholders.[127] The costs involved include a possible threat of expropriation before any transaction occurs, which could dampen managerial motivation. The concentration of ownership in a company often reflects a compromise between these contrasting factors.

In recent years, institutional investors have had greater activism with the increase of their ownership, especially in the U.S.. Between 1980 and 2017, the institutional ownership of U.S.

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[122] Andrei Shleifer and Robert W Vishny, 'Large Shareholders and Corporate Control' (1986) 94 Journal of political economy 461, 471.

[123] Katrien Craninckx and Nancy Huyghebaert, 'Large Shareholders and Value Creation through Corporate Acquisitions in Europe. The Identity of the Controlling Shareholder Matters' (2015) 33 European Management Journal 116; Joanna Ho, Cheng Jen Huang and Christo Karuna, 'Large Shareholder Ownership Types and Board Governance' (2020) 65 Journal of Corporate Finance 101715; Xiao Chen, Chi-Wen Jevons Lee and Jing Li, 'Government Assisted Earnings Management in China' (2008) 27 Journal of Accounting and Public Policy 262; Patrick Jahnke, 'Ownership Concentration and Institutional Investors' Governance through Voice and Exit' (2019) 21 Business and Politics 327.

[124] Shleifer and Vishny, 'Large Shareholders and Corporate Control' (n 125) 471; Wayne H Mikkelson and Richard S Ruback, 'An Empirical Analysis of the Interfirm Equity Investment Process' (1985) 14 Journal of financial economics 523; Clifford G Holderness and Dennis P Sheehan, 'Raiders or Saviors? The Evidence on Six Controversial Investors' (1985) 14 Journal of Financial Economics 555.

[125] Shleifer and Vishny, 'Large Shareholders and Corporate Control' (n 125) 482.

[126] Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 Journal of political economy 1155, 1158.

[127] Mike Burkart, Denis Gromb and Fausto Panunzi, 'Large Shareholders, Monitoring, and the Value of the Firm' (1997) 112 The quarterly journal of economics 693.

publicly traded companies increased from 32 percent to 73 percent of the total market. Furthermore, the 100 largest institutions now possess over 50 percent of all equity. More prominent institutional investors frequently exercise 'voice' through proxy voting and engaging in private negotiation with the management without a shareholder vote, which aims to influence corporate decisions.[128]

Insider ownership: Managerial ownership is presumed to align with the interests of the management and the shareholders.[129] As managerial ownership increases, managers have more incentives to avoid value-destroying behaviours like shirking responsibilities and excessive perquisite consumption because they directly bear a substantial portion of the financial consequences. However, there are limitations to this approach. Managers might be unwilling or financially unable to significantly increase their stake in the company due to personal wealth constraints and risk aversion.[130] Allocating a large portion of personal wealth into one firm can lead to a poorly diversified investment portfolio, increasing personal financial risk.[131] Empirical studies have inconsistent results suggesting low degrees of managerial ownership can align incentives, but high levels tend to create a risk-averse effect.[132] The effect of management ownership on corporate value depends upon the tradeoff between management ownership and managerial entrenchment.[133]

1.4.1.3 Executive Compensation

Executive compensation models serve as another method to enhance shareholder protection by aligning the CEO's goals with those of the shareholders, beyond simply monitoring of board of directors and controlling CEO actions. In most publicly traded companies, compensation packages typically include the expected value of compensation (deferred compensation in the form of restricted stock and option grants that cannot be convertible into cash right away); realized value (base salaries, a bonus tied to short-term performance metrics);[134] and other

[128] Willard T Carleton, James M Nelson and Michael S Weisbach, 'The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF' (1998) 53 The journal of finance 1335; Eliezer M Fich, Jarrad Harford and Anh L Tran, 'Motivated Monitors: The Importance of Institutional Investors' Portfolio Weights' (2015) 118 Journal of Financial Economics 21.

[129] The management ownership refers to the shares held by the board members, the CEO, and the top executives. Randall Morck, Andrei Shleifer and Robert W Vishny, 'Management Ownership And Market Valuation. An Empirical Analysis' (1988) 20 Journal of Financial Economics 293.

[130] Paul J Beck and Thomas S Zorn, 'Managerial Incentives in a Stock Market Economy' (1982) 37 The Journal of Finance 1151.

[131] ibid.

[132] Bradley W Benson and Wallace N Davidson III, 'Reexamining the Managerial Ownership Effect on Firm Value' (2009) 15 Journal of Corporate Finance 573.

[133] For discussion of managerial entrenchment practices , see: Walsh and Seward (n 118).

[134] Arantxa Jarque and John Muth, 'Evaluating Executive Compensation Packages' (2013) 10697225 Economic Quarterly 251, 252.

managerial perks encompass a range of other benefits, including pension rights and severance packages, commonly referred to as 'golden parachutes.'

However, it remains controversial of the relationship between executive compensation and firm performance. The empirical evidence shows a mixed result in different periods and countries with positive, [135] negative[136] and no relationship. [137] The reason for the lack of sensitivity to pay performance is that excellent risk tolerance is imposed on the risk-aversion managers, which may not be an efficient incentive mechanism.[138] In addition, executive compensation alone may not significantly improve corporate performance as the legal and political external factors have an impact.[139]

1.4.2 External Governance Mechanism

1.4.2.1 The Takeover Market

The takeover market represents the market for control over the management of corporate resources and acts as a disciplinary mechanism when internal controls fail. [140] As managers often pursue their interests, their actions can deviate from maximizing shareholder interests. The market for corporate control is based on the assumption of a strong correlation between inefficient corporate management and the company's share price. [141] When a company underperforms, its share price typically falls compared to its industry peers or the broader

[135] *US-based evidence:* Michael C Jensen and Kevin J Murphy, 'Performance Pay and Top-Management Incentives' (1990) 98 Journal of political economy 225; John F Boschen and Kimberly J Smith, 'You Can Pay Me Now and You Can Pay Me Later: The Dynamic Response of Executive Compensation to Firm Performance' [1995] Journal of Business 577. *Japan-based evidence:* Sudipta Basu and others, 'Corporate Governance, Top Executive Compensation and Firm Performance in Japan' (2007) 15 Pacific-Basin Finance Journal 56; Carl R Chen, Weiyu Guo and Vivek Mande, 'Managerial Ownership and Firm Valuation: Evidence from Japanese Firms' (2003) 11 Pacific-Basin Finance Journal 267. *China-based evidence:* Mei Yu, 'State Ownership and Firm Performance: Empirical Evidence from Chinese Listed Companies' (2013) 6 China Journal of Accounting Research 75.

[136] *US-based evidence:* John E Core, Robert W Holthausen and David F Larcker, 'Corporate Governance, Chief Executive Officer Compensation, and Firm Performance' (1999) 51 Journal of financial economics 371; Hamid Mehran, 'Executive Compensation Structure, Ownership, and Firm Performance' (1995) 38 Journal of Financial Economics 163. *Japan-based evidence:* Davit Adut, Anthony D Holder and Ashok Robin, 'Predictive versus Opportunistic Earnings Management, Executive Compensation, and Firm Performance' (2013) 32 Journal of Accounting and Public Policy 126.

[137] Katsuyuki Kubo, 'Executive Compensation Policy and Company Performance in Japan' (2005) 13 Corporate Governance: An International Review 429; Brian K Boyd, 'Board Control and CEO Compensation' (1994) 15 Strategic management journal 335.

[138] Joseph G Haubrich, 'Risk Aversion, Performance Pay, and the Principal-Agent Problem' (1994) 102 Journal of Political Economy 258.

[139] Michael C Jensen and Kevin J Murphy, 'Performance Pay and Top-Management Incentives' (1990) 98 Source: Journal of Political Economy 225; Shleifer and Vishny, 'A Survey of Corporate Governance' (n 10) 738.

[140] Fama (n 26) 295.

[141] Henry G Manne, 'Mergers and the Market for Corporate Control' (1965) 73 Journal of Political economy 110, 112.

market.[142] This makes the company a potential acquisition target.[143] Acquirers buy significant shares to gain control of the target company. By assuming control, they aim to rectify inefficiencies and agency problems, thereby enhancing the value of their investment. This includes making critical decisions about senior executives' hiring, dismissal, and compensation.[144]

‘Takeovers’ includes mergers, tender offers (friendly or hostile), and proxy contests.[145] Merger happens through the agreement negotiated between the bidder and the target management on terms of the target and then the proposal submission to the shareholder meeting for a vote. The tender offer is when the bidder buys some or all the target company's shares directly from its shareholder. Target management welcomes friendly tender offers. In contrast, hostile bids are opposed by the target management.[146] Proxy contests occur when a group of dissident shareholders attempt to obtain control of the board and vote out the incumbent management.[147] The leveraged buyout refers to the special investment company (private equity firms) purchasing a company using almost entirely debt secured with the company's assets being purchased.[148]

Empirical studies provide evidence that takeovers have positive price effects on the target companies in the short run and a mixed impact in the long run.[149] However, the takeover is quite costly. The cost includes the expenses required to persuade unwilling shareholders (the bidder may have to pay part of the expected benefits of improved performance), the search expenses, bidding costs and other transactional costs.[150] As a result, this sole monitoring mechanism allows managers some leeway to operate below optimal performance, provided their actions don’t decrease the company’s stock price beyond the expenses involved in a takeover. Implementing defensive measures, amendments to corporate charters, and anti-

[142] ibid.

[143] ibid.

[144] Marc Moore and Martin Petrin, *Corporate Governance: Law, Regulation and Theory* (Macmillan International Higher Education 2017); Michael C Jensen and Richard S Ruback, ‘The Market for Corporate Control: The Scientific Evidence’ (1983) 11 Journal of Financial Economics 5.

[145] Gregg A Jarrell, James A Brickley and Jeffry M Netter, ‘The Market for Corporate Control: The Empirical Evidence since 1980’ (1988) 2 Journal of Economic perspectives 49, 51.

[146] Mark L Mitchell and J Harold Mulherin, ‘The Impact of Industry Shocks on Takeover and Restructuring Activity’ [1996] Journal of Financial Economics 193, 199.

[147] Peter Dodd and Jerold B Warner, ‘On Corporate Governance: A Study of Proxy Contests’ (1983) 11 Journal of financial Economics 401, 401.

[148] Bengt Holmstrom and Steven N Kaplan, ‘Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s’ (2001) 15 Journal of economic perspectives 121, 124.

[149] Christian Tuch and Noel O’Sullivan, ‘The Impact of Acquisitions on Firm Performance: A Review of the Evidence’ (2007) 9 International journal of management reviews 141, 141,159.

[150] Sanford J Grossman and Oliver D Hart, ‘Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation’ [1980] The Bell Journal of Economics 42; Oliver Eaton Williamson, *Corporate Control and Business Behavior: An Inquiry into the Effects of Organization Form on Enterprise Behavior* (1970).

takeover legislation have further escalated the financial burden and risks linked to executing takeovers.[151]

1.4.2.2 The Legal and Regulatory System

The legal and regulatory system establishes the legal structures and procedures adopted to explain and enforce the existing law. Regulations include compulsory instructions (e.g., legislation and judicial laws) that can be legally enforced, provide the legal obligations that are binding to all parties with a stake in the firm;[152] soft regulations (e.g., stock exchange listing requirements and statement of accounting practice, code of conduct guidelines, statement of best practice, and business ethics) follows the comply or explain approach which is more flexible for firms to choose.[153]

The legal system provides multiple rule dimensions to make corporate governance more effective. It provides the set of issues of incorporation. The corporate law establishes the basic legal characteristics of the company regarding the legal personality, limited liability, transferable shares, delegated management, and ownership structure.[154] The law regulates the relationships between corporate constituencies, especially the distribution of interests.[155] Besides, to protect the shareholders and potential investors, the legal system mandates public-traded companies the integrated disclosure of financial and operating information to the public.[156] Thus, the legal system provides the non-binding guidelines and the statutory sanctions to direct and force the corporate players to pursue effective governance.

The internal and external governance mechanisms interact and complement each other. The legal system as the governance mechanism has become increasingly essential since the work of LLSV.[157] They argue that the extent to which the country's law protects investor rights and enforces the rules are the primary determinants that shape the evolution of corporate finance and governance in that country.[158] Stronger legal investor protection relaxes the financing

[151] Tatyana Sokolyk, 'The Effects of Antitakeover Provisions on Acquisition Targets' (2011) 17 Journal of Corporate Finance 612; P Sudi Sudarsanam, 'The Role of Defensive Strategies and Ownership Structure of Target Firms: Evidence from UK Hostile Takeover Bids' (1995) 1 European Financial Management 223.

[152] Reinier Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Reinier Kraakman and others eds, Oxford University Press 2017).

[153] Dimity Kingsford Smith, 'Governing the Corporation: The Role of'soft Regulation'' (2012) 35 University of New South Wales Law Journal, The 378, 382–83.

[154] Henry Hansmann and Reinier Kraakman, 'What Is Corporate Law?' in Reinier Kraakman and others (eds), *The anatomy of corporate law: A comparative and functional approach* (Oxford: Oxford University Press 2004) 1–19.

[155] Kraakman and others (n 155) 18.

[156] Frank H Easterbrook and Daniel R Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 Virginia Law Review 669, 685.

[157] LLSV refers to a series of influential research papers done by La Porta, Lopez-Lopez-de-Silanes, Shleifer, and Vishny which first published in 1997. La Porta and others, 'Legal Determinants of External Finance' (n 97).

[158] La Porta and others, 'Law and Finance' (n 1).

constraints, then produces more efficient takeover outcomes.[159] The excellent protection of potential financiers against the takeover by the entrepreneurs raises their willingness to invest, thus expanding the scope of the capital markets.[160]

The legal system also interacts with the internal governance. The legal system provides the rights, powers, and duties of the board of directors; thus, directors have more incentive to fulfil their monitoring role or are at risk of being replaced.[161] After a series of corporate failures, the legislation emphasized board independence. More stringent criteria for board independence are adopted to improve the behaviour of the board monitoring. [162]

1.5 Corporate Governance Problems

The agency model, as indicated, is considered one of the oldest theories to discuss corporate governance problems which arise since ownership and control were separated. The agency problem, as described by Alchian and Demsetz in 1972, highlights the inherent conflict of interest that can occur within a firm structured through either limited or unlimited contractual relationships. In this setup, the principal (owner of the firm) and the agent (manager of the firm) often have divergent objectives and interests, which form the basis of the agency problem. While the principal's primary concern is maximising firm value and shareholder wealth, agents might prioritise their personal interests, which don't always align with those of the principals.

Initially, the agency problem focused on this principal-agent dynamic, examining how principals can ensure that agents act in the owners' best interests rather than in their own. Typical solutions involve performance-based incentives, monitoring mechanisms, and contractual covenants to align the interests of the agents with those of the principals. However, the complexity of modern corporate structures and financial environments has expanded the scope of the agency problem not only between the principal and agent but also beyond covering the conflicts between the dominant shareholder and the minority shareholders.[163] Here agency

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[159] La Porta and others, 'Legal Determinants of External Finance' (n 97) 1132. Also see: Mike Burkart and others, 'Legal Investor Protection and Takeovers' (2014) 69 The Journal of Finance 1129 <https://onlinelibrary.wiley.com/doi/full/10.1111/jofi.12142> accessed 1 May 2021.

[160] La Porta and others, 'Legal Determinants of External Finance' (n 97) 1149.

[161] Jeremy J Marcel and Amanda P Cowen, 'Cleaning House or Jumping Ship? Understanding Board Upheaval Following Financial Fraud' (2014) 35 Strategic Management Journal 926.

[162] For example, NYSE revised listing rules after Enron scandal: NYSE Listed Company Manual. Jeffrey N Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (2010) 59 Stanford Law Review <https://heinonline.org/HOL/Page?handle=hein.journals/stflr59&id=1477&div=46&collection=journals> accessed 9 April 2018.

[163] Shleifer and Vishny, 'A Survey of Corporate Governance' (n 10).

conflicts are classified as principle-agent conflicts (vertical conflicts) and horizontal conflicts (principal-principal conflicts).[164]

1.5.1 Principal-Agent Conflicts (Vertical Conflicts)

1.5.1.1 Overview of Principal-Agent Conflicts

Principal-agent conflicts prevail in Anglo-American countries such as the U.S. where the ownership of public held corporations is widely dispersed. Berle and Means highlighted the separation of ownership and control as a defining feature of large, modern corporations. In these contexts, the diffusion of ownership among a broad base of shareholders tends to dilute individual shareholders' influence over managerial decisions and reduce shareholders' incentive and ability to monitor managerial activities. The principal-agent conflicts lie in the divergence of interests between the owners of a firm who wish to maximise shareholder value and the managers who are tasked with the company's day-to-day operations. Ideally, managers would act in the best interests of the shareholders by making decisions that enhance the firm's value. However, due to differing objectives and personal incentives, managers might prioritise their welfare over that of the shareholders.

Managers, acting rationally from their perspective, seek to maximise their utility, which may lead to decisions that do not align with the interests of the shareholders.[165] This rationality of managers' pursuing self-interests can lead to decisions that are more about personal gain than about the health or success of the corporation. In addition, managerial entrenchment exacerbates agency conflicts by making it challenging to replace managers, thereby increasing costs for the company. Entrenched managers often make specialised investments that make their expertise crucial, reducing their risk at the expense of shareholders.[166] They might also choose capital structures that lessen pressure from creditors and implement anti-takeover mechanisms to protect themselves from the external capital market's disciplinary measures.[167]

The dispersed ownership structure significantly complicates the effective monitoring of managers. The costs incurred by any single shareholder in trying to monitor management are not compensated by a corresponding share of the benefits, which are distributed across all

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164 Mark J Roe, 'The Institutions of Corporate Governance', *Handbook of new institutional economics* (Springer 2005) 372.

165 Oliver Williamson, *Economic Institution of Capitalism* (New york free press 1985).

166 Andrei Shleifer and Robert W Vishny, 'Management Entrenchment: The Case of Manager-Specific Investments' (1989) 25 Journal of Financial Economics 123, 123–24 <https://www.sciencedirect.com/science/article/pii/0304405X89900998>.

167 Philip G Berger, Eli Ofek and David L Yermack, 'Managerial Entrenchment and Capital Structure Decisions' (1997) 52 The journal of finance 1411; Lucian Bebchuk, Alma Cohen and Allen Ferrell, 'What Matters in Corporate Governance?' (2009) 22 The Review of Financial Studies 783 <https://doi.org/10.1093/rfs/hhn099>.

shareholders.[168] This discrepancy leads to the 'free-rider' problem. Thus, shareholders rely on others to undertake the task of monitoring rather than taking it upon themselves.[169]

1.5.1.2 Evidence on Principal-Agent Conflicts

Based on the theoretical argument of principal-agent conflicts, empirical studies found evidence specifically related to conflicts of interest arising from perquisite consumption, compensation issues, diversification decisions, and managerial behaviours against takeover bids.

Perquisites consumption: Jensen and Meckling observed the excessive consumption of perquisites, or perks, as a classic manifestation of conflicts of interest between managers and firm owners.[170] However, as compared to managers who excessively invest free cash flow into personal projects to develop the firm beyond reasonable limits, the consumption of perquisites like luxurious office furnishings and company aero planes is likely the least costly, although still significant.[171] With the increased shareholder activism, perquisite consumption has shifted towards more economic behaviour, and managers have become more vigilant and proactive in curbing excessive managerial benefits.

Managerial compensation and corporate performance: The critical dimension in examining the conflict of interest between shareholders and managers is the relationship between managerial compensation and firm performance. Numerous studies have shown a weak correlation, reflecting the inherent conflict of interest.

Jensen and Murphy's seminal work discovered a weak correlation between managerial compensation and corporate performance. Compared with corporate market value, managerial pay is more sensitive to the firm's asset size.[172] The compensation of top managers substantially increased even when firm performance was poor, suggesting the divergence of interests between executive pay and shareholder interests.

Moreover, managers manipulate financial outcomes to optimize the value of their compensation packages, specifically through adjustments in income-decreasing or increasing accruals.[173]

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[168] H Alchian, A., and Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62 American Economic Review 777, 780.

[169] ibid 779–81.

[170] Jensen and Meckling (n 26) 313.

[171] Shleifer and Vishny, 'A Survey of Corporate Governance' (n 10) 742; Bryan Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (Random House 2010).

[172] Jensen and Murphy (n 142) 262.

[173] Paul M Healy, 'The Effect of Bonus Schemes on Accounting Decisions' (1985) 7 Journal of Accounting and Economics 85 <https://www.sciencedirect.com/science/article/pii/0165410185900291>.

Further, managers are found to manipulate earnings downwards when their bonuses are at maximum levels to sustain or increase their compensation.[174]

Diversification decisions: Shareholders-manager conflicts often manifest in diversification strategies. While there are theoretical arguments that diversification can offer benefits and costs to shareholders, the prevalent evidence typically indicates that corporate diversification tends to be associated with significant value losses.[175] The increasing corporate focus tends to enhance firm value. Denis *et al.* provide evidence that agency problems may lead firms to persist with value-reducing diversification strategies and that market disciplinary forces play a disciplinary role in corporate focus.[176]

Lins and Servaes' research on the valuation impact of diversification for large samples of firms from Germany, Japan, and the U.K. observed notable differences in the diversification discount, which they linked to variations in corporate governance structures.[177] Specifically, they discovered that higher insider ownership concentration tends to mitigate the diversification discount. However, this effect depends on the specific country, with no discernible impact observed in German firms.

Anti-takeover strategies: The anti-takeover strategies include amendments to corporate charters that prevent takeovers, the adoption of poison pills, dual-class recapitalizations, and defensive restructuring of assets and ownership. Several studies indicate that implementing anti-takeover measures generally results in a decrease in shareholder value. Akhibe and Madura observed the long-term share price performance after implementing the antitakeover amendment. The accumulated value effect decreased by 13.55 percent after three years and decreased by 23.12 percent after seven years.[178]

Takeovers serve as a discipline for top executives with poor performance. The top executive turnover rate of the target significantly increases after the completion of the takeover.[179] Thus, managers are motivated to support anti-takeover strategies even though they are increasing

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[174] Robert W Holthausen, David F Larcker and Richard G Sloan, 'Annual Bonus Schemes and the Manipulation of Earnings' (1995) 19 Journal of accounting and economics 29.

[175] Larry HP Lang and Rene M Stulz, 'Tobin's q, Corporate Diversification, and Firm Performance' (1994) 102 Journal of political economy 1248; Antoinette Schoar, 'Effects of Corporate Diversification on Productivity' (2002) 57 The Journal of Finance 2379; Sanjai Bhagat and others, 'Hostile Takeovers in the 1980s: The Return to Corporate Specialization' (1990) 1990 Brookings Papers on Economic Activity. Microeconomics 1.

[176] David J Denis, Diane K Denis and Atulya Sarin, 'Agency Problems, Equity Ownership, and Corporate Diversification' (1997) 52 The journal of finance 135.

[177] Karl Lins and Henri Servaes, 'International Evidence on the Value of Corporate Diversification' (1999) 54 The Journal of Finance 2215.

[178] Denis, Denis and Sarin (n 179).

[179] Kenneth J Martin and John J McConnell, 'Corporate Performance, Corporate Takeovers, and Management Turnover' (1991) 46 The Journal of Finance 671.

firm value, the aim of which is to protect their private benefits of control rather than to advance the interests of shareholders.[180]

1.5.2 Principal-Principal Conflicts (Horizontal conflicts)

1.5.2.1 Overview of Principal-Principal Conflicts

Governance problems in public companies can vary significantly depending on whether there is a controlling shareholder.[181] Block holders minimise the ‘principle-agent’ conflicts by aligning shareholders and managers (shareholders and managers are the same individuals) or exerting enhanced management monitoring.[182] Shleifer and Vishny propose that block holders can mitigate the free rider issue arising from diffused ownership.[183] Since blockholders have more at stake, they are more inclined to engage in active oversight and make sure that managers prioritize shareholders’ best interests. In addition, owners who possess substantial shareholdings are highly motivated to monitor management closely, as they bear significant losses due to managerial opportunism.[184] This concentrated ownership can effectively reduce managerial agency problems.

However, this increasing ownership can mitigate some agency problems; meanwhile, it creates another type of agency conflict between major(controlling) and minor (minority) shareholders.[185] Such principal conflicts arise in firms with concentrated ownership, common in many Continental European and East Asian countries and many other emerging economies.[186] Typically, one or more major shareholders (block holders) hold a significant portion of the company’s shares, giving them substantial influence or control over the company. The two dominant types of companies within concentrated ownership jurisdiction are state-owned enterprises and family-owned companies. Therefore, the government and families are the two significant controlling shareholders.[187] The control of the controlling shareholder can be further enhanced using pyramiding structure and management appointment, cross-ownership, and

[180] Shleifer and Vishny, ‘A Survey of Corporate Governance’ (n 10) 747.

[181] Lucian A Bebchuk and Michael S Weisbach, ‘The State of Corporate Governance Research’ (2010) 23 The review of financial studies 939, 948.

[182] La Porta and others, ‘Corporate Ownership around the World’ (n 21) 474.

[183] Shleifer and Vishny, ‘A Survey of Corporate Governance’ (n 10) 754.

[184] Raúl Barroso Casado and others, ‘Shareholder Protection: The Role of Multiple Large Shareholders’ (2016) 24 Corporate Governance: An International Review 105.

[185] Brian L Connelly and others, ‘Ownership as a Form of Corporate Governance’ (2010) 47 Journal of management studies 1561.

[186] Annelies Renders and Ann Gaeremynck, ‘Corporate Governance, Principal-principal Agency Conflicts, and Firm Value in European Listed Companies’ (2012) 20 Corporate Governance: an international review 125; Stijn Claessens, Simeon Djankov and Larry HP Lang, ‘The Separation of Ownership and Control in East Asian Corporations’ (2000) 58 Journal of Financial Economics 81 <https://www.sciencedirect.com/science/article/pii/S0304405X00000672>.

[187] Ernest WK Lim, ‘Concentrated Ownership, State-Owned Enterprises and Corporate Governance’ (2021) 41 Oxford Journal of Legal Studies 663, 3 <https://doi.org/10.1093/ojls/gqaa050>.

dual-class shares, which results in the deviation from one-share-one vote rules.[188] Departures from the principle of one-share-one-vote increase the private benefits of control and conflicts of interest and, therefore, come at an expense for the non-controlling shareholders.[189]

According to La Porta et al., controlling shareholders have incentives and power to extract gains from the minority shareholders,[190] which can be referred to as the 'expropriation' or 'tunnelling'[191] Controlling shareholders can make decisions that disproportionately benefit themselves at the expense of minority shareholders.[192] Controlling shareholders might engage in self-dealing or other actions that siphon value away from the firm, disadvantaging minority shareholders. This can include preferential treatment in transactions, tunnelling of resources, or making strategic decisions that primarily benefit the controlling party.[193] Moreover, in countries or firms where ownership is highly concentrated, minority shareholders often struggle to protect their interests. They may lack the voting power or legal mechanisms necessary to challenge the decisions of the controlling shareholders.[194]

The most important driver is the extent to which controlling shareholders can access and utilize private information.[195] Specifically, family-run firms, where management is typically in the hands of family members, have a distinct advantage due to their access to private information, enabling them to engage in tunnelling more effectively. In the context of family-controlled businesses with more severe asymmetry of information, the tunnelling of controlling shareholders would be intensified because the tunnelling activities in such contexts often benefit the stakeholders connected to the controlling family. In contrast, state-owned enterprises (SOEs), despite having the potential for tunnelling due to their controlling

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188 Milton Harris and Artur Raviv, 'Corporate Governance: Voting Rights and Majority Rules' (1988) 20 Journal of financial economics 203.

189 Joseph PH Fan and others, 'Expropriation of Minority Shareholders: Evidence from East Asia' [1999] Available at SSRN 620647; Massimo Belcredi and Lorenzo Caprio, 'Separation of Cash-Flow and Control Rights: Should It Be Prohibited?' (2004) 1 International Journal of Disclosure and Governance 171.

190 La Porta and others, 'Investor Protection and Corporate Governance' (n 106) 4.

191 Hadiye Aslan and Praveen Kumar, 'Strategic Ownership Structure and the Cost of Debt' (2012) 25 The Review of Financial Studies 2257 <https://doi.org/10.1093/rfs/hhs062>.

192 Kenneth A Kim, P Kitsabunnarat-Chatjuthamard and John R Nofsinger, 'Large Shareholders, Board Independence, and Minority Shareholder Rights: Evidence from Europe' (2007) 13 Journal of Corporate Finance 859 <https://www.sciencedirect.com/science/article/pii/S092911990700079X>; Joseph PH Fan and Tak Jun Wong, 'Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia' (2005) 43 Journal of accounting research 35; Belen Villalonga and Raphael Amit, 'How Do Family Ownership, Control and Management Affect Firm Value?' (2006) 80 Journal of financial Economics 385.

193 Simon Johnson and others, 'Tunneling' (2000) 90 American economic review 22; Art Durnev and E Han Kim, 'To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation' (2005) 60 The Journal of finance 1461.

194 La Porta and others, 'Investor Protection and Corporate Governance' (n 106); Barroso Casado and others (n 187).

195 Angelo M Solarino and Brian K Boyd, 'Are All Forms of Ownership Prone to Tunneling? A Meta-analysis' (2020) 28 Corporate Governance: An International Review 488.

shareholder status, do not automatically resort to such practices.[196] The governance of SOEs often aligns with broader state or party goals, including fulfilling political ambitions. Thus, while family owners might strengthen the ownership-tunnelling relationship through their private information advantage, the absence of such information in SOEs weakens this relationship, with public responsibilities and transparency serving as mitigating factors.

1.5.1.2 Evidence on Principal-Principal Conflicts

The controlling shareholder's expropriation of minority shareholders ('tunnelling') can take several forms, including *director tunnelling* and *indirect* tunnelling.[197] First, a controlling shareholder may directly extract resources from the company for personal gain through self-dealing transactions. These transactions range from outright theft or fraud, which, despite being illegal, are often not detected or punished, to asset sales and contracts designed to favour the controlling shareholder, such as advantageous transfer pricing, inflated executive compensation, misuse of loan guarantees, and misappropriation of corporate opportunities.[198] Direct tunnelling is more observable and typically involves tangible asset transfers that diminish company value for personal gain.[199]

Empirical studies across various developing economies offer robust evidence of direct tunnelling. The survey of South Korean mergers shows that controlling shareholders used intra-group acquisitions to siphon value from minority shareholders.[200] A standard proxy to assess tunnelling is a wedge, which refers to the divergence between the voting rights and cash-flow rights of controlling shareholders.[201] Bertrand et al. observed a significant diversion of cash flows from firms with low cash-flow rights to those with high cash-flow rights by controlling shareholders in India.[202] Cheung et al. also demonstrated significant losses to minority shareholders in Hong Kong when listed companies engaged in connected transactions with their controlling shareholders.[203] Jiang et al. revealed instances of tunnelling through the

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[196] ibid.

[197] Johnson and others (n 196) 3; Solarino and Boyd (n 198) 489.

[198] Lucian A Bebchuk and Assaf Hamdani, 'The Agency Costs of Controlling Shareholders' [2018] Unpublished working paper, Harvard Law School and Tel Aviv University; Solarino and Boyd (n 198) 489.

[199] Johnson and others (n 196) 23.

[200] Kee-Hong Bae, Jun-Koo Kang and Jin-Mo Kim, 'Tunneling or Value Added? Evidence from Mergers by Korean Business Groups' (2002) 57 The journal of finance 2695.

[201] Mike W Peng and Yi Jiang, 'Institutions behind Family Ownership and Control in Large Firms' (2010) 47 Journal of management Studies 253; Bae, Kang and Kim (n 203); Mingzhi Liu and Michel Magnan, 'Self-dealing Regulations, Ownership Wedge, and Corporate Valuation: International Evidence' (2011) 19 Corporate Governance: An International Review 99.

[202] Marianne Bertrand, Paras Mehta and Sendhil Mullainathan, 'Ferreting out Tunneling: An Application to Indian Business Groups' (2002) 117 The quarterly journal of economics 121.

[203] Yan-Leung Cheung, P Raghavendra Rau and Aris Stouraitis, 'Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong' (2006) 82 Journal of Financial economics 343.

manipulation of intercorporate loans, where controlling shareholders utilize these financial instruments to transfer substantial sums of money for the purpose of siphoning funds.[204]

Furthermore, dominant shareholder's tunneling has been found to be collusion with managers. controlling shareholders often collaborate with managers to undermine performance-based incentives.[205] This weakening of incentives is particularly marked in firms that are less profitable and have dimmer prospects, suggesting that in struggling firms, the incentive to engage in tunnelling is even stronger. Additionally, the study provides preliminary evidence of rent-sharing behaviour between controlling shareholders and managers, indicating that the benefits derived from such collusion are mutually shared among the insiders. This behaviour adversely affects the alignment of interests between management and broader shareholder groups, especially minority shareholders.[206]

In contrast with direct tunnelling, indirect tunnelling is subtle and more complex, making it harder to detect. The controlling shareholder can increase their ownership stake ***without*** actual asset transfer by engaging in practices like diluting the equity, freezing out minority shareholders, engaging in insider trading, making creeping acquisitions, or executing other financial manoeuvres that adversely affect minority shareholders.[207] Controlling shareholders exploit minority shareholders through financial mechanisms, such as diluting minority stakes by restricting new share subscriptions to closed groups. Share dilution is notably prevalent in emerging markets in the process of rapid privatization.[208]

Empirical studies assess the indirect tunnelling by proxies for firm value and financial performance. From the international comparative perspective, La Porta et al.'s study shows that in countries with better protection of minority shareholders' rights, firms tend to have higher market valuations and pay higher dividends, which suggests that solid investor protections deter indirect tunnelling.[209]

1.5.3 Corporate Governance Problems in State-Owned Enterprises (SOEs)

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[204] Guohua Jiang, Charles MC Lee and Heng Yue, 'Tunneling through Intercorporate Loans: The China Experience' (2010) 98 Journal of financial economics 1.

[205] Mike Burkart and Fausto Panunzi, 'Agency Conflicts, Ownership Concentration, and Legal Shareholder Protection' (2006) 15 Journal of Financial intermediation 1; Min Zhang and others, 'Controlling Shareholder-Manager Collusion and Tunneling: Evidence from C Hina' (2014) 22 Corporate Governance: An International Review 440.

[206] Zhang and others (n 208).

[207] Johnson and others (n 196) 3.

[208] Johnson and others (n 196); Muhammad Farooq and others, 'Ownership Structure and Financial Constraints–Evidence from an Emerging Market' (2022) 48 Managerial Finance 1007; Lucy Chernykh, 'Ultimate Ownership and Control in Russia' (2008) 88 Journal of Financial Economics 169.

[209] La Porta and others, 'Investor Protection and Corporate Governance' (n 106).

SOEs comprise 22 per cent of the world's largest enterprises and have an essential role in emerging markets.[210] SOEs in China remain a central economic player that commands the most critical sectors of the economy in electricity, petroleum, aviation, banking, and telecommunication, which is for economic, social and political considerations.[211] Since the prominent role of SOEs in China, the thesis focuses on the corporate governance problems in government-controlled companies. The governance problems in SOEs are distinct from those of private corporations because of their governmental ownership. The conflict of interest between managers and shareholders, as well as between state controlling shareholders and minority shareholders, arises because of state ownership. Here are the problems associated with SOEs: unclear principals and objectives, state as shareholder vs regulator, political interference, and shareholder expropriation.

1.5.3.1 Lack of Clear Principals and Objectives:

In private companies, shareholders primarily act as principals, focusing on appointing competent board members, setting clear corporate objectives, monitoring performance, and providing capital for growth. However, SOEs often lack a clearly defined principal or owner.[212] Instead, state ownership is administrated through various government agencies, including a stand-alone ministry (e.g. Indonesia's Ministry of State-owned Enterprises), ownership department or unit (State-Owned Assets Supervision and Administration Commission under the State Council of China), and other government entities.[213] This diversity in ownership management can lead to conflicts between the state's ownership interests and its regulatory and policymaking responsibilities, leaving the company vulnerable to short-term political agendas that compromise efficiency.[214] States frequently set conflicting objectives, lack rigorous monitoring of corporate performance, and cannot provide adequate financing. Without well-established legal framework or effective law enforcement, the state often assumes roles that should be reserved for the board, such as CEO appointment and dismissal and budgets and investment plans approval.[215] This situation invites political meddling, direction and approach inconsistency, and corruption opportunities.[216]

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[210] OECD., State-Owned Enterprises as Global Competitors A Challenge Or an Opportunity? (OECD publishing 2016).

[211] World Bank, *Corporate Governance of State-Owned Enterprises: A Toolkit* (The World Bank 2014) 3.

[212] Yair Aharoni, 'State-Owned Enterprise: An Agent without a Principal' [1982] Public En.

[213] World Bank (n 214) 82.

[214] Indri Dwi Apriliyanti, Marleen Dieleman and Trond Randøy, 'Multiple-principal Demands and CEO Compliance in Emerging Market State-owned Enterprises' [2023] Journal of Management Studies; Xiaoyuan Dong and Louis Putterman, 'Soft Budget Constraints, Social Burdens, and Labor Redundancy in China's State Industry' (2003) 31 Journal of Comparative Economics 110.

[215] Luca Gnan and others, 'SOEs Ownership and Control: Independence and Competence of Boards Members' (2011) 8 Corporate Ownership & Control 720, 722.

[216] Anja Baum and others, 'Governance and State-Owned Enterprises: How Costly Is Corruption?' [2024] Economics of Governance 1.

Private sector companies typically aim to increase 'shareholder value'. However, in the context of SOEs, the presence of various interests held by different government agencies sometimes results in varied and occasionally conflicting goals.[217] In addition to seeking profitability, SOEs are usually tasked with broader mandates and public service obligations. These tasks include offering essential services like train, postal, or telephone at regulated pricing, along with broader social and industrial policy objectives.[218] These goals can be both explicit and implicit.

When SOEs are tasked with multiple, ambiguous, or conflicting objectives, managers may attempt to fulfil all these goals but achieve zero in the end. Alternatively, they may prioritise their interests, creating conflicts between the managers and the state-controlling shareholder. In a market economy, the labour market is an efficient approach to solve this agency problem.[219] However, in countries without developed labour markets, the personnel appointment and dismissal of SOEs are made by the state or local governments, which results in managers lack the incentive to pursue SOEs profitability.[220] Instead, the management in SOEs often receives incentives to address social issues like unemployment and social instability to obtain personal gain, such as promotion in the bureaucratic structure.[221]

Government interference, often driven by political motives disguised as diverse policy goals and mandates, further complicates matters.[222] Without clear goals, assessing managerial performance becomes challenging, increasing the risk of political capture and misuse of the SOE's resources.

1.5.3.2 State Shareholder vs Regulator

The state's dual role as both the controlling shareholder of SOEs and as a regulatory authority presents a substantial challenge in maintaining transparent and accountable governance structures.[223] The state's dual capacity enables it to influence the legislative and regulatory frameworks that govern these enterprises. The state's power stems from the government's

[217] Mariana Pargendler, 'State Ownership and Corporate Governance' (2011) 80 Fordham L. Rev. 2917, 2921.

[218] Andriati Fitriningrum, 'The Impacts of Government and Management Conflicting Objectives on the State-Owned Enterprises (SOEs) Performances: The Case of Indonesia Publicly Listed SOEs' (2020) 18 Jurnal Aplikasi Manajemen 632, 633.

[219] Fama (n 26) 292.

[220] Eric C Chang and Sonia ML Wong, 'Governance with Multiple Objectives: Evidence from Top Executive Turnover in China' (2009) 15 Journal of Corporate Finance 230.

[221] Chong-En Bai and others, 'A Multitask Theory of State Enterprise Reform' (2000) 28 Journal of Comparative Economics 716; Jenik Radon and Julius Thaler, 'Resolving Conflicts of Interest in State-owned Enterprises' (2005) 57 International Social Science Journal 11.

[222] Mara Faccio, 'Politically Connected Firms' (2006) 96 American economic review 369.

[223] Juliet Roper and Michele Schoenberger-Orgad, 'State-Owned Enterprises: Issues of Accountability and Legitimacy' (2011) 25 Management Communication Quarterly 693; Pargendler (n 220) 2921.

access to extensive resources and deep expertise and its vested interest in maintaining control over economically and socially critical sectors.[224]

Firstly, aligning the government's interests with other dominant economic players, such as family-owned companies, complicates the legislative process. These entities often share the goal of shaping regulations to favour established interests, thereby securing their control over economic activities.[225] This collaboration can lead to legislative outcomes that prioritise the needs and desires of controlling shareholders over the broader public interest.[226] When the government acts as a controller of SOEs, it is incentivised to pass or selectively enforce laws that enhance its position and safeguard its enterprises from competitive pressures or stringent regulatory oversight.

Moreover, the public's tolerance for a certain degree of cronyism or extraction of private benefits by the government, in return for the societal and economic benefits provided by SOEs, further entrenches the state's dual role.[227] This tolerance can diminish the impetus for rigorous enforcement of corporate governance standards, leading to a regulatory environment where SOEs might not be held to the same accountability standards as private sector companies.[228] This leniency is particularly evident in sustainability and corporate governance reporting, where SOEs may fail to meet required standards without facing significant repercussions.

The ‘comply or explain’ code of corporate governance commonly applied in corporate governance practices, particularly around environmental, social, and governance reporting issues, underscores this problem.[229] The framework is built on the assumption that there is an asymmetry of information between companies and their shareholders and that shareholders can act on disclosures to penalise or reward the company’s board.[230] However, these assumptions do not apply in the context of SOEs. As a controlling shareholder, the government often has access to all necessary information, reducing the information gap. Additionally, the government's ability to influence or directly appoint board members diminishes the likelihood

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[224] Pargendler (n 220) 2921–2.

[225] Lucian Arye Bebchuk and Mark J Roe, ‘A Theory of Path Dependence in Corporate Ownership and Governance’ (1999) 52 Stanford Law Review 127, 157.

[226] ibid 157–60.

[227] Rajeswary Ampalavanar Brown, ‘Indonesian Corporations, Cronyism, and Corruption’ (2006) 40 Modern Asian Studies 953; Huangnan Shen, Lei Fang and Kent Deng, ‘Rise of ‘Red Zaibatsu’in China: Entrenchment and Expansion of Large State-Owned Enterprises, 1990-2016’ (Department of Economic History, London School of Economics and Political Science 2017).

[228] World Bank (n 214) 140–42.

[229] World Bank (n 214).

[230] Jongmoo Jay Choi, Heibatollah Sami and Haiyan Zhou, ‘The Impacts of State Ownership on Information Asymmetry: Evidence from an Emerging Market’ (2010) 3 China Journal of Accounting Research 13, 47; Estíbaliz Biedma López and others, ‘SOEs’ Commitment to Transparency: Voluntary Disclosure as a Driver of Mandatory Disclosure’ [2024] Annals of Public and Cooperative Economics.

that non-compliance with disclosure rules will result in significant penalties for the SOEs' directors.[231]

This situation is exacerbated by the government's potential reluctance to enforce or even establish necessary regulatory standards that would constrain its powers or expose SOEs to greater scrutiny and competition.[232] For example, there has been a notable lack of rigorous measures to monitor and assess the quality of ESG disclosures by SOEs. Without such measures, it becomes highly improbable that the government will initiate reforms that require independent audits of these disclosures, thus perpetuating a cycle of inadequate oversight.

In conclusion, the government's roles as both a regulator and a controlling shareholder create inherent conflicts of interest that can undermine the governance of SOEs. This dual role can lead to regulatory gaps, reduced accountability, and a governance environment that allows SOEs to operate under different standards than their private counterparts. Addressing these issues requires revaluating the regulatory frameworks and perhaps the introduction of more stringent, independent oversight mechanisms to ensure that SOEs adhere to high standards of transparency and accountability, ultimately safeguarding the interests of all stakeholders.

1.5.3.2 Political Interference and Expropriation of Shareholder Rights

The government's involvement in state-owned enterprises (SOEs) frequently extends beyond public governance into personal and political motivations, often at the expense of the enterprises' long-term profitability and efficiency.[233] This practice, wherein the government leverages its control over SOEs to extract private benefits through, for example, related party transactions and executive compensation, undermines the interests of minority shareholders and other stakeholders.[234] Such government actions include not only the diversion of financial assets for private gain but also the manipulation of these enterprises to advance political agendas or personally benefit specific individuals.

In China, for example, the State-Owned Assets Supervision and Administration Commission('SASAC'), which acts as the controlling shareholder for Chinese SOEs, has been known to engage in related-party transactions ('RPTs') that compromise these enterprises' long-term profitability and operational efficiency. The RPTs include corruption-RPTs and policy-

[231] Donghua Chen and others, 'Selective Enforcement of Regulation' (2011) 4 China Journal of Accounting Research 9, 12–13 <https://www.sciencedirect.com/science/article/pii/S1755309111000037>.

[232] ibid 13.

[233] Faccio (n 225) 369.

[234] Nancy Huyghebaert and Lihong Wang, 'Expropriation of Minority Investors in Chinese Listed Firms: The Role of Internal and External Corporate Governance Mechanisms' (2012) 20 Corporate Governance: An International Review 308 <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1467-8683.2012.00909.x> accessed 2 March 2021; Claessens, Djankov and Lang (n 189).

RPTs.[235] The former occurs when SOEs senior executives and government officials tunnelling for personal benefits. The latter occurs when the government, as the controlling shareholder, initiates RPTs for public good and policies.[236] Beyond mere financial exploitation, SOEs' senior executives appointed by the government pursue non-financial gains, such as facilitating career advancements for politicians through their associations with SOEs.[237]

Additionally, the government, acting as the controller of SOEs, has been found to misappropriate corporate assets and redirect resources, depriving these enterprises of essential inputs and opportunities for growth.[238] Such actions typically bolster the government's immediate political interests or reward individuals within the government's circle with undue advantages, a practice widely recognised as cronyism.[239]

The politicized board and management facilitate the pervasive influence of the government in the management of SOEs. SOEs frequently struggle with board compositions that lack the necessary experience and expertise essential for fulfilling key corporate governance roles such as strategic guidance, management oversight, and the establishment of strong internal controls.[240] Often, SOE boards comprise various stakeholders with competing agendas that might not align with the company's best interests, leading to conflicts that can impede sound commercial decision-making. SOEs boards become an institution to approve government decisions, providing no real oversight over management, which typically reports directly to the government instead.[241]

Besides, as the controlling shareholder, the government can appoint, reappoint, or dismiss directors and senior managers at will.[242] The appointment of government personnel to critical positions within SOEs further extends the government's influence, ensuring that corporate decisions align with governmental policies and preferences rather than with business logic or shareholder value. Thus, the government can remove independent directors without cause, which results in a significant underrepresentation of independent directors on SOE boards and a disregard for established corporate governance norms.[243] Even when independent directors

[235] Sang Yop Kang, 'Reframing Related Party Transactions in China's State-Owned Enterprises' [2020] Peking University School of Transnational Law Research Paper 5.

[236] ibid.

[237] Li-Wen Lin and Curtis J Milhaupt, 'We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China' (2013) 40 Revista chilena de derecho 801, 829–34.

[238] S Subramanian, 'A Comparison of Corporate Governance Practices in State-Owned Enterprises and Their Private Sector Peers in India' (2016) 5 IIM Kozhikode Society & Management Review 200.

[239] Brown (n 230).

[240] Anna Menozzi, María Gutiérrez Urtiaga and Davide Vannoni, 'Board Composition, Political Connections, and Performance in State-Owned Enterprises' (2012) 21 Industrial and Corporate Change 671.

[241] W Richard Frederick, 'Enhancing the Role of the Boards of Directors of State-Owned Enterprises' (OECD 2011) 17.

[242] Lin and Milhaupt (n 240) 829–34.

[243] Nada K Kakabadse, Hong Yang and Richard Sanders, 'The Effectiveness of Non-executive Directors in Chinese State-owned Enterprises' (2010) 48 Management Decision 1063, 1072–73.

are present, their autonomy can be compromised because the board positions are reserved for those politically loyal and obedient individuals.[244]

Consequently, SOE directors and managers often find themselves constrained by the need to align with government directives, aware that their career progression—and other benefits—hinge on their compliance with governmental expectations. This situation creates a governance environment where decisions are more likely to reflect the prevailing government's priorities rather than the best interests of the enterprise or its broader base of stakeholders. Such dynamics severely restrict any potential dissent within the leadership of SOEs, as the risk of retribution for non-compliance is high, ensuring that the government's control over these enterprises is direct and indirect.

Concluding Remarks

This chapter has provided a comprehensive introduction to corporate governance, outlining foundational concepts, theoretical perspectives, and governance mechanisms essential for understanding the broader dynamics influencing corporate behavior. By examining the definitions, theoretical frameworks (including agency theory, stakeholder theory, stewardship theory, and resource dependence theory), and various governance models (shareholder-centric versus stakeholder-inclusive), this chapter establishes the necessary theoretical background to critically analyze the adoption and functioning of the independent director system.

The exploration of principal-agent and principal-principal conflicts underscores the complexities that arise within corporate governance structures, highlighting the importance of effective governance mechanisms such as independent directors to mitigate these issues. Additionally, the chapter's detailed analysis of governance challenges specific to state-owned enterprises, such as political interference and conflicting regulatory and shareholder roles, directly prepares the ground for discussions in later chapters about China's unique institutional environment and its impact on governance effectiveness.

Critically, the insights presented here form the basis for subsequent chapters by providing essential theoretical tools and comparative context. Chapter 2 will further expand upon these theoretical foundations through an in-depth examination of legal transplant theory, emphasizing the conditions required for successful adoption of foreign governance models. Chapter 3 will utilize these governance frameworks and comparative insights to analyze the origin and global diffusion of independent directors, clarifying how differences in institutional settings affect their role and effectiveness. Chapters 4 and 5 will apply the foundational concepts discussed in this chapter to specifically analyze China's independent director system, examining why formal transplantation has struggled to translate into substantive governance improvements.

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[244] World Bank, Held by the Visible Hand:The Challenge of SOE Corporate Governance for Emerging Markets 2006 26–7.

In essence, Chapter 1 sets the stage for the thesis's central inquiry into why the independent director model, despite its formal adoption, continues to exhibit deficiencies in China. This foundation enables a structured exploration of the intersections between theory, comparative analysis, and practical governance outcomes in subsequent chapters.

Chapter 2 Theoretical Perspective of Legal Transplant

Introduction

Chapter 2 explores the theoretical framework of legal transplants, a concept central to understanding how legal systems evolve by adopting foreign legal rules and institutions. Section 2.1 starts by exploring various metaphors used to conceptualize legal transplants, such as medical, botanical, and alternative frameworks, highlighting the complexity and diversity of thought surrounding this process. It discusses the significance of legal transplants in the context of global legal development, emphasizing the historical prevalence and ongoing relevance of this phenomenon. Section 2.2 further examines the feasibility of legal transplants, presenting the differing views of scholars like Watson, who argues for the ease of legal transplants, and Legrand, who contends that they are inherently impossible due to cultural and societal differences. Legal transplants evolved to a more moderate stance, which suggests by Kahn-Freund that the success of legal transplants depends on various factors, including the adaptability of the legal rules to the recipient country's context.

Sections 2.3 and 2.4 address the criteria and conditions for the success of legal transplants, acknowledging the challenges in defining success or failure due to the varied contexts in which legal transplants occur. It explores the role of local adaptation, social demand, and knowledge of the transplanted rule in determining the effectiveness of legal transplants.

Section 2.5 focuses on the legal transplant in the realm of corporate governance and examines the ongoing debate over convergence and divergence in corporate governance models across different countries. Section 2.6 discusses the specific case of legal transplants in China, illustrating how China has selectively adopted and integrated foreign legal concepts within its unique legal and cultural framework. China's approach to legal transplantation is characterized by a careful balance between preserving national sovereignty and embracing foreign legal innovations.

This chapter critically reviews the theories and cases of legal transplants and presents an analytical framework to evaluate and understand the effectiveness of legal transplants based on current theoretical assumptions. This sets the stage for further discussion on how legal transplants function in different environments, particularly in the context of China's evolving legal system.

2.1 Legal Transplants: Concept and Significance

2.1.1 The Metaphors of Legal Transplants

During the late 1960s and early 1970s, the discussion of organ transplantation and organ rejection was very much in the air.[245] It was thus hardly surprising that Alan Waston[246] and Kahn-Freund[247] both alluded to using it as a metaphor to describe the borrowing of legal rules and institutions in a comparative law discussion of around 1974. This analogy highlights the process of transferring laws from one legal system to another, much like how an organ is transplanted from one body to another. For instance, Watson likens legal transplantation to the transplantation of a human organ, suggesting that a successful transplanted legal rule, like an organ, can integrate into the recipient legal system and thrive in the new environment.[248]. While Watson acknowledges that the transplanted rule may undergo changes or operate differently in the recipient system, he cautions against interpreting these changes as a rejection of the rule.[249] He emphasizes that his theory of legal transplantation does not concern itself with what happens after the rule is adopted.[250] Similarly, Feldman suggests that comparing the search for compatible legal rules to the search for a suitable organ donor is helpful, offering hope to individuals in need within the global community.[251]

However, although the appeal of the medical transplant metaphor seems compelling, some scholars are sceptical of its applicability in elucidating legal transplantation. For instance, Nelken criticizes the medical metaphor for being overly rigid and simplistic as a heuristic device. He offers two main reasons: First, it oversimplifies the complex social process of legal transplantation and fails to consider subjective elements such as the creation and the enforcement of the meaning, including the interpretation of "similarity" and "success."[252] Legal transplants occur due to societal demands for change rather than an objective match between healthy and diseased organs. Second, medical transplants involve highly invasive surgery, where the body is unaware that it is in its best interest. This aspect of the metaphor fails to differentiate between a society willingly adopting a legal rule and one having it imposed upon them.[253] Teubner argues that the medical metaphor suggests that the outcome of legal transplantation is either an outstanding achievement or a complete failure. Nevertheless, the

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[245] ‘Progress of Transplants’ *New York Times* (27 December 1969) 22. available at: http://select.nytimes.com/gst/abstract.html?res=F50613FE38581B7493C5AB1789D95F4D8685F9

[246] Alan Watson, *Legal Transplants: An Approach to Comparative Law*, vol 22 (2nd edn, 1974).The book was first published in 1974 [hereinafter Legal Transplants]

[247] Otto Kahn-Freund, ‘On Uses and Misuses of Comparative Law’ (1974) 37 The Modern Law Review 1. [hereinafter *On Uses and Misuses of Comparative Law*].

[248] Alan Watson, *Legal Transplants: An Approach to Comparative Law* (2nd edn, University of Georgia Press 1993) 27.

[249] ibid.

[250] Alan Watson, ‘Legal Transplants and Law Reform’ (1976) 92 Law Quarterly Review 79, 79.

[251] Eric Feldman, ‘Patients’ Rights, Citizen’s Movements, and Japanese Legal Culture’ 215.

[252] David Nelken, ‘Towards a Sociology of Legal Adaptation’, Adapting legal cultures, vol 4 (Hart Publishing Portland 2001) 18.

[253] Nelken, ‘Towards a Sociology of Legal Adaptation’ (n 8).

binary of success or failure is too simplistic to describe the actual outcomes of legal transplantation, which are more likely to be nuanced and mixed.[254]

This leads some scholars to advocate that a botanical metaphor is more fitting for describing legal transplantation. This botanical analogy compares legal transplantation to grafting foreign plants or relocating crops or plants into foreign soils. According to Baade, this metaphor more effectively conveys Watson's idea of "legal transplant", as transplanted crops or plants can prosper both in their native environment and in a new setting.[255] For instance, Roman law continued to function in Rome even after being adopted in other regions, like Egypt.[256] In contrast, organ transplantation typically involves implanting a single organ from one member of a species into another.[257] However, Nelken is equally critical of the botanical metaphor as he is of the medical one. He argues that similar to the medical analogy, the botanical metaphor suggests that in order for the plant to integrate into its new surroundings successfully, it may be necessary for it to sever any remaining connection with its original source.[258]

2.1.2 Alternative Conceptions of Legal Transplants

Beyond the metaphors of medical and botanical transplants, scholars have proposed other frameworks to explain the legal transfer process.[259] Teubner offers an alternative with the term "legal irritants" to more precisely capture the impact of transplanted legal rules on the receiving legal system. Furthermore, these 'legal irritants' resist straightforward integration into the new cultural setting, rather, they initiated a profound transformation within the internal context, ultimately reconfiguring the external rule's interpretation.[260] However, Teubner's "legal irritants" metaphor loses the comparative perspective that transplant metaphors offer.[261] Örücü suggests the metaphor of "transposition," which he finds particularly suitable for describing 'massive changes based on competing models.'[262] He draws an analogy to musical transposition, where adjustments are made to suit the new context, arguing that legal

[254] Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergencies' (1998) 61 The Modern Law Review 11, 17.

[255] Hans W Baade, 'Transplants of Laws and of Lawyers' in Phaedon J Kozyris (ed), Justice in Particular. Festschrift in honour of Professor P. J. Kozyris (Sakkoulas Ant N 2007) 2.

[256] ibid.

[257] ibid.

[258] David Nelken, 'Legal Transplants and beyond: Of Disciplines and Metaphors' in Esin Harding, Andrew and Örücü (ed), *Legal transplants and beyond: of disciplines and metaphors* (Kluwer Law International 2002) 32.

[259] These alternatives stem from a shared dissatisfaction with the term "legal transplant," which is often seen as too static and rigid to effectively convey the dynamic, interactive, and ongoing nature of legal transplantation.

[260] Teubner (n 10) 17.

[261] Máximo Langer, 'From Legal Transplants to Legal Translations: The Globalization of Plea Bargaining and the Americanization Thesis in Criminal Procedure' (2004) 45 Harvard International Law Journal 1, 30.

[262] Esin Örücü, 'Law as Transposition' (2002) 51 International & Comparative Law Quarterly 205, 207.

transposition involves similar modifications to adapt the law to the conditions of the recipient system.[263]

Wise supports the term "circulation", arguing that "circulation" better captures the continuous change and transit of legal concepts and regulations.[264] But Langer is critical of both "legal transplant" and "circulation." He agrees with Wise that "legal transplantation" lacks the flexibility to take into consideration the changes that legal concepts and organizations may experience when incorporated into other legal systems. But Langer also criticizes the concept of "circulation," arguing that the focus should be on how legal ideas and rules are transformed during the transplantation process, rather than merely on their movement. As an alternative, Langer proposes the metaphor of "legal translation," in which the contexts of the original and the receiving legal systems are compared to different "languages".[265] This metaphor, he argues, better captures the transformations that occur both during the initial transplantation and after the rule has been integrated into the receiving system.[266]

Each of these metaphors emphasizes various aspects of the process involved in a legal transplantation. Collectively, these perspectives provide valuable heuristic tools for comprehending legal transplantation as an evolving, ongoing, and complicated process that involves both the transfer of law from its initial system and its adaptation within the receiving system.

2.1.3 Significance of Legal Transplants

Decades before Alan Watson "popularized" the term "legal transplants," scholars such as Charles de Montesquieu[267], Roscoe Pound[268] and Albert Kocourek[269] had already employed this metaphor in their discussions on legal changes, reforms, and developments. The transplant metaphor has gained attention not only in academia but also within the judiciary. For example, in a 1956 judgment, Lord Denning likened English common law to an English oak tree, arguing that it cannot simply be transplanted to Africa without expecting it to retain its original character—it requires "careful tending" to thrive in a new environment.[270] Watson himself

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[263] ibid.

[264] Edward M Wise, 'The Transplant of Legal Patterns' (1990) 38 American Journal of Comparative Law Supplement 1, 1 <https://heinonline.org/HOL/Page?handle=hein.journals/amcomps38&id=13&div=&collection=> accessed 6 July 2021.

[265] Langer (n 17) 33.

[266] ibid 33–34. Other apposite metaphors include 'grafting', 'implantation', 're-potting', 'cross-fertilization', 'contamination', 'infiltration', 'infusion', 'digestion', 'melting pot', and so on.

[267] Charles-Louis de Secondat Montesquieu and Charles de Secondat baron de Montesquieu, *The Spirit of Laws* (The Lawbook Exchange, Ltd 2005).

[268] Roscoe Pound, 'Theory of Judicial Decision I The Materials of Judicial Decision' 36 Harvard Law Review 641, 641–662.

[269] Albert Kocourek, 'Factors in the Reception of Law' (1935) 10 Tulane Law Review 209, 209.

[270] *Nyali Ltd v Attorney-General [1956] 1 QB 1* 16.

acknowledged in *Legal Transplants* that he was not the first to explore the concept of "transplants" or "transplantation" in the context of transnational legal movements. He pointed out that one of the earliest examples of private law transplantation dates back to the Babylonian Code of Hammurabi in the early 17th century B.C.[271]

Legal transplantation has been accepted as the principal means to implement legal reforms and changes across the world. For instance, Örücü claims that transferring legal institutions and concepts across borders is an integral process of legal evolution. This phenomenon has been evident throughout history and is still vital at present, with an expectation that it will become even more prevalent in the future.[272] He further argues that it is widely recognized that genuine innovation in law is rare, with borrowing and imitation playing a crucial role in understanding the course of legal change.[273] Sacco is the proponent of Örücü, arguing that truly original legal innovations are extremely rare, perhaps occurring once in a thousand instances.[274] Consequently, the practices of borrowing and imitation are fundamental to understanding how the legal system evolves.[275] Watson notes that the most significant driver of legal development has been the numerous direct transplants of legal systems throughout human history.[276] Notable examples of legal transplants such as Solon of Athens, who studied the laws of various Greek city-states to inform his social reforms; Aristotle, another prominent figure, analyzed over 150 city constitutions to develop his seminal work, *Politics*; The influence of Greek legal principles extended even to the early Roman legal system, as evidenced by the incorporation of references to ancient Greek laws in the XII Tables, Rome's first legal code;[277] As the Roman Empire declined, its legal traditions were preserved by the conquering Germanic tribes, ensuring the survival and transmission of Roman legal principles into the medieval period.[278] The Renaissance and the Industrial Revolution further amplified the importance of comparative law, as emerging nation-states sought to modernize their legal systems by drawing on the experiences of others. Even the foundational Western legal systems were not immune to external influences; for example, French and German law heavily borrowed from Roman

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[271] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2) 22–24.

[272] Örücü (n 18) 205.

[273] ibid 206.

[274] Rodolfo Sacco, 'Legal Formants: A Dynamic Approach to Comparative Law (Installment I of II)' (1991) 39 The American Journal of Comparative Law 1, 398.

[275] ibid.

[276] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2).

[277] René David and John EC Brierley, *Major Legal Systems in the World Today : An Introduction to the Comparative Study of Law* (2nd edn, Free Press 1978); Andrew Borkowski, *Textbook on Roman Law* (Blackstone Press Limited 1994) 26.

[278] Alan Watson, *The Evolution of Law* (Johns Hopkins U Press 1989); Michael H Hoeflich, 'Law, Society, and Reception: The Vision of Alan Watson' (1987) 85 Michigan Law Review 1083, 1083.

legal traditions,[279] while Anglo-American law also integrated elements of civil law.[280] The 19th and early 20th centuries saw the expansion of these legal systems beyond Europe, particularly through colonization and the expansion of the global market, which introduced European legal concepts to regions such as Africa, Asia, and Latin America. Following World War II, the wave of globalization and the emergence of the U.S. as a global power led to the spread of the American legal model as an "ideal" framework for law and development, particularly in newly independent states.[281]

More recently, several significant developments during the 1990s have shifted the notion of legal transplants from being a purely theoretical deliberations to practical concerns about what is required for a successful implementation of foreign legal institutions.[282] It is often suggested that politicians and judges disregard comparative law due to its perceived complexity and theoretical nature, which can be challenging for a non-specific audience. Firstly, the end of the Cold War, the reunification of Germany, and the collapse of the Soviet Union led numerous nations to seek out legal frameworks and institutions modelled after democratic nations with market-based economies. During this transitional period, civil society organizations, international financial institutions, and quasi-governmental organizations from Western Europe and the U.S. played a crucial role in assisting these newly independent or transitional states. They were primarily engaged in formulating and executing the official components of democracy and decentralized economic systems.[283] The scale of this assistance was substantial; for example, U.S. government aid to Eastern Europe amounted to approximately

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[279] JH Merryman, *The Civil Law Tradition: An Introduction to the Legal Systems of Western Europe and Latin America* (2nd edn, Stanford University Press 1985) 10 <https://books.google.co.uk/books?id=uR8ykAHUdvwC>.

[280] Watson demonstrates that *Commentaries on the Laws of England,* by William Blackstone, the founder of English law, was based on a reference to Dutch scholar Dionysius Gothofredus's (1549–1622) interpretation of the *Institutes* of Justinian. English and American conflicts of law referred to *Praelectines Iuris Vivilis et Hodienrni* by Ulrich Huber, a Dutch scholar. *See*: Watson, *Legal Transplants: An Approach to Comparative Law* (n 4) 109–110. Jerome Frank points out that "[c]ivil law tradition has many impacts on common law." He expounds on the far-reaching but often neglected impacts of civil law tradition on American common law in the areas of the constitution, conflicts of law, legal interpretation, and judicial procedure: "The influences of civil law on common law are legion. Many of them doubtlessly can't be detected." Jerome Frank, 'Civil Law Influences on the Common Law--Some Reflections on Comparative and Contrastive Law' (1955) 104 University of Pennsylvania Law Review 887, 888.

[281] Daniel Berkowitz, Katharina Pistor and Jean Francois Richard, 'The Transplant Effect' (2003) 51 American Journal of Comparative Law 163.

[282] See: Basil S Markesinis, *Comparative Law in the Courtroom and Classroom: The Story of the Last Thirty-Five Years* (Bloomsbury Publishing 2003) 61–62; Basil Markesinis, 'Comparative Law-A Subject in Search of an Audience' (1990) 53 Modern Law Review 1, 3; Basil Markesinis, *Foreign Law and Comparative Methodology* (Oxford: Hart 1997) 3.

[283] See e.g. Lawrence Tshuma, 'The Political Economy of the World Bank's Legal Framework for Economic Development', *International economic regulation* (Routledge 2018) 75; Gianmaria Ajani, 'By Chance and Prestige: Legal Transplants in Russia and Eastern Europe' (1995) 43 The American Journal of Comparative Law 93.

$300 million annually, with nearly $1 billion dedicated to democracy promotion programs during the 1990s.[284]

Secondly, the Maastricht Treaty, signed in February 1992, marked the beginning of a significant push toward regionalization and harmonization within Europe.[285] This treaty set European states on a course towards closer economic and political integration, emphasizing the creation of an internal market and monetary union. To accomplish these objectives, it was necessary to create multilateral trade agreements, establish universally acknowledged rules and procedures, and build a shared framework of legal institutions among member states.[286] This drive towards unification and standardization within Europe further highlighted the importance of legal transplants as a tool for achieving these regional objectives.

Beyond Europe, the field of development economics began to focus increasingly on institutions, particularly legal and judicial institutions, as pivotal to the discussion of law and development.[287] Nobel laureate Douglas North argued that institutions play a vital role in defining and enforcing complicated and impersonal transactions, encompassing economic interactions.[288] This perspective placed legal institutions at the forefront of New Institutional Economics, highlighting their role in fostering and facilitating economic activity.[289] Consequently, development professionals, who had previously focused on free trade and fiscal reform, expanded their scope to encompass legal and judicial institutions.[290] By 2002, the World Bank's Legal Vice Presidency reported that the Bank had provided legal assistance to 87 countries across 45 specialized areas, such as taxation, contracts, legislative drafting, indigenous peoples' laws, resettlement, natural resources law, rural credit, and AIDS-related laws.[291]

[284] Thomas Carothers, Aiding Democracy Abroad: The Learning Curve (Carnegie Endowment 2011).

[285] Reinhard Zimmermann, 'Civil Code and Civil Law-The" Europeanization" of Private Law within the European Community and the Re-Emergence of a European Legal Science' (1994) 1 Columbia Journal of European Law 63; Wolfgang Wiegand, 'The Reception of American Law in Europe' (1991) 39 The American Journal of Comparative Law 229.

[286] Zimmermann (n 41).

[287] David M Trubek, 'Law and Development: Forty Years after "Scholars in Self-Estrangement"' (2016) 66 University of Toronto Law Journal 301.

[288] C Douglass, 'Institutions' (1991) 5 The Journal of Economic Perspectives 97, 100.

[289] Chantal Thomas, 'Law and Neoclassical Economic Development in Theory and Practice: Toward an Institutionalist Critique of Institutionalism' (2010) 96 Cornell Law Review 967, 980.

[290] Kevin E Davis and Michael J Trebilcock, 'The Relationship between Law and Development: Optimists versus Skeptics' (2008) 56 The American Journal of Comparative Law 895; John Ohnesorge, 'The Regulatory State in East Asia' in F Bignami and D Zaring (eds), *Comparative Law and Regulation* (Edward Elgar Publishing 2016); Tshuma (n 39).

[291] Legal Vice Presidency, *Initiatives in Legal and Judicial Reform* (The World Bank 2004) 9 <https://documents1.worldbank.org/curated/en/139831468778813637/pdf/250820040Edition.pdf#page=6.33>.

The emergence of New Institutional Economics allowed the development community to view legal institutions as diagnostic tools and means for reform implementation.[292] Legal reforms frequently entail adopting successful laws and practices from the Global North or wealthy countries that sponsored the reforms.[293] These reforms could encompass improving court administration, creating alternative methods for dispute resolution, establishing administrative court systems, or establishing bankruptcy and commercial courts.[294] The assumption was that these reforms could be executed in a technical and non-political way, which was particularly significant for the World Bank, given its governance framework forbids political involvement.[295] However, the difficulties associated with these assumptions have been extensively explored in academic research that investigates the interplay between law and politics.[296]

2.2 Feasibility of Legal Transplants

Despite its theoretical and practical importance, there is considerable disagreement among comparative legal scholars on key issues related to legal transplants, including the viability of such transplants, how to define their "success" or "failure," and the conditions necessary for their success, among others. This section examines the diverse perspectives on the feasibility of legal transplants, setting the stage for the subsequent case study on legal transplantation. The debate regarding the feasibility of legal transplants was notably represented by Watson, who argues that legal transplantation is "socially easy",[297] and legal sociologists who argue against the prospect for legal transplants outside their original social and cultural contexts.

2.2.1 Transplants are Easy

Watson, on basis of his historical investigation into Roman law, observing that legal transplants have been "extremely common" throughout Western legal history and remain so today, contends that legal transplants are not only feasible but also “socially easy”, means despite potential resistance from the legal community of policymakers, it remains evident that legal rules can be transferred with relative ease and integrated into a different legal system without significant challenges.[298] Successful legal adaption can occur even when the borrowed rule originates from a totally different legal framework, one that may be more advanced or politically distinct. As Watson claims, the primary goal for a law reformer seeking to adopt elements from foreign legal systems should be identify a concept that can be seamlessly integrated into the

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[292] ibid.

[293] Deval Desai and Michael Woolcock, ‘Experimental Justice Reform: Lessons from the World Bank and Beyond’ (2015) 11 Annual Review of Law and Social Science 155, 174; Ajani (n 39) 39.

[294] Presidency (n 47); Juan Carlos Botero and others, ‘Judicial Reform’ (2003) 18 The World Bank Research Observer 61, 88; Anthony Wanis-St John, ‘Implementing ADR in Transitioning States: Lessons Learned from Practice’ (2000) 5 Harvard Negotiation Law Review 339.

[295] Tshuma (n 39).

[296] See: Richard L Abel, ‘Law and Society: Project and Practice’ (2010) 6 Annual review of law and social science 1.

[297] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2) 95.

[298] ibid 95–6.

domestic law.[299] While having a thorough understanding of the donor system's legal or political structures might enhance the reformer's effectiveness, it is not a prerequisite for successful legal borrowing. Indeed, the adaptation of foreign laws can be accomplished even in the absence of detailed knowledge about the political, social, or economic context in which the original law was developed.[300]

The reason behind this is that legal rules are not uniquely crafted for a specific society' but rather can be 'adapted to suit the needs of various nations.[301]. Watson's theory challenges the "mirror theories of law," which posits that law is a reflection of a society's customs, morals and culture. These theories claim that law is not an isolated entity but is instead a reflection of society, shaped by its economy and social structures, where nothing is considered a historical coincidence, and everything is influenced by societal factors.[302] By contrast, Watson views law as an independent component within a social framework, possessing its own intrinsic life and dynamism.[303]

Watson recognised that legal transplants "come in all shapes and sizes."[304] He explains the "transplant bias" observed in Western legal systems is due to the nature of the legal profession itself.[305] Lawyers — whether they serve as legislators, judges, or scholars —form an elite class responsible for the interpretation, preservation, and development of the law. Historical observations allow us to make some generalizations about how lawyers have approached its role. Lawyers as a group tend to be creatures of habit, often viewing legal rules as ends in themselves. When they make changes to the law, they either minimize the perceived extent of these changes or adopt rules from foreign legal systems that are viewed with high prestige and authority.[306] Hoeflich contends that it is the professional tradition and concerns of this group that shape the law, particularly private law, far more than any societal influences.[307] Watsons notes the widespread practice of legal transplantation, along with the persistence of laws that may be ineffective or unsuitable, underscores the relative autonomy of law. [308] He further argues that there is no strong or fixed connection between a rule of private law and the social,

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[299] Watson, 'Legal Transplants and Law Reform' (n 6) 79.

[300] ibid.

[301] ibid 96.

[302] Lawrence M Friedman, *A History of American Law* (2nd edn, Simon and Schuster 1985) 2.The author conceives of law: 'not as a kingdom unto itself, not as a set of rules and concepts, not as the province of lawyers alone, but as a mirror of society. it takes nothing as historical accident, nothing as autonomous, everything as relative and molded by economy and society'.

[303] Alan Watson, 'Comparative Law and Legal Change' (1978) 37 The Cambridge Law Journal 313, 314–315.

[304] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2) 30.

[305] ibid 99.

[306] William Ewald, 'Comparative Jurisprudence (II): The Logic of Legal Transplants' (1995) 43 The American Journal of Comparative Law 489, 503 <https://academic.oup.com/ajcl/article/43/4/489/2571861> accessed 8 June 2021.

[307] Hoeflich (n 34) 1085.

[308] See Alan Watson, 'Law out of Context' (2000) 4 Edinburgh Law Review 147.

political, or economic context from which it arises, suggesting that law does not necessarily reflect society.[309]

2.2.2. Transplants are Impossible

At the other extreme, Pierre Legrand, a comparative legal sociologist, has consistently argued since the mid-1990s that the concept of legal transplant is inherently impossible.[310] In his critique of Watson's approach in 1997, Legrand contends that the idea of 'legal transplants' is precariously grounded in analogies, specifically mechanical ones. In its promotion of an exaggerated form of positivism, this approach fails to acknowledge and articulate the complex, multi-layered interactions within a social system. By refusing or being unable to recognize that law serves as a medium for the ideological reframing of deeply rooted cultural values, this perspective overlooks a significant aspect of reality, which persists regardless of such denial.[311]

Legrand's argument builds upon epistemological principles and anthropological theory, asserting that law cannot be detached from its cultural and societal context. He posits that law only exists when it is interpreted and applied within a specific "interpretative community."[312] In Legrand's view, the law is shaped by myths and narratives that are deeply rooted in a particular culture, and these elements can only be imperfectly understood through translation, making it unrealistic to expect the law to produce the same effects in a different cultural context.[313] He argues that the transplantation of legal rules is impractical because interpreting and applying a rule in the receiving society necessitates an interpretation process unique to that society. To truly transplant a legal rule, one would also need to transplant the legal interpreters from the originating country.[314] Legrand's position, which requires the transplanted rule to retain an identical meaning in its new environment as in the original, may be viewed as overly stringent. Most scholars, particularly legal sociologists, agree that local adaptation is necessary during legal transplantation, which might require both the terminology and the meaning of the transplanted rule to evolve from the original. The core of the debate between Watson and Legrand lies in how legal changes occur during transplantation: Watson sees it as a natural and expected outcome, while Legrand views it as evidence of the transplant's failure.

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[309] See Alan Watson, *The Evolution of Law* (Blackwell 1985).

[310] Pierre Legrand, 'The Impossibility of Legal Transplants' (1997) 4 Maastricht Journal of European and Comparative Law <https://heinonline.org/HOL/Page?handle=hein.journals/maastje4&id=115&div=13&collection=journals> accessed 15 May 2018; Pierre Legrand, 'What "Legal Transplants"?' (2001) 55 Adapting legal cultures 67, 55.

[311] Legrand, 'The Impossibility of Legal Transplants' (n 66) 122.

[312] David Nelken and Johannes Feest, *Adapting Legal Cultures* (Hart Pub 2001) pt Introduction <https://books.google.co.uk/books?hl=en&lr=&id=88TbBAAAQBAJ&oi=fnd&pg=PA55&dq=what+legal+transplants&ots=5KxotHivy7&sig=j0VG5Fs6Kv043udNYfG2cSdmxYE#v=onepage&q=what legal transplants&f=false> accessed 23 March 2019.

[313] ibid 3.

[314] Legrand, 'The Impossibility of Legal Transplants' (n 66) 114.

In recent years, the perspectives offered by Watson, who argues that legal transplants are socially "easy", and Legrand's assertion of the impossibility of legal transplant have been increasingly viewed as extreme by mainstream legal scholars. The current consensus tends to adopt a more moderate stance. As Cohn articulates, these polarized viewpoints have largely given way to a more nuanced middle ground, where scholars reject both Watson's overly optimistic view of effortlessly successful transplants and Legrand's outright dismissal of their feasibility. [315] Contemporary research has shifted towards a culturalist approach, where outdated legal formalism has been replaced by realist, socio-political, and cultural theories that treat law as a dynamic social construct.[316] Within this framework, legal culture is recognized as a crucial factor in determining the success of legal transplantation. Rather than seeing legal systems as entirely isolated or hermetically sealed, this perspective acknowledges that while law is deeply embedded in its cultural and social context, it is also open to various external influences, including those from foreign legal systems.[317]

2.2.3. Transplants are Feasible but Difficult

Between Waston's 'socially easy' and Legrand's 'impossible', Kahn-Freund argues that not all legal rules or institutions are transplantable (or non-transplantable), but "there are degrees of transferability" that falls along a continuum, ranging from organ transplants to mechanical transplants.[318] Kahn-Freund also proposed criteria for assessing the transferability of legal rules and institutions, building on Montesquieu's viewpoint that it would be "*un grand hazard*"- an extraordinary and rare occurrence - if the institutions of one nation could effectively function within another.[319] He suggested that if a foreign legal system's rules fit well within another country's legislative framework, it is a great coincidence.[320] Thus, Kahn-Freund argued that legislative transplantation is often challenging and should not be assumed to be easily achievable. In other words, legislative transplantation can, to Kahn-Freund's mind, prove to be difficult between the donor and the recipient countries, and one should not take it for granted that parts of the donor's legal system may be readily transplantable into the recipient's system.

This complexity raises questions about the obstacles to successful legal transplantation. Kahn-Freund identified two critical groups of variables that could hinder this process: environmental factors, such as differences in geography, society, economy, and culture, and "purely political" factors, including the nature of governance.[321] He acknowledged that over the two centuries

[315] Margit Cohn, 'Legal Transplant Chronicles: The Evolution of Unreasonableness and Proportionality Review of the Administration in the United Kingdom' (2010) 58 American Journal of Comparative Law 583, 587–88 <https://academic.oup.com/ajcl/article-lookup/doi/10.5131/ajcl.2009.0048> accessed 23 March 2019.

[316] ibid.

[317] ibid.

[318] Kahn-Freund (n 3) 6.

[319] ibid.

[320] ibid 7.

[321] Eric Stein, 'Uses, Misuses--and Nonuses of Comparative Law' (1977) 72 Northwestern University Law Review 198, 199.

since Montesquieu, the significance of geographical, economic, social, and cultural elements has dramatically diminished due to industrialization, urbanization, advances in communication, and increased human mobility. [322] These developments have given rise to a process of economic, social, and cultural assimilation or integration among developed countries (and within the dominant classes of developing countries)[323], which has substantially reduced the environmental barriers to legal transplantation.[324]

However, Kahn-Freund believed that political factors have become increasingly important, given the growing divergence in political systems, which can avoid or hinder the successful transfer of legal institutions from one country to another.[325] He identified three stages of political differentiation: First, the divide between the communist and non-communist worlds and between dictatorships and democracies within the capitalist world, where, despite similarities in livelihoods, the role of pressure groups like independent trade unions and employers' associations differ.[326] Second, the variations on the democratic types include the presidential model developed in the U.S. and the parliamentary model in the UK, as well as countless mixtures, such as the French Constitution of 1958 and the German Basic Law of 1949.[327] And third – and in many ways, to Kahn-Freund, the most essential differentiation –the vastly increased influence of organized interests in creating and maintaining legal institutions.[328] By organized groups, they referred not only to those representing economic interests but also to those advocating cultural, religious, and charitable causes, all of which share in political power, with the extent of their influence and the manner in which it is exercised varying from one country to another.[329] He cited examples of the Catholic Church's political power in Ireland, which led to the rejection of new developments in divorce and alimony laws[330] that had successfully been transplanted from Australia and New Zealand to the United Kingdom and had influenced similar reforms in Canada, New York, Japan, and Scandinavian countries.[331] Kahn-Freund concluded that one cannot assume that rules and institutions are easily transferable. Any effort to apply a legal framework outside its original environment carries risks of rejection.[332] He hoped that the awareness of this risk would not deter legislators in any country from employing the comparative method. However, he emphasized that such use requires knowledge not only of the foreign law but also of its social, and especially its political,

[322] Kahn-Freund (n 3) 9.at 9

[323] Watson, *Legal Transplants: An Approach to Comparative Law* (n 4) 8.

[324] Stein (n 77) 199.

[325] Watson, *Legal Transplants: An Approach to Comparative Law* (n 4) 13.

[326] ibid 11.

[327] ibid 12.

[328] ibid.

[329] ibid.

[330] That is, according to Kahn-Freund, the acceptance of the new idea in various legal systems that divorce is a relief of the misfortune of marriage failure rather than "a redress for fault or sin" See Kahn-Freund, above Kahn-Freund (n 3) 14.

[331] ibid

[332] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2) 27.

context. The practical application of comparative law becomes problematic only when it is guided by a legalistic mindset that overlooks the law's broader context.[333]

2.3 Criteria for Successful Legal Transplants

Beyond the issue of the 'feasibility' of legal transplants, there is also little consensus on how to assess whether a particular transplant is successful or unsuccessful. Teubner stresses that the results of legal transplantation are rarely clear-cut; instead, they often fall somewhere in between the success and failure.[334] Nelken supports the idea that defining successful legal transplants is inherently challenging due to the significant variations in practice across different contexts. He points out that legal transplants occur in diverse regulatory areas, each with unique purposes, and are implemented within distinct social and legal environments. These differences make it difficult, if not impossible, to establish a universal standard for evaluating the success of legal transplants.[335]

Wise[336] and Dezalay and Garth[337] notice that regulators have the tendency to give local rules international names or labels. As a result, they argue that for a legal transplant to be considered successful, the substantive role must also be effectively transplanted. However, the relationship between the label and the substance can be problematic. For example, Berkowitz et al. highlight that the substance of the rules must be tailored to fit local circumstances to avoid adverse

[333]Watson, *Legal Transplants: An Approach to Comparative Law* (n 4) 27.

Watson challenged the fundamental tenets of Kahn-Freund's thesis in his theory of legal transplants. To Watson's mind, Kahn-Freund's pessimistic view of legal transplants is not borne out by history, which clearly shows that successful transplantation from very different legal systems has frequently been accomplished. Watson believes that systematic knowledge of the foreign donor system is not necessary. He refers to the reception of Roman law by Western Europe in the Middles Ages as a principal illustration of successful legal transplantation. He finds it questionable whether environmental factors are nowadays less important than political factors. He maintains that it is enough to look at the recipient's power structure to assess whether the donor's law could be successfully introduced into the recipient. Hence, for instance, the success of the transplant of Western law into Japan was due to the "Japanese desire for it, not their knowledge of the French and German political context or any similarity of that political context with what existed in Japan." Watson, 'Legal Transplants and Law Reform' (n 6). There was no further response from Kahn-Freund, who died in 1979. Stein provided a balanced summary of the perspectives of both scholars, distinguishing between their approaches by labeling Kahn-Freund as a "Lawyer-Sociologist" and Alan as a "Legal Historian." In making this distinction, Stein highlighted that Alan often took a "macro-legal" perspective, focusing on significant legal transplants that stand out as key events in the broader scope of global history. On the other hand, Kahn-Freund was more inclined toward a "micro-legal" approach, with a particular focus on contemporary law reform. Stein (n 77) 199.

[334] Teubner (n 10) 17.

[335] David Nelken, 'The Meaning of Success in Transnational Legal Transfers' (2001) 19 Windsor YB Access Just. 349.

[336] Wise (n 20) 9–10.

[337] Yves Dezalay and Bryant Garth, 'The Import and Export of Law and Legal Institutions: International Strategies in National Palace Wars' in Johannes Feest David Nelken (ed), *Adapting Legal Cultures*, vol 241 (Oxford, Hart Publishing 2001) 241–56.

"transplant effects".[338] Consequently, when the label and the content are separated, a successful transplant might only involve the content adapting independently.[339]

The traditional Watsonian approach to legal transplants considers the mere existence of a specific rule in the receiving country's law books as a marker of success. However, this approach might overlook whether the rule is actually followed or effectively implemented. For example, Daniel notes that while Indonesia has adopted an Anglo-American corporate governance code, most listed firms do not adhere to it, raising questions about whether this should be viewed as a successful transplant.[340]

Miller suggests another criterion for success: the receiving society must actively follow the transplanted norm.[341] However, Kanda and Milhaupt's (2003) study of fiduciary duties in Japan demonstrates that a legal transplant may require substantial time before it is fully integrated and applied, as seen in the 30-year gap before the law was enforced in court.[342] This delay reflects a society's "immune system," which can either resist or slowly adapt to the transplant.

Mattei offers additional criteria for assessing the success of a legal transplant. According to Mattei, the transplant is successful if it results in the same social outcomes as it did in its originated country.[343] Nevertheless, empirical evidence indicates that this is not always the case. For example, La Porta et al theorized that strong minority shareholder protection would lead to greater ownership dispersion in listed corporations.[344] However, Cankar et al. found that after Slovenia strengthened minority shareholder protections, ownership of listed firms actually re-concentrated.[345]

Larsson-Olaison suggests a novel approach to understanding legal transplants, moving away from the traditional dichotomous perspective that views them as either successful or

[338] Berkowitz, Pistor and Richard (n 37) 168–69.

[339] Ulf Larsson-Olaison, 'Convergence of Corporate Governance Systems: A Legal Transplant Perspective' (2020) 5 Competition & Change 450, 6.

[340]William E Daniel, 'Corporate Governance in Indonesian Listed Companies-A Problem of Legal Transplant' (2003) 15 Bond Law Review 345.

[341] Jonathan M Miller, 'A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process' (2003) 51 The American Journal of Comparative Law 839, 843.

[342] Hideki Kanda and Curtis J Milhaupt, 'Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51 The American Journal of Comparative Law 887, 897–900 <https://academic.oup.com/ajcl/article-lookup/doi/10.2307/3649132> accessed 13 December 2018.

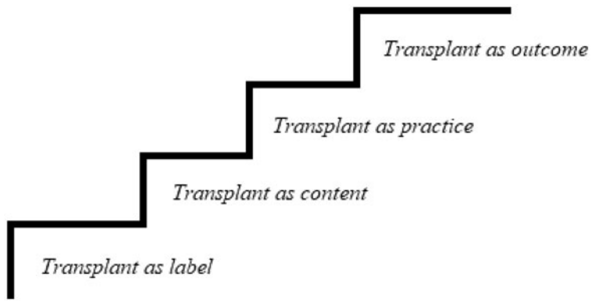
[343] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics' (1994) 14 International Review of Law and economics 3.

[344] Rafael La Porta and others, 'Law and Finance' (1998) 106 Journal of political economy 1113; Rafael La Porta and others, 'Corporate Ownership around the World' (1999) 54 The journal of finance 471 <https://onlinelibrary.wiley.com/doi/full/10.1111/0022-1082.00115>.

[345] Nina K Cankar, Simon Deakin and Marko Simoneti, 'The Reflexive Properties of Corporate Governance Codes: The Reception of the 'Comply-or-explain'Approach in Slovenia' (2010) 37 Journal of Law and Society 501, 514.

unsuccessful. Instead, he introduces a "staircase metaphor" to represent the varying degrees of success that a legal transplant can achieve. This metaphorical model allows for a more nuanced evaluation, recognizing that success is not a binary outcome but can exist at different levels or stages. The staircase metaphor illustrates various levels of success applied to assess the success of a legal transplant at a particular time.[346] This means that as a legal transplant progresses, it may achieve varying levels of success, each represented by a step on the staircase. Importantly, Larsson-Olaison emphasizes that this model is not normative; it does not suggest that reaching a higher step is inherently better than remaining on a lower one. The metaphor is intended to provide theoretical clarity, which in turn can enhance empirical research by offering a more precise framework for analyzing and comparing legal transplants.

Figure 2.1 The transplant staircase[347]



Scholars typically rely on three criteria to evaluate the success of legal transplants: formal convergence with the original system, functionality in the host context, and the attainment of policy objectives.

2.3.1 Form and conception

Scholarly debate has focused on the degree of similarity required between a transplanted legal norm and its source model for the transplant to be deemed successful. Central to this discussion is whether success should be measured by textual resemblance, functional equivalence, or conceptual continuity. A conceptual approach, concerned with the transmission and transformation of legal meaning, offers a more analytically useful lens for evaluating convergence than strict formal or linguistic parallels.

Watson’s view reflects a formalist understanding of convergence. He considers a transplant successful when legal rules appear “expressed in apparently similar terms” or demonstrate “obvious similarities both of substance and of formulation” between the source and recipient systems.[348] In his account, the continued use of shared terminology—even where little of the underlying rationale or structure has been retained—may suffice to indicate success, provided

[346] Larsson-Olaison (n 95) 458.

[347] ibid 456.

[348] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2) 20,23.

the transplanted rule is not rejected and remains operative over time.[349] In this way, Watson treats the transplantation process as largely complete once the rule is domesticated within the recipient legal order, irrespective of subsequent divergence in function or institutional context.

By contrast, Legrand adopts a far more exacting standard, grounded in the belief that legal rules are inseparable from the cultural and epistemic frameworks in which they are embedded.[350] On his account, a legal transplant can only be considered successful if both the propositional content and the socio-cultural meaning of the original rule are preserved in the recipient jurisdiction. This implies that formal convergence requires not merely terminological or doctrinal similarity, but a replication of the legal concept itself—a condition that, in comparative practice, is rarely attainable.[351] While Legrand's critique draws attention to the limits of formal equivalence, his criteria are arguably too rigid to accommodate the realities of legal diffusion, which often necessitate adaptation and contextual negotiation.

A conceptual approach shifts the focus from surface-level identity to the underlying institutional logic and normative objectives driving a rule. From this perspective, a legal transplant need not copy the form or language of the original provision, so long as it reflects the same basic ideas or serves comparable functional purposes. Formal convergence, then, is understood as the internalization of a shared conceptual architecture rather than as the reproduction of exact legal expressions.

It also explains the evolutionary and chronological character of legal development. The transplanted norm changes as they interact with local institutions, political systems, and legal cultures. Therefore, the issue is not whether the transplanted rule stays the same but rather whether its conceptual roots remain clear and active in the new setting. It could be considered a successful transplant if the rule keeps reflecting the fundamental rationale or governance function of the original—albeit in a locally changed form.

To evaluate the success of transplanting the independent director system into China's corporate governance framework based on the criterion of form convergence, the transplanted legal institution should reflect the conceptual equivalent of its original model, particularly the U.S.. Although the exact formal borrowing is not absolutely required, the transplanted institution must preserve the essential rationale underlying independent directorship—that of an independent board member who oversees, mitigates managerial agency problems, and protects minority shareholder interests. In China, however, the political and institutional environment has significantly shaped the adaptation of the concept. Although the terminology and the concept have been adopted, the degree to which the transplanted institution preserves its conceptual function is debatable. If local changes, such as appointment processes dominated by controlling shareholders or weak enforcement of fiduciary duties, undermine the capacity of independent directors to exercise their oversight, the transplant risks losing the

[349] ibid 97.

[350] Legrand, 'The Impossibility of Legal Transplants' (n 66) 117; Legrand, 'What "Legal Transplants"?' (n 66).

[351] Legrand, 'The Impossibility of Legal Transplants' (n 66) 117.

conceptual consistency. Therefore, such inconsistency of adapted rule and the local context may have further implications in its functions and objectives aimed to achieve.

2.3.2 Function

From the functional approach, the success of legal transplant is evaluated in terms of whether achieving intended purpose within the recipient jurisdiction. This approach turns attention form formal or conceptual alignment with the original model to the practical utility and outcome of the transplanted rule in addressing the specific needs of the adopted legal system. It contends that a transplant should be considered successful if it accomplishes the objectives set by the domestic policymakers, regardless of whether it mirrors the rule's concept in its original country.[352] Defining the criterion of success lies in the transplanted law's ability to fulfil its intended functions in the host jurisdiction, tailored to local conditions and institutional environments. It rightly emphasizes that legal borrowing is often motivated by the aspiration to solve particular problems or fill regulatory gaps within the recipient country, rather than to replicate foreign models for their own sake.

However, a purely function-oriented evaluation of legal transplantation is not without limitations. The objectives behind transplantation are often multiple, ambiguous, and subject to change over time. What may have constituted a central policy aim at the time of adoption may be less relevant or be supplanted by new priorities as the legal, economic, or political context evolves. Furthermore, evaluating whether a rule has achieved its goals frequently requires engagement with broader social, political, and economic data, thus straddling the boundary between legal analysis and sociological inquiry.

The functional success of China's transplantation of the independent director system may be evaluated by examining whether the institution is performing its intended legal functions within the Chinese corporate governance framework. Drawing from the U.S. corporate governance model, the core purpose of independent directorship lies in providing objective oversight, enhancing board accountability, and protecting minority shareholders from abuses of power—particularly those stemming from managerial opportunism. In China, the introduction of the independent director system intended as a technical solution to long-standing governance issues, especially within listed companies where ownership is highly concentrated, and state influence is pervasive. Accordingly, the benchmark for functional success is whether the transplanted institution has become operational in a way that allows it to fulfil these key governance objectives in the Chinese context.

To assess this, one must consider not only the legal framework on paper but also its practical application in corporate decision-making, regulatory enforcement, and judicial review. This includes evaluating whether independent directors are genuinely empowered to monitor managerial conduct, whether they exercise meaningful influence in board decisions, and

[352] TT Arvind, 'The 'Transplant Effect'in Harmonization' (2010) 59 International & Comparative Law Quarterly 65; Ling Zhou, 'The Independent Director System and Its Legal Transplant into China' (2011) 6 Journal of Company Law 262.

whether their presence has led to greater protection for minority shareholders or improved disclosure standards. However, as in all legal systems, such functional assessments are inherently difficult to quantify with precision. Even in jurisdictions where the institution originated, the effectiveness of independent directors remains contested and often varies by firm or sector.

It is also crucial to acknowledge that the performance of the independent director system in China may be constrained by structural or contextual factors that lie beyond the transplantation process itself. These include political considerations, weak regulatory incentives, the dominance of controlling shareholders, and the absence of robust civil or class action enforcement mechanisms. As such, a lack of visible success in terms of outcomes does not necessarily indicate a failure of the transplant *per se* but may instead reflect broader systemic limitations. The appropriate criterion for success, therefore, should be whether the independent director institution has taken root within the Chinese corporate governance regime and is capable—at least in principle—of performing its intended legal functions. Using the metaphor of botanical transplantation, it is not essential that the plant flourish immediately; rather, success is signalled by its capacity to survive and potentially adapt to local soil conditions over time.

2.3.3 Enforcement

From the perspective of legal enforcement, a successful transplant requires more than formal and functional adoption of a legal rule into the recipient's legal frameworks, it requires that the rule be actively enforced and implemented by the relevant legal actors.[353] In this view, the core criteria for evaluating success lies in the extent to which the transplanted law is used through enforcement mechanisms (judicial, administrative, or regulatory), and thereby has real legal impacts.[354] A transplanted rule that remains only in books, not invoked in legal proceedings, or unenforced by courts and relevant parties cannot constitute a meaningful legal reform.

The regular and consistent enforcement of a transplanted rule serves as a strong indicator that the institution has taken root within the recipient legal system. Enforcement reflects not only institutional capacity but also the normative acceptance, which suggests the rule's functional embedment within the legal culture. No enforcement indicates the failed transplant.[355] However, as legal enforcement of a transplanted rule may take time to develop, especially in the early stage of transplantation.[356] During the initial period, enforcement may be weak, inconsistent, or even absent. It is not necessarily because the transplant has failed, but because institutions, regulators, and society are still adjusting to the new rule. The rule might still become effective in the future as the legal system, regulatory bodies, and market actors gradually learn how to

[353] Berkowitz, Pistor and Richard (n 37); Katharina Pistor and Philip A Wellons, *The Role of Law and Legal Institutions in Asian Economic Development, 1960-1995* (Oxford University Press 1999) 12.

[354] Daniel Berkowitz, Katharina Pistor and Jean Francois Richard, 'Economic Development, Legality, and the Transplant Effect' [2003] European Economic Review 2.

[355] Kanda and Milhaupt (n 98) 890.

[356] Kanda and Milhaupt (n 98).

implement and comply with it. Thus, the success or failure should be assessed longitudinally, paying attention to the gradual development of enforcement capacity and demand.

Importantly, the criterion of enforcement success does not require that the transplanted rule be applied identically to its use in its origin country. While the original model may serve as reference, local institutional contexts and normative priorities may shape the way in which the law is enforced in the recipient country.[357] What matters is not strict fidelity to foreign precedent, but whether the rule is enforced in a manner that preserves its essential function and contributes meaningfully to the purposes for which it was introduced.

In this regard, enforcement serves as both a formal and functional marker of legal transplants. It shows the operational vitality of the transplanted rule and reflects the recipient system's willingness to subject legal actors to its authority. Therefore, when evaluating the success of legal transplantation through the lens of enforcement, the key inquiry is whether the transplanted law has moved beyond paper and become a functioning instrument of regulation or adjudication within the local legal order. Where that threshold is met—even with local variations in application—the transplant may be considered effective from an enforcement standpoint.

2.4 Conditions for Successful Legal Transplants

What conditions are necessary for a successful transplant is another unsettled debate in legal transplants scholarship. Given the complexity and intricacy of the phenomenon, determining these conditions is far from straightforward. The current literature suggests the following factors should be taken into account.

2.4.1 Transferability of the Rules

The concept of transferability refers to the chance that a legal rule can be effectively adjusted to fit the receiving system, or conversely, the risk that it might be rejected following transplantation.[358] This notion is central to assessing the potential success of a legal transplant.

As noted in section 2.2, Kahn-Freund suggests that legal rules exist on a spectrum. On one end are "organic" rules, which are deeply embedded in the social, cultural, or political context of the originating system and are therefore difficult to transplant. These rules are more likely to be rejected if they are exported to a different environment. On the other end are "mechanical" rules, which are more context-independent and can be transplanted more easily.[359] The extent to which a legal rule is adjustable or prone to rejection determines its place on this continuum.[360]

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[357] H Patrick Glenn, *Legal Traditions of the World: Sustainable Diversity in Law* (Oxford University Press, USA 2014).

[358] Kahn-Freund (n 3) 6–7.

[359] ibid.

[360] Teubner builds on this idea by introducing the concepts of "tight coupling" and "loose coupling" of legal rules with relevant social processes. He argues that even in cases where there is loose coupling, meaning the rule is not tightly

It is generally assumed that the higher the transferability of a legal rule, the more effective its transplantation is likely to be. Kahn-Freund advises law reformers to give careful consideration to the transferability of a rule before proceeding with legal transplantation. This consideration can be helpful in identifying the specific contexts within the source system that are linked to the rule, as well as the challenges that may arise in the recipient system.[361]

However, figuring out the transferability of a legal rule is not a straightforward task as it is possible for contextual factors to present significant challenges. Kahn-Freund emphasizes that the degree to which a rule is related to the power structure of the legal system where it was initially enacted is a significant factor in determining whether or not the law can be transferred.[362] For instance, constitutional models are particularly challenging to transplant because they involve the distribution of political power and the management of local relationships. These rules are deeply interwoven with the political context, making their successful transplantation less likely.[363] By contrast, company and commercial law are usually regarded to be more easily transferable, even to a receiving legal system with completely different contextual background as the fact that these laws are neutral in cultural aspects.[364]

2.4.2 Local Adaptation

Local adaption consists of transplant adaption and enforcement adaption. Transplant adaptation occurs when law reformers in the recipient nation first import a legal rule from its original legal system through legislative action. Örücü use the metaphor of "transposition" to describe this phase, where law reformers choose from among various models available in foreign legal systems and modify the selected model to fit the local context before legislating it as part of domestic law.[365] As demonstrated by Berkowits et al. in their empirical studies, this process of "transposition" is crucial to guarantee that the transplanted rule is context-specific and relevant to local law users, thus enhancing its effectiveness and application.[366] When foreign law is adopted in the way that takes into account the specific requirements and circumstances of the host country, it has positive effects on the efficiency of the legal institutions in the receiving country. By contrast, if the transplanted rule fails to address the main contextual challenges, the transplanted rule may either be disregarded or applies inconsistently with the intention of the original model.[367]

linked to its original context, the transplantation process is not mechanically easy, as Kahn-Freund might suggest. Teubner (n 10) 18.

[361] Kahn-Freund (n 3) 17.

[362] ibid 13.

[363] ibid

[364] Roger Cotterrell, 'Is There a Logic of Legal Transplants' (2001) 71 Adapting legal cultures 82.

[365] Örücü (n 18) 207.

[366] Berkowitz, Pistor and Richard (n 37) 174.

[367] ibid.

The success of transplant adaptation is closely tied to the law reformers' ability to make well-informed decisions when selecting the appropriate model of transferring legal rules from multiple options in foreign legal systems[368] and making the necessary modifications to suit local contexts and needs.[369] Extensive comparative research and economic analysis serve as important tools for law reformers in this process.[370]

Following the initial adoption, the second phase of local adaptation is enforcement adaptation, which occurs through the interpretation and application of the transplanted rule by local legal institutions. Örücü refers to this process as "tuning,"[371] where local actors—judges, lawyers, and other legal intermediaries[372]—gradually internalize the borrowed law, adapting it further to the local context through its enforcement.

Enforcement adaptation is crucial because it involves the dynamic process of trial, error, and correction as the rule is applied in practice. This phase is where the transplanted rule is refined and integrated into the recipient legal system. The effectiveness of this process depends heavily on the adaptability and competence of local legal actors. They must not only apply the rule but also possibly modify the functioning of local institutions to accommodate the new rule, especially when faced with challenges arising from contextual differences. The success of enforcement adaptation is also contingent on the earlier stage of transplant adaptation. If the initial choice of the rule model was inappropriate or poorly adapted, enforcement adaptation becomes more challenging. However, effective enforcement adaptation can still enhance the operation of the transplanted rule, ensuring that it evolves and becomes an integral part of the recipient legal system.

2.4.3 Social Demand for Transplant

The success of a legal transplant relies not solely on the conditions provided by the donor country but equally on those that exist in the receiving country. For legal institutions to function effectively, there must be a pre-existing societal demand for the law, ensuring that it is actively utilized rather than just existing on paper.[373] Social demand for the law refers to the extent to which there is a social need or desire for the transplanted rule. Legal transplants are not always driven by existing social demand; sometimes, they are imposed or introduced without a clear need in the recipient society. In these cases, even a well-transplanted legal rule may become

[368] ibid 180.

[369] The extent of modification necessary during transplant adaptation can vary. Langer identifies three approaches to adaptation: Strictly literal translation (or "copy and paste"), which involves minimal change; Faithful but autonomous restatement, which balances fidelity to the original context with meaningfulness to the local context; Substantial recreation, which prioritizes utility in the recipient country over adherence to the original context. Langer (n 17) 33–34.

[370] Berkowitz, Pistor and Richard (n 37) 180.

[371] Örücü (n 18) 207.

[372] Berkowitz, Pistor and Richard (n 37) 174.

[373] ibid 167.

nothing more than a dead letter, unused and unenforced, because it does not address any pressing local issues or needs.

A lack of demand for a transplanted legal rule can stem from various factors, including the absence of an actual societal need, the existence of local alternative rules, or a general unawareness of the rule among the populace. There is a strong correlation between the necessity of the legal rule within the society and the reasons behind the transplantation.[374] Law reformers ideally take local demand into account when determining transplant a law, particularly in cases where the transplantation is voluntary and intended to address a specific legal issue.[375]

2.4.4 Knowledge of the Rule and Other Factors

Another critical factor for the successful transplantation of a legal rule is the level of awareness and understanding of that rule among the population in the receiving country. Berkowitz et al. contend that the effectiveness of a transplanted legal rule largely depends on how well the local population grasps the rule and the values underpinning it.[376] A thorough understanding of a borrowed legal rule among the general public can increase the demand for that rule, thus enhancing the likelihood of its successful integration. For legal professionals to effectively apply a borrowed rule, they need to comprehend not only its wording but also the underlying concepts, values, and its place within the broader legal framework.[377]

Unfortunately, history shows that the misunderstanding of rules is common.[378] Achieving a complete and entirely accurate understanding of a borrowed rule, even among legal professionals, may be an unrealistic expectation. The degree of knowledge required for a successful legal transplant varies: the higher level of understanding, the more likely the transplant is to be effective.[379]

Apart from the above conditions, Watson points out that chance and mistakes also influence the success of legal transplants. Sometimes, a legal rule can become influential even if it is misunderstood or if its transplantation process involves errors.[380] These random elements add complexity to predicting the success of a legal transplant.

To sum up, the success of legal transplantation depends on a multifaceted set of conditions, including the rule's transferability, local adaptation efforts, the demand for the rule in society, and the level of knowledge about the rule among the population. While transferability and

[374] Kanda and Milhaupt (n 98) 891.

[375] Fei Deng, 'Legal Transplant as a Device of Legal Change in Transitional Economies: The Case of Importing Common-Law-Style Corporate Fiduciary Duties into Contemporary China' 26.

[376] Berkowitz, Pistor and Richard (n 37) 173.

[377] ibid.

[378] Alan Watson, 'Aspects of Reception of Law' [1996] American Journal of Comparative Law 341.

[379] Deng (n 131) 28.

[380] Watson, *Legal Transplants: An Approach to Comparative Law* (n 2) 99.

adaptation are crucial technical aspects, the social demand and the knowledge base within the recipient country are equally important. Without these, even the most carefully adapted legal transplant might fail to take root. Additionally, the unpredictable roles of chance and mistake suggest that legal transplantation is as much an art as it is a science, requiring flexibility and a deep understanding of both the law and the society into which it is being introduced.

2.5 Legal Transplants on Corporate Governance

2.5.1 Global Initiatives on Corporate Governance

Over the past two decades, international organizations have become increasingly active in promoting cooperation and harmonization within corporate governance frameworks. The Organisation for Economic Co-operation and Development (OECD) was a pioneer in this effort, establishing an intergovernmental task force in 1998 to create globally acceptable standards for corporate governance.[381] In May 1999, ministers from the 29 OECD member states unanimously endorsed the OECD Principles of Corporate Governance (OECD CG Principles). These principles do not prescribe specific corporate board structures or operations but instead provide a flexible framework to help both member and non-member countries develop corporate governance systems that align with their unique institutional and regulatory environments. In June 1999, the OECD and the World Bank agreed to collaborate on improving corporate governance through initiatives such as the annual Global Corporate Governance Forum, Policy Dialogue, and Development Round Tables. That same year, the Commonwealth Association for Corporate Governance (CACG) introduced the "Principles of Corporate Governance in the Commonwealth," aimed at helping countries develop national strategies for promoting good corporate governance, similar to the OECD's efforts.

At the non-governmental level, the International Corporate Governance Network (ICGN) issued a robust statement on global corporate governance principles in July 1999. The ICGN, founded in 1995 by major institutional investors, represents a diverse group of investors, companies, financial intermediaries, academics, and other stakeholders interested in advancing global corporate governance practices. The ICGN principles build on the OECD principles, providing additional guidance on their practical implementation.[382]

At the regional level, the European Commission has initiated numerous projects to foster a common understanding of corporate governance across the European Union. However, the EU

[381] This task force included representatives from 29 OECD member states, the European Union Commission, the World Bank, the IMF, the Bank for International Settlements, and various business, labor, and investment communities, with the aim of proposing principles of corporate governance and ensuring their acceptance and implementation.

[382] International Corporate Governance Network, 'ICGN Global Governance Principles' (1999).revised in July 2005

has not pursued a unified corporate governance code of best practices for all member states, believing that harmonization should evolve in response to emerging needs.[383]

Parallel to these international and regional efforts, there has been a notable rise in the development of corporate governance codes and principles at the national level. Codes of good corporate governance have become increasingly prevalent over the past few decades. The United States in 1978 and the United Kingdom in 1992 were the first major economies to issue such codes, and during the 1990s, these two countries set benchmarks for best practices in corporate governance. Their Anglo-American governance models, focused on board composition, auditor and director independence, shareholder rights protection, financial reporting, disclosure, and transparency, have influenced other economies seeking to drive economic development and growth.[384]

As of now, the European Corporate Governance Institute's (ECGI) database contains over 460 corporate governance codes, principles, and recommendations issued by various international and regional organizations, including the Commonwealth, the EBRD, the Latin American Corporate Governance Roundtable, the OECD, and the UN, as well as by approximately 95 individual countries or jurisdictions worldwide.[385] While the specific content of these codes varies across different economies and business systems, they generally share the goal of enhancing the quality and sustainability of corporate board governance, improving accountability to shareholders, and maximizing shareholder and/or stakeholder value. These efforts to codify corporate governance practices reflect the globalization of the international economy and contribute to the ongoing debate about whether this will lead to global dominance by, or convergence toward, an Anglo-American model of corporate governance.[386]

2.5.2 Convergence, Divergence Debate

As discussed in Chapter 1, corporate governance models differ significantly across countries. In recent years, the debate over whether corporate governance systems worldwide are converging has attracted considerable attention across various disciplines.[387] In the

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[383] Paul Collier and Mahbub Zaman, 'Convergence in European Corporate Governance: The Audit Committee Concept' (2005) 13 Corporate Governance: an international review 753, 754; Marlene Davies and Bernadette Schlitzer, 'The Impracticality of an International "One Size Fits All" Corporate Governance Code of Best Practice' (2008) 23 Managerial Auditing Journal 532, 533–44.

[384] Mario Krenn, 'Decoupling as a Sustainable Firm Response to Pressures for Convergence and Divergence in Corporate Governance: The Case of Codes of Good Corporate Governance' (2014) 15 Journal of Management Policy and Practice 103, 103.

[385] 'Codes' (*ECGI*) <https://www.ecgi.global/publications/codes>.

[386] Collier and Zaman (n 139) 126.

[387] Convergence refers the growing similarity in the governance practices of publicly traded companies across various nations. Scholars differentiate between convergence in form and convergence in function. Convergence in form pertains to the increasing alignment of legal frameworks and institutional structures, while convergence in function implies that although countries may have distinct rules and institutions, they can still achieve similar outcomes, such

provocative work "The End of History for Corporate Law" in 2001, Hansmann and Kraakman argue that the world is moving toward a shareholder-centerc ideology of corporate law, suggesting that the fundamental principle of corporate governance—indeed, the majority of corporate law—have reached a significant level of consistency across various developed market jurisdictions. They further assert that this emerging consensus is already having a profound impact on corporate governance practices globally.[388] Many scholars have concurred with this convergence theory.[389]

However, not all agree that the world is converging toward a shareholder-oriented model where shareholders' interests dominate corporate governance. For instance, Bebchuk and Roe simply dismiss the convergence argument by arguing that corporate governance systems in various countries will never converge despite the powerful forces pressing towards convergence because their structures and rules are path-dependent.[390] There may however be functional convergence where corporates may change their own corporate governance practices by committing to other 'better' systems, in which event formal differences may be functionally relevant but equivalent effects may be attained by way of contractual arrangements.[391]

In a historical sociology perspective, path dependence means "that what has happened at an earlier point in time will affect the possible outcomes of a sequence of events occurring at a later point in time"[392] In the context of law, path dependence theory emphasises the "lock-in"[393] effect and self-enforcement[394] of early legal systems. On the one hand, the existing systems

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as ensuring transparency and managerial accountability. See: Ronald J Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function' (2001) 49 The American Journal of Comparative Law 329.

388 Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2000) 89 Georgetown Law Journal 439, 439 <https://heinonline.org/HOL/Page?handle=hein.journals/glj89&id=461&div=20&collection=journals> accessed 19 June 2021. They argue that the primary factors driving this convergence include the failure of alternative models (such as manager-oriented, labor-oriented, and state-oriented models) to remain competitive in global markets, the pressure of global commerce that pushes firms toward shareholder-value-maximization to attract low-cost capital, and the shift in influence from managers to an emerging shareholder class. See: ibid 443–53.

389 Convergence refers to increasing isomorphism in the governance practices of public corporations from different countries. Researchers have made a distinction between convergence in form and convergence in function. Convergence in form relates to increasing similarity in terms of legal framework and institutions. Convergence in function suggests that different countries may have different rules and institutions but may still be able to perform the same function such as ensuring fair disclosure or accountability by managers. Gilson (n 143) 146; John C Coffee Jr, 'Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1998) 93 Northwestern University Law Review 641.

390 Lucian Arye Bebchuk and Mark J Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127, 132.

391 Gilson (n 143); Coffee Jr (n 145).

392 William H Sewell Jr, 'Three Temporalities: Toward a Sociology of the Event' 262–63.

393 Taylor C Boas, 'Conceptualizing Continuity and Change: The Composite-Standard Model of Path Dependence' (2007) 19 Journal of theoretical Politics 33, 37.

394 James Mahoney, 'Path Dependence in Historical Sociology' (2000) 29 Theory and society 507, 512.

are protected by the interest groups currently enjoying the benefit. On the other hand, the interaction between the new and existing institutions is distinct from that in the first place; the reproduction process would have a “lock-in” effect, making it difficult to abolish.[395]

The competition would force a national system to converge to a successful form when making the change. The success of the US economy makes the US national governance, including its market-centred capitalism and the corporate governance model, prevail worldwide, which has been reinforced by the promotion of international financial institutions such as the International Monetary Fund (IMF) and the World Bank.[396] However, due to the requirement of a legislative process and the high cost of changing the form of legal institutions, functional convergence is generally the first response to the pressure of competition. In sum, compared with formal convergence, functional convergence is more accessible to achieve in practice.

Interest in corporate governance has surged, particularly following major corporate collapses such as Enron, WorldCom, Tyco, and Parmalat at the turn of the century, followed by the global financial crisis of 2008, which many economists consider the most severe financial downturn since the Great Depression of the 1930s. These corporate failures, along with the recent financial crisis, have significantly shaken the institutional norms and foundations of advanced economies. Consequently, the necessary market and regulatory adjustments and settlements are still ongoing. These events underscore the urgent need for robust corporate governance systems to restore investor confidence in business investments. Whether implemented voluntarily or mandatorily, these systems aim to promote and ensure accountability, fairness, responsibility, and transparency within corporations and, by extension, within capital markets worldwide[397]. As regulatory and market adjustments continue, there is speculation about the future direction of corporate governance, with some anticipating that increased complexity and divergence, rather than uniformity and convergence, will emerge.[398]

2.5.3 Legal Transplants and Legal Origin Theory

The convergence-or-divergence scholarship appears to exist alongside the legal transplant thesis discussed in previous sections. However, scholars engaged in the convergence-or-divergence debate do not seem to intersect much with discussions on legal transplants, and vice versa. The legal origin theory on the other hand, rests on the very claim made by Waston that legal transplants are common and ‘socially easy’. Few scholars have had as profound an impact on corporate governance research as Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. Following a series of groundbreaking papers in the late 1990s, they became collectively known as LLSV, with their work sparking significant

[395] ibid 515.

[396] Gilson (n 143) 331.

[397] Thomas Clarke, ‘The Continuing Diversity of Corporate Governance: Theories of Convergence and Variety’ [2016] Ephemera: Theory and Politics in Organization 19.

[398] ibid.

debate and inspiring numerous studies.[399] Rooted deeply in financial economics, LLSV's approach turned law into quantifiable metrics that could be compared and analyzed. This method, unsurprisingly, was not always well-received by legal scholars. Nevertheless, their research has had a substantial academic impact and has also influenced corporate governance reforms globally.[400]

LLSV draws on Watson's concept as a starting point in Law and Finance: stating that laws in various countries are seldom created from scratch; instead, they are often borrowed—either voluntarily or involuntarily—from a few legal traditions.[401] For analytical purposes, LLSV categorized these legal traditions into two main types: common law and civil law. Common law is typically found in Anglo-American countries, primarily the UK and its former colonies. Civil law, on the other hand, is divided into French, German, and Scandinavian subgroups. French civil law is adopted in France, its former colonies, and a few countries influenced by the Napoleonic expansion. German civil law is prevalent in German-speaking countries and some other parts of Continental Europe, as well as in key Asian economies that have modernized on a German model. LLSV classified Scandinavian countries as a distinct subgroup, given their significant differences from those practicing German civil law.

Building on this foundation, LLSV explored the significance of legal origin in understanding legal development. They concluded that legal framework significantly impacts corporate governance. They argue that stronger protection of minority shareholders and creditor rights correlate with more advanced capital markets, both in terms of valuation and diversity[402], and lead to wider ownership dispersion.[403] Subsequent researchers used LLSV's data to demonstrate that well-developed capital markets have a positive impact on a country's economic outcomes.[404] Thus, a key proposition emerging from the LLSV approach is that law shapes capital markets, which in turn influence economic outcomes. This relationship is causal, though LLSV later argues it is not deterministic — belonging to a particular legal "family" (such as civil law) does not mean a country is doomed to poor investor protection indefinitely.[405] For instance, a country could adopt Anglo-American laws and potentially experience greater ownership diffusion and more developed capital markets. According to LLSV, socially easy legal transplants hold true, as legal origin has historically exerted influence through transplantation and continues to shape

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[399] For a review see: Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46 Journal of economic literature 285; Gerhard Schnyder, Mathias Siems and Ruth V Aguilera, 'Twenty Years of "Law and Finance": Time to Take Law Seriously' (2021) 19 Socio-Economic Review 377.

[400] See: La Porta, Lopez-de-Silanes and Shleifer (n 155); Mathias Siems and Simon Deakin, 'Comparative Law and Finance: Past, Present, and Future Research' [2010] Journal of Institutional and Theoretical Economics (JITE)/Zeitschrift für die gesamte Staatswissenschaft 120.

[401] Watson, *Legal Transplants: An Approach to Comparative Law* (n 4) 1115.

[402] Rafael La Porta and others, 'Legal Determinants of External Finance' (1997) 52 The Journal of Finance 1131 <http://doi.wiley.com/10.1111/j.1540-6261.1997.tb02727.x> accessed 25 March 2019.

[403] See:La Porta and others, 'Law and Finance' (n 100) 32.

[404] Ross Levine, 'Law, Finance, and Economic Growth' (1999) 8 Journal of financial Intermediation 8.

[405] La Porta, Lopez-de-Silanes and Shleifer (n 155).

future development. As noted by Dajankov et al., the legal transplantation, rather than the specific local circumstances, significantly shapes how nations regulate and exercise social control over businesses, encompassing areas such as state ownership and regulatory frameworks. This finding challenges traditional regulatory theories, which typically focus on the influence of local industry characteristics and the power of interest groups in shaping regulatory practices.[406]

2.6 Legal Transplants in China

The contemporary Chinese legal system is primarily constructed on Western legal models that have been extensively imported. There are no longer any traditional Chinese legal system in place in China. These include the royal codes and legal apparatus in Tang and Qing dynasties. Despite this, the current system retains certain distinctive features, particularly its strong nationalist and socialist characteristics.[407]

The traditional Chinese legal system, which endured for more than 2,000 years, underwent a fundamental transformation as a result of the rising global markets and the impact of globalization. Despite the enduring influence of the traditional legal culture and ideology, the old legal structure has been completely replaced.

This transition started during the late Qing dynasty and early Nationalist Republic when the royal "ancestor's law and traditional legal system" were discarded in favour of adopting a Western legal framework. Consequently, legal transplantation has become a prominent characteristic of the Chinese legal system.

Following the People's Republic of China (PRC), which was established in 1949, the newly formed government initially rejected the Western legal pattern and instead embraced the Soviet Union's legal pattern. This extensive transplantation process was curtailed in the early 1960s when China broke off relations with the Soviet Union. During the Cultural Revolution, the Soviet-modelled legal system was dismantled. After the Cultural Revolution ended, under Deng Xiaoping's leadership, China began structural reforms and opened its doors to embrace globalization. An initiative was undertaken to enhance the legal system with the aim of restoring the damaged legal framework. Subsequently, China has introduced numerous foreign and international laws and institutions. The Chinese model of legal transplant is characterised by several traits which distinguish it from the experience of many other developing countries.

2.6.1 Integration of Transplanted and Indigenous Concepts

[406] Simeon Djankov and others, 'The New Comparative Economics' (2003) 31 Journal of comparative economics 595, 610.

[407] Chenguang Wang, 'Legal Transplantation and Legal Development in Transitional China' (2013) 4 World Bank Legal Rev. 161, 172.

The guiding principles during this transplantation process are deeply influenced by ideas from the late Qing period, particularly the notion of maintaining a core Chinese identity while adopting Western knowledge for practical purposes or a more contemporary notion of “socialism with Chinese characteristics.” These principles involve organically combining imported laws and institutions with traditional Chinese culture, prevailing ideologies, and unique local circumstances. Thus, China’s legal development has followed a path that diverges from that of Asia, Africa, and Latin America during the 1960s law-and-development movement, which often entails the complete wholesale adoption of Western legal frameworks imposed by foreign experts.[408]

Wang highlights several critical aspects of China’s approach to legal transplantation:[409]

To insist on the nationalistic and socialist character of legal evolution. China is committed to embedding transplanted laws and systems within a legal structure that is deeply rooted in Chinese culture, particularly in alignment with its dominant political ideology.

To focus on addressing and resolving specific Chinese issues. China adopts a pragmatic approach by setting clear objectives for transplanted laws and institutions, ensuring they are aligned with the practical realities of Chinese society.

To insist on national sovereignty and the principle of “taking facts as the basis”. China’s legislative, administrative, and judicial bodies retain the authority to innovate and adapt legal frameworks based on a thorough analysis of the Chinese social context and international demands, ensuring that laws are not blindly borrowed but are instead carefully tailored to fit the Chinese environment.

To insist on integration within the national legal framework. Imported legal concepts are meticulously studied and adapted to ensure their compatibility with existing Chinese laws and systems.

Although there is ongoing debate about the meaning of "Chinese characteristics" and socialism, these principles emphasized by China may effectively safeguard the independence of Chinese legal system, preserving its unique attributes. Therefore, the integration of foreign laws and mechanisms into China’s social and legal framework has been smooth,[410] so that it has avoided the “rejection reaction”.[411]

2.6.2 Selective Transplantation

[408] ibid 172–73.

[409] ibid 173.

[410] ibid 173–74.

[411] Chenguang Wang, ‘Inter Borrowing and Absorption of Legal Systems of Different Countries—An Important Topic in Comparative Law’ (1992) 4 China Legal Science.

Potter articulates the concept of “selective adoption,” which refers to the interplay and nuanced combination of international legal principles with local cultural norms.[412] China’s approach to legal transplantation is not a blind or wholesale adoption; rather, it is largely driven by its own needs. This approach requires careful consideration of the target laws, the problems they aim to solve, the potential social impacts, and the comparative social environments of the countries involved in the exchange. This method ensures that legal transplants are active, purposeful, and selective.[413]

In contrast to other developing countries, which may face external pressure to implement legal reforms as a prerequisite for receiving financial assistance from international institutions such as the World Bank or the International Monetary Fund (IMF), China has found its own path by selective borrowing and transplantation. For example, in the realm of economic law, China has adopted foreign investment and trade laws and regulations in order to attract foreign investors and businesses. Meanwhile, it established a number of rules for foreign currency exchange and joint venture management, thereby maintaining its autonomy over foreign trade operations. Politically, China underscores its commitment to socialism and leadership of the Communist Party, firmly rejecting the Western doctrine of separation of powers. On the other hand, it actively borrows foreign mechanisms that enhance the supervision and control of government power, such as the establishment of anti-corruption bureaus.[414]

This selective transplantation strategy allows China to retain its core values and political structure while benefiting from the most effective aspects of foreign legal systems. Through this approach, China crafts a legal system that is uniquely suited to its national context, avoiding the defect of wholesale legal adoption that may not align with its social, political, or economic realities.

2.6.3 Embracing Openness and Flexibility in Legal Transplantation

China’s reform process is characterized by openness to experimentation and the willing to accept the possibility of failure. While generally adopting an gradual and step-by-step approach to reform, China has also encouraged to take bold and innovative experiments, particularly in legal transplantation. In the aspects of structure and legal framework, especially in reforming specific laws and institutions, China has consistently embraced the bold introduction and adaption of effective foreign laws and mechanisms.

For instance, in the realm of civil law, China has integrated concepts such as the rights to privacy, compensation for spiritual damages, and the principle of adapting to changing circumstances. Similarly, in the fields of commercial and economic law, China has adopted

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[412] Pitman Potter, ‘Selective Adoption and Institutional Capacity Building: Methods of Applying In- Ternational Rules under the Impacts of Globalization’ in Pitman Potter &Gu Xiaorong (ed), *The Hypothesis of “Selective Application” and China’s Legal Practice* (Shanghai Academy of Social Sciences Press 2009).

[413] Wang (n 163) 174.

[414] ibid 174–75.

legal rules and elements form company law, securities law and competition law. China has also actively incorporated elements from the common law tradition, particularly in areas such as banking and commercial law, but primarily rooted in the continental legal tradition.

This blending of legal traditions allows China to create a dynamic and adaptable legal system, one that is capable of meeting the unique needs of its society while also benefiting from the strengths of other legal systems around the world. Through this open and tolerant approach to legal transplantation, China continues to evolve its legal landscape in a way that is both innovative and deeply informed by global best practices.

Concluding Remarks

This chapter has laid the theoretical foundation for evaluating legal transplants by critically examining how legal norms are borrowed, adapted, and implemented across different jurisdictions. Through various metaphors, ranging from medical and botanical analogies to concepts such as legal irritants, translation, and transposition, the chapter demonstrates that legal transplantation is not a uniform or linear process, but rather a complex and dynamic interaction between foreign legal models and domestic socio-political environments.

A central argument developed in this chapter is that the success of a legal transplant cannot be judged solely by formal adoption or textual resemblance to the original model. Instead, success must be evaluated across three interrelated dimensions: conceptual convergence, functional performance, and enforcement. Conceptual convergence requires the transplanted rule to reflect the underlying rationale and purpose of its original context. Functional effectiveness depends on whether the transplanted rule can achieve its intended objectives within the local institutional and cultural framework. Enforcement success, meanwhile, is indicated by the rule’s actual application and regulatory or judicial uptake in practice.

This theoretical framework provides an analytical lens for assessing the transplantation of the independent director system in China—a system formally modelled on Anglo-American corporate governance norms but implemented in a radically different institutional setting. It shows that while legal transplants may be feasible, their success depends heavily on conditions such as the transferability of the rule, local adaptation, societal demand, and institutional understanding. China’s approach to legal transplants highlight that transplantation is often driven by both internal reform goals and external conformity, the adaption to the local context may better serve domestic priorities. This theoretical framework is essential to grasp the gap between the formal presence of independent director system in China’s corporate governance structure and its limited effects. It provides a critical basis for the subsequent comparative analysis by offering the conceptual tools to examine how the independent director system functions in practice, and why, despite continuous reforms, the legal transplant has not resulted in substantive board independence in the Chinese context.

Chapter 3 Independent directors: its origin and transplantation

Chapter 3 explores the origins, functions, and global diffusion of independent directors as a crucial and popular component of modern corporate governance. Section 3.1 begins with the conceptual foundation, analysing the functions of independent directors within boards. Section 3.2 examines the special authority of independent directors and how they contribute to corporate governance.

Section 3.3 traces the historical roots of the board of directors, highlighting how the early corporate governance structure has shaped the modern concept of independent directors, particularly in Anglo-American corporate governance. This section addresses the rise of independent directors in the US, focusing on the shift from advisory boards to monitoring boards. Then, section 3.4 further explores the concept of independent directors, which originally emerged in US corporate governance and has been transplanted into various jurisdictions worldwide. U.K., Germany, Japan, Singapore, and China are chosen to be the main jurisdictions to illustrate the variety of independent directors in their unique legal, economic, and cultural contexts, resulting in significant differences in the role and effectiveness of independent directors. Furthermore, it discusses the challenges and adaptations faced by independent directors in different governance environments, particularly in concentrated ownership structures where their influence may differ significantly from those in dispersed ownership settings.

3.1 The Function of Independent Directors on the Board

Scholars observe that the traditional functions of all members of the board of directors can be broadly categorised into four basic types: monitoring, management, advising and networking. Apart from monitoring, the rest of the functions are for all directors as these board roles do not generate a conflict of interest between the insiders and the shareholders. Independent directors are suitable to be monitored and make independent decisions when a conflict of interest arises. The emphasis on board functions has varied over time and across different firms. In recent decades, however, there has been a trend towards prioritising monitoring at the expense of other functions.[415]

3.1.1 Monitoring

Chapter 1 reviews the main corporate governance problems that arise in different ownership structures. In diffused shareholding companies, a vertical conflict of interest is generated between the corporate insiders and the widely dispersed shareholders. In concentrated shareholding companies with the controlling shareholders, the horizontal conflicts are between the large shareholders and the minority shareholders. Therefore, the monitoring function of independent directors varies significantly in companies with different ownership structures.

[415] Stephen M Bainbridge, *Corporate Governance After the Financial Crisis* (2012) 44.

3.1.1.1 In Dispersed Shareholding Companies

The rise of independent directors is associated with the shift from being primarily an "advising board" to a "monitoring board."[416] In this structure, inside directors make decisions and receive advice from outsider directors. In contrast, independent outsiders are responsible for monitoring these decisions. The rationale for this division is clear: managers' interests often diverge from those of shareholders. Despite all board members having fiduciary duties towards shareholders, proving wrongdoing in corporate decisions is often challenging. Agency costs can manifest in various subtle ways, such as managerial perquisites consumption and wasting corporate resources, favouring low-risk or short-term projects, sub-optimally adjusting investment levels, or resistance to takeover.[417] Therefore, only a broad mandate for monitoring can effectively mitigate these issues.

SOA provides independent directors' sole authority in the audit committee: to hire, oversee, compensate and fire the outside auditors.[418] Besides, they serve in advisory roles on nomination and remuneration committees. The increase of independent directors on the board makes them more involved in hiring CEOs and other senior executive officers, as well as setting their remuneration. When managers know they are being closely monitored by independent directors, they are more likely to make decisions that align with shareholder interests. If they attempt to deviate, independent directors can use their voting rights to intervene.

Observers view independent directors in dispersed companies as primarily acting as the substitute for external regulation.[419] The US Courts and legislatures are cautious about interfering with corporate management's business decisions. Thus, under the Delaware corporate law, the rule that transactions between a corporation and its directors must be fair to the corporation is not strictly enforced as a law. This is because if the board of the corporation has directors who have no conflict of interest in the transaction, and a majority of these disinterested directors approve the transaction after being fully informed, the law does not require additional scrutiny or fairness.[420]

Thus, the primary objective of independent directors is to enhance corporate decision-making and address the issue associated with managerial control over the board. This approach is

[416] Jeffrey N Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (2010) 59 Stanford Law Review 1520–26 <https://heinonline.org/HOL/Page?handle=hein.journals/stflr59&id=1477&div=46&collection=journals> accessed 9 April 2018.

[417] See Chapter 1.5

[418] Sarbanes-Oxley Act of 2002, 15 U.S.C. §301

[419] Donald C Clarke, 'Three Concepts of the Independent Director' (2007) 32 Delaware Journal of Corporate Law 73, 80 <https://heinonline.org/HOL/Page?handle=hein.journals/decor32&id=79&div=8&collection=journals>.

[420] ibid 103–04.

cost-effective for the government and keeps courts and legislators from becoming too involved in corporations' internal affairs.

3.1.1.2 In Concentrated Shareholding Companies

In concentrated shareholding companies, the main objective of corporate governance is to oversee the controlling shareholders and minimize the expropriation of the minority shareholders. The controlling shareholders has the dual role as both the principals and agents, which renders the typical approach of monitoring. In contrast with the board-centered decision-making system in dispersed shareholding companies, jurisdictions characterized with concentrated shareholding adopt the shareholder meeting-centred approach that shareholder carries out both the managerial and monitoring.

However, the majority voting rules favour the controlling shareholder, granting them extensive powers to govern the corporation. Controlling shareholders have decisive power over director appointments. Controlling shareholders have the decisive authority in appointing directors. Directors, including independent directors in companies dominated by controlling shareholders cannot be elected or re-elected without the support of the controlling shareholders, and they remain in their roles only as long as the controlling shareholder desires.[421] This control over the personnel ensures that board decisions align with the controlling shareholder's interests, which may not always align with those of the minority shareholders.[422]

Additionally, social norms often create a sense of obligation or gratitude toward the controlling shareholder, who is responsible for appointing the directors.[423] The current election regime does not provide independent directors with adequate incentives to protect public investors, as their positions are dependent on the controller, not the public investors. Even if a majority of public investors wish to remove them, they will remain on the board as long as the controller desires. Directors' initial election and continued tenure are entirely depend on the controlling shareholder.

This puts the question mark on directors independence in concentrated shareholding companies. For instance, in the context of freeze-out transactions where the controlling shareholder forces out minority shareholders and compensates them with cash or stock, Delaware court have ruled that approval by a special committee of independent directors is not sufficient to eliminate the need for judicial review.[424] The courts have highlighted the controlling shareholders' significant influence in appointing independent directors as a reason for this cautious approach

[421] Lucian A Bebchuk and Assaf Hamdani, 'Independent Directors and Controlling Shareholders' [2017] University of Pennsylvania Law Review 1271, 1287.

[422] Simon Johnson and others, 'Tunneling' (2000) 90 American economic review 22, 22.

[423] Lucian Bebchuk and Jesse Fried, *Pay without Performance*, vol 29 (Harvard University Press Cambridge, MA 2004).

[424] ibid.

In European countries where independent directors are introduced by the non-binding code of best practice recommendations but rather the corporate legal requirement, independent directors do not have particular legal status, authorities and liabilities in contrast with other board members.[425] In other words, corporate law does not specifically recognize independent directors.

In sum, while independent directors in companies with concentrated ownership are expected to monitor conflicts of interest involving the controlling shareholder and protect minority shareholders from expropriation, the corporate decision-making framework does not effectively empower them to perform this monitoring role. Instead, they serve more as a supplementary mechanism to external regulation in addressing issues related to the expropriation of minority shareholders.

3.1.2 Managing

Corporate laws typically grant boards of directors a number of exclusive powers, at least on the surface. For instance, the approval of the board is required for significant corporate actions such as issuing new shares, selling all or most of the company's assets, or amending the corporation's charter.[426] Additionally, any transactions between the company and its senior management or the board members must receive board approval to ensure fairness. However, the majority of board members are outsiders of the company and do not involve in the daily operations. Consequently, the actual management of the company is delegated to senior executives by the board. While boards are allowed to delegate its management managerial function to the senior executives, it retains a crucial role in supervising and evaluating the management's performance of running the corporation.[427]

3.1.3 Networking and Advising

Board members with the diverse background can offer advice and valuable networking opportunities to the company. Compared to inside directors, outside directors affiliated with financial institutions, such as investment banks, commercial banks, law firms, or government, can provide access to networks that help the company acquire more resources. The affiliated business relationship is argued to be an incentive for these directors to monitor the management.[428] Board members with political background may assist the company in navigating business dealings with the government and, more importantly, provide political cover when necessary. Additionally, the outside directors can serve as the brain trust or the consultant.

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[425] German Corporate Governance Code 2022 C6,7.

[426] Bainbridge (n 1). 45

[427] Model Bus. Corp. Act. §8.01(b)

[428] Barry D Baysinger and Henry N Butler, 'Corporate Governance And The Board Of Directors: Performance Effects Of Changes In Board Composition' (1985) 1 Journal of Law, Economics, & Organization 101.

Their independence, expertise and knowledge allow them to offer alternative perspectives to the management and critically evaluate options during the decision-making process.[429]

3.2 The Authority of Independent Directors

3.2.1 Voting Power

Independent directors possess voting rights on all board matters, which serve as their most direct means of executing their oversight responsibilities and enhancing corporate governance.

According to the DGCL, the related party transaction or the conflict-of-interest transaction refers to any dealings between the corporation and its directors or officers. Such transactions are not subject to invalidation if one of the following conditions is met: (1) the relevant details are disclosed or known to the board or a committee, and the transaction is approved by a majority of disinterested directors acting in good faith; (2) the essential facts are revealed or known to the shareholders who then approve the transaction in good faith; or (3) the transaction is deemed fair to the corporation.[430] Once the conflict of interests is observed by the disinterest directors, they can vote against such transactions.

Things may be different in jurisdictions with concentrated ownership. For instance, German law requires approval from the supervisory board, which may lack independence, but only in cases where directors are involved on both sides of the transaction. But for other interested transactions, such conflicts of interest are not recognized.[431]

In sum, independent directors have the ability to oppose self-dealing transactions by casting dissenting votes at the board level. If these directors hold substantial voting influence, such as a majority of board seats, they might be able to block the transaction at this point. However, this opposition does not fully prevent the transaction, as the controlling shareholder can still push it through using their voting power at the shareholders' general meeting. Consequently, while independent directors' opposition may not stop the transaction, it can increase public scrutiny and raise the associated costs for the controlling shareholder, which will be explored further in the next section.

3.2.2 Public Disclosure

Independent directors can pose a threat to the corporate insiders and controlling shareholder by publicly disclosing suspected transactions. First, public disclosure is closely associated with the stock price. Jeffrey Gordon observed the increasing informativeness of stock price meanwhile public companies are required for a more comprehensive disclosure with vast

[429] Bainbridge (n 1) 49.

[430] Delaware General Corporation Law. § 144(a).

[431] Luca Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis' (2000) 2 International and Comparative Corporate Law Journal 297, 317.

amount of information.[432] With enhanced information transparency, external stakeholders no longer face significant information asymmetry with management. The increased reliability and value of stock market signals allow them to use stock price as an indicator of managerial performance.[433] This makes stock prices a more trustworthy signal for capital allocation and monitoring management within the firm and across other organizations. Therefore, the disclosure of suspected transactions would expose managerial malfeasance and cause a decrease in share price, which further damages the benefits of shareholders.

3.3 The Evolution of Independent Directors

3.3.1 The Origin of the Board of Directors

The concept of a board of directors has its roots in the early 17th century with the formation of the East India Company, initially known as the Governor and Company of Merchants of London Trading into the East Indies. This company was granted a Royal Charter by Queen Elizabeth I in 1600, enabling it to commence trading.[434] The governance and management of the company were overseen by the Governor and a "Court of Committee," composed of twenty-four members elected and appointed by the Governor or his deputy.[435] This Court of Committee is analogous to what we now recognize as a modern board of directors, serving as the governing body of the company and delegating executive responsibilities to manage the company's operations in the interest of its shareholders.

Following the establishment of East India Company, English trading companies continued to favour the governance structures cantered around boards. For example, the 1670 charter of Hudson's Bay Company established a governance structure that included the governor, deputy governor and a board of seven committees elected annually by the proprietors of the company.[436] Similarly, the 1711 charter of South Sea Company included provisions for a governor, sub-governor, deputy governor, and a board of directors with thirty members.[437] In 1694, the Bank of England received the Royal Charter from King Willian and Queen Mary,[438] which introduced the term "Court of Directors" in English legal literature.[439] This Court of Directors, consisting of 24 members, was responsible for "ordering the Affairs of the

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[432] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2) 1541.

[433] ibid 1470.

[434] East India Company official Website, 'East India Company' <http://www.theeastindiacompany.com/home/timeline/> accessed 5 November 2017.

[435] Praveen B Malla, *Corporate Governance : History, Evolution, and India Story* (Routledge 2010). 5-6

[436] George Cawston and Augustus Henry Keane, *The Early Chartered Companies (AD 1296-1858)* (The Lawbook Exchange, Ltd 2001). 279-80

[437] William Robert Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720*, vol 1 (The University Press 1912). 205

[438] 'History | Bank of England' <https://www.bankofengland.co.uk/about/history> accessed 28 September 2020.

[439] Ronald Ralph Formoy, *The Historical Foundations of Modern Company Law* (Sweet and Maxwell 1923). 16, 21

Corporation,"[440] paving the way for what would later become known as the board of directors.[441] Over time, the "Court of Directors" evolved into the modern board of directors, centralizing the governance model around the board as the executive body responsible for policy-making and company management. This board-centered governance model places the board at the center of corporate governance, acting as the executive body responsible for making policies and running the company.[442]

The historical development of board-centred governance in English trading companies demonstrates their pioneering role in establishing the board of directors as a corporate governance mechanism.[443]

The early development of board-centred governance in continental Europe is parallel to that in the England. The Dutch East India Company, officially known as the United East India Company (Vereenigde Oostindische Compagnie or VOC), was chartered just two years after the English East India Company. The VOC's charter provided for governance by a general council of sixty governors (bewindhebbers),[444] representing various chambers from Amsterdam, Rotterdam, Delft, Hoorn, Enkhuizen, and Zeeland.[445] However, managing the company with such a large board proved impractical, leading to a reduction to seventeen members. In 1623, the Committee of Nine was created, along with the Accounting Committee, to supervise the governors and hold them accountable.[446] These committees can be seen as early examples of the modern supervisory board in companies that follow the two-tier board model of corporate governance.[447]

The worldwide expansion of English and Dutch corporations in the 17th and 18th centuries likely influenced early American corporations to adopt boards as a corporate governance mechanism. Although the influence might have been subtle due to the dissolution of chartered

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[440] Bank of England, *An Abstract of the Charter to the Governour and Company of the Bank of England* (2008) <http://name.umdl.umich.edu/A23868.0001.001>.

[441] Stanley C Vance, *Corporate Leadership: Boards, Directors, and Strategy* (McGraw-Hill Companies 1983). 1

[442] KN Chaudhuri, *The Trading World of Asia and the English East India Company: 1660-1760* (Cambridge University Press 1978) <https://www.cambridge.org/core/books/trading-world-of-asia-and-the-english-east-india-company/86AB2ECE6301348690C3F85C61142BFA>. 27

[443] Franklin a Gevurtz, 'The Historical and Political Origins of the Corporate Board of Directors' (2004) 33 Hofstra Law Review 89 <http://www.ssrn.com/abstract=546296>. 110-26

[444] Clive M Schmitthoff, *The Law and Practice of International Trade: Schmitthoff's Export Trade* (Stevens and Sons 1990). 93-94

[445] Holden Furber, *Rival Empires of Trade in the Orient, 1600-1800* (University of Minnesota Press 1976). 188

[446] Ella Gepken-Jager, 'The Dutch East India Company' in Ella Gepken-Jager, Gerard Van Solinge and Levinus Timmerman (eds), *VOC 1602-2002: 400 Years of Company Law*, vol 6 (Kluwer 2005). 56

[447] ibid. 56-57

colonies by the time business corporations were established in America, the corporate governance patterns set by colonial companies took root in US practices.[448]

US corporate statutes and business practices have a long-standing tradition of granting boards ultimate power over company management.[449] Early US corporations, such as those in banking and manufacturing, were established under individual legislatively granted charters, creating a set of corporate governance practices. For example, The Society for Establishing Useful Manufactures (SUM), one of the earliest corporations in American history, was chartered by New Jersey Governor William Paterson in 1791 to develop a manufacturing town. SUM was managed by thirteen directors elected annually by shareholders. Although SUM lasted only five years, closing in 1796 due to the ineptitude of some directors, it provided a model for modern corporations.

Similarly, the charter of the First Bank of the United States in 1791 stipulated that directors were to be elected annually by shareholders.[450] Unlike the Bank of England's board, the First Bank of the United States had 25 directors, with one appointed annually as the bank's president, who could appoint other officers.[451] New York's 1811 Act, considered the first incorporation law, mandated that a company's stock, property, and concerns be managed by trustees, with elections directed by corporate bylaws.[452] Modern US corporate statutes have made some changes, such as replacing "trustees" with "directors" and indicating that management is "by or under the direction of" the board,[453] suggesting that boards may not need to engage in day-to-day operations.[454] However, the basic norms of board governance established by early legislation remain.

The board-centred corporate governance model, the borrowing of the term "director" from the U.K. governance practice and the similarity in board size, as well as imposing term limits on directors, has shaped the modern form of board of directors in modern corporations

3.3.2 The Rise of Independent Directors

The widely held belief is that the independent director mechanism became a cornerstone of corporate governance in the United States during the 1970s. However, between the 1950s and

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[448] Gevurtz (n 29). 111

[449] For example: the establishment of Society for Establishing Useful Manufactures (SUM) in 1791; and Early in New York's 1811 Act, provided that "the stock, property and concerns of such company shall be managed and conducted by trustees, who, except those for the first year, shall be elected at such time and place as shall be directed by the by laws of the said company…"

[450] Bank Act, ch. 10, § 4 (1791). The charter of the first Bank if the United States expired in 1811. Then the second Bank of the United States was chartered in 1816.

[451] Ibid. §§ 4, 6.

[452] 1811 New York Laws LXVII

[453] *See, e.g.,* Delaware General Corporation Law. § 141(a) (2001); Model Bus. Corp. Act. § 8.01(2002).

[454] *See, e.g.,* Del. Gen. Corp. Law. § 141(a) (2001); Model Bus. Corp. Act. § 8.01(b) (2002).

1970s, stakeholder capitalism and the managerial model of corporate governance dominated the U.S. landscape.[455] Companies aimed not only to maximize corporate value but also to balance the competing interests of various stakeholders.[456] During this period, boards of directors comprised both insiders and outsiders, often representing entities with interlocking directorships or having business or financial ties to the company, such as investment banks, commercial banks, law firms, suppliers, or customers.[457] In essence, boards were an extension of management, providing passive advice without challenging management's decisions.[458]

The passive board of directors eventually resulted in the unexpected corporate failure in the 1970s, notably the bankruptcy of the Penn Central[459]--a major railway company, and the "Watergate scandal" – an illegal domestic campaign contribution.[460]

The SEC's investigation into Penn Central's collapse revealed that the company lacked mechanisms to provide directors with adequate financial information. The board members were merely figureheads who did not seek to understand the company's financial status and simply approved major transactions without scrutiny.[461] This scandal was linked to Watergate, which involved numerous prominent public companies in corrupt payment schemes.

The Watergate scandal exposed illegal contributions to Nixon's campaign and uncovered a broader pattern of bribery involving domestic and international companies. Over 50 public corporations faced criminal prosecution or SEC enforcement, and 400 acknowledged bribery involvement.[462] SEC uncovered severe financial misconduct, including the creation of "slush funds" through false or recorded transactions, which were used to finance illegal corporate campaign contributions.[463] The manipulation requires both internal corporate financial records and the financial statements submitted to the SEC. Moreover, diverting corporate funds outside the standard accounting procedures opened the door to the potential theft of corporate assets. One of the companies involved, the American Ship Building Company and its CEO, settled the SEC's case through a consent decree. The key provision of this settlement was forming a

[455] Alfred D Jr Chandler, *The Visible Hand:The Managerial Revolution in American Business* (1977).

[456] Frank W Abrams, 'Management's Responsibilities in A Complex World' (1951) 29 Harvard Business Review 29. 30

[457] Baysinger and Butler (n 14). 110

[458] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2); Myles L Mace, *Directors: Myth and Reality* (Boston: Division of Research, Graduate School of Business Administration, Harvard University 1971).

[459] Joseph R Daughen and Peter Binzen, The Wreck of the Penn Central (Beard Books 1999).

[460] Joel Seligman, 'A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project' (1986) 55 Geo. Wash. L. Rev. 325.

[461] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1515

[462] Seligman (n 46); United States Securities and Exchange Commission and others, *Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices* (US Government Printing Office 1976).

[463] Seligman (n 46) 334.

special review committee composed of three independent, external directors. This committee was entrusted with the crucial responsibility of investigating the company's illegal contributions and determining whether any additional corporate funds had been misappropriated or diverted for unrecorded purposes.[464]

Investigations showed that senior management in many companies was aware of the corrupt payments, while the outside directors were kept in the dark and not involved in the corporation's internal processes. As advisory bodies, outside directors were excluded from internal controls and lacked the necessary knowledge to question such transactions.

3.3.2.2 Shift to a Monitoring Board

1970s marked the rise of independent director alongside a shift from the advisory board to the monitoring board. The structure and governance of boardrooms in large public corporations underwent significant changes.[465] The inclusion of outside directors became more prevalent, with many companies forming committees of outside directors to handle issues like selecting independent auditors and overseeing management.[466] Corporate management and directors' attitudes also shifted, with many outside directors beginning to understand their responsibilities to the corporation. They became more engaged by reading corporate statements and annual/quarterly reports. This indicated their awareness of the need to maintain a safe distance from management.[467]

In the meantime, corporate scholarship has significant influence on promoting monitoring model of the board. Melvin Eisenberg's seminal work: '*The Structure of the Corporation: A Legal Analysis'* published in 1976. Eisenberg argued that in large public companies, the roles of management and monitoring should be distinct: senior management should focus on making decisions and setting policies, while the board's primary function should be to oversee and evaluate management's performance.[468] To effectively carry out this monitoring role,

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[464] Ronald P Kane and Samuel Butler III, 'Improper Corporate Payments: The Second Half of Watergate' (1976) 8 Loyola University Chicago Law Journal 1, 9–11.

[465] Myles L Mace, 'The Changing Role of Directors in the 1970s' (1975) 31 Business Lawyer (ABA) 1208 <https://heinonline.org/HOL/Page?handle=hein.journals/busl31&id=1280&div=97&collection=journals> accessed 7 January 2021; Marshall L Small, 'The Evolving Role of the Director in Corporate Governance' (1978) 30 Hastings Law Journal 1356-62 <https://heinonline.org/HOL/Page?handle=hein.journals/hastlj30&id=1381&div=55&collection=journals> accessed 7 January 2021.

[466] National Industrial Conference Board, J Bacon and American Society of Corporate Secretaries, 'Corporate Directorship Practices. (2nd Printing.).' (1967) <https://books.google.co.uk/books?id=lwqrzQEACAAJ>. 6; National Industrial Conference Board, J Bacon and American Society of Corporate Secretaries, 'Corporate Directorship Practice' (1973). 2; National Industrial Conference Board, J Bacon and American Society of Corporate Secretaries, 'The Board of Directors' (1977). 84

[467] Mace (n 51). 1208-09

[468] Melvin A Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Little, Brown and Company 1976) 162.

Eisenberg emphasized that the board must be independent from senior executives and that directors should be well-informed and possess the necessary knowledge to perform their duties.[469]

3.3.2.3 The Takeover Decades

The 1980s saw the appearance of the use of external financial markets for corporate control, forming the wave of takeovers which reshaped the blueprint of corporations in the US. Although the 1980s were labelled as the hostile takeover decade, the transactions were dominated by friendly deals.[470] Only 14 percent of deals during 1980s were hostile,[471] but still caused the threat for public corporation.[472] Economic studies found that merger activity occurs as the reaction to industry shocks, particularly associated with shocks of deregulation, oil price shocks, foreign competition, and financial innovation in 1980s.[473] The hostile bids during this period were argued to be the cure to the inefficiency of the management. To a particular company, the competition among management teams of the control of company could make better use of the corporate assets and create more value; to the economy, the threat of hostile bid provided the disciplinary and stimulated effects on the management that could make the assets of the economy more productive.[474]

Another source of pressure to the management is the increasingly important role of the institutional investors.[475] The shareholder-value-pursuing institutional investors were willing to sell to bidders offering the higher price.[476]

For the management team, a monitoring board with independent directors was considered as the protection against hostile takeovers. To resist the aggressive external market approach for corporate control (e.g.: the hostile takeovers), the management hope to rely on the board-centred corporate governance.[477] When shareholders suspect the motive of management to resist the takeover bids, the independent evaluation by independent directors that against the

[469] ibid 170.

[470] Gregor Andrade, Mark Mitchell and Erik Stafford, 'New Evidence and Perspectives on Mergers'. 104

[471] ibid.

[472] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1521

[473] Mark L Mitchell and J Harold Mulherin, 'The Impact of Industry Shocks on Takeover and Restructuring Activity' [1996] Journal of Financial Economics 193.

[474] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1521

[475] ibid. Appendix, Figure 6. By 1980, the equity fraction of institutional investors was over 40%, concentrated in largest public firms.

[476] Michael Bradley, Anand Desai and E Han Kim, 'The Rationale behind Interfirm Tender Offers: Information or Synergy?' (1983) 11 Journal of Financial Economics 183.

[477] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1522-23

"intrinsic value" of the firm could provide the legitimate ground of the defensive measure the bid.[478]

Additionally, the Delaware courts' opinion constituted the legal sources of independent directors against hostile bid. The courts utilized the outsider-dominated board when handling takeover proceedings, with the Delaware Supreme Court ruling that approval by an outsider-staffed board indicated good faith and reasonable investigation.[479] As the majority of large companies followed the monitoring board model, Delaware courts established the practice avoiding the interference of the corporate business in substance, that only looking at the decision-making process in the target company but not looking into the substance. This allowed the corporations, whose boards with a majority of independent directors and decision-making process exercised at least independence in appearance, to "just say no" to hostile bidders with judicial approval.[480]

The hostile takeover movements in the US in the 1980s highlighted shareholder value as the ultimate corporate objective. Directors' independence was perceived by the managerial elites as the best protection against hostile takeovers, though encroaching on their autonomy. The management turned to embrace the independent directors on the board as a necessary element of shareholder capitalism.[481]

3.3.2.4 New Wave of Board Reform Since The 2000s

In the 1990s, US corporations were characterized by a shift towards to the monitoring board and a focus on maximizing shareholder value, signalling the decline of stakeholder capitalism and the dominance of managerial power. By the 2000s, 78 per cent of the board members in U.S. public companies were independent, and 23 per cent of companies were chaired by non-executive directors.[482] The "monitoring model" gained widespread acceptance, with a growing consensus that independent directors contributed to improved board performance.

[478] Ira M Millstein, 'The Evolution of the Certifying Board' (1993) 48 The Business Lawyer 1485. 1493-95 *Unocal v Mesa Petroleum Co* 493 A.2d 946 (Del. 1985).

[479] *Unocal v. Mesa Petroleum Co.* (n 64).

[480] *Paramount Communications, Inc v Time Inc* 571 A.2d 1140 (Del. 1989). *Also see*: Jeffrey N Gordon, 'Corporations, Markets, and Courts' (1991) 91 Columbia Law Review 1931.

[481] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1526

[482] Urska Velikonja, 'The Political Economy of Board Independence' (2013) 92 North Carolina Law Review <https://heinonline.org/HOL/Page?handle=hein.journals/nclr92&id=881&div=22&collection=journals> accessed 21 January 2020. 857

However, major corporate scandals in the early 2000s, such as Enron accounting scandal and collapse, exposed significant shortcomings in board oversight of financial accounting and internal controls.[483]

Enron Corporation (Enron), established in 1985, quickly rose to prominence as the global leader in electricity, natural gas, communications and pulp and paper industries. Before the year 2000, its annual revenues had skyrocketed from around $9 billion in 1995 to over $100 billion.[484] However, by the end of 2001, it was uncovered that Enron's financial stability had been maintained mainly through institutionalized, systematic, and creatively orchestrated accounting fraud. Enron's stock price plummeted from $90 per share in mid-2000 to less than $1 per share by the end of 2001, resulting in shareholder losses amounting to nearly $11 billion.[485] In revising its financial statements for the preceding five years, Enron identified $586 million in losses. The company ultimately declared bankruptcy on December 2, 2001.

The burst of the corporate scandals during the early 2000s, including Enron and its ilk, were attributed to various factors: (1) the stock market bubble; (2) moral problems and greed in the business community;(3) inefficiencies in the board governance; (4) failure of gatekeepers.[486] Among these, the failure of gatekeepers -- including securities analysts, securities lawyers, debt rating companies, investment bankers and especially the auditors – was identified as a primary factor destabilizing corporate governance at the start of the 2000s.[487] The exposed financial scandals involved numerous instances of financial misstatements, fabricated profits, insider trading, etc.. [488] The auditor with great material relationship was discouraged from providing integrity auditing reports or disclosing the corporate unethical doings.[489]

The financial scandals also highlighted the weakness in the board governance that had evolved since the 1970s, especially the independent monitoring board since the 1990s.[490] In 1990s,

[483] Jr John C. Coffee, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', *Corporate Governance in ContextCorporations, States, and Markets in Europe, Japan, and the US* (Oxford University Press 2005) 302 <http://www.oxfordscholarship.com/view/10.1093/acprof:oso/9780199290703.001.0001/acprof-9780199290703-chapter-30>; Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2) 1535–37.

[484] Paul M Healy and Krishna G Palepu, 'The Fall of Enron' (2003) 17 The Journal of Economic Perspectives 3 <http://www.jstor.org/stable/3216854>.

[485] ibid.

[486] Jr John C. Coffee, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms' (2004) 84 BUL Rev. 301. 302

[487] ibid. 304

[488] George J Benston and Al L Hartgraves, 'Enron: What Happened and What We Can Learn from It' (2002) 21 Journal of Accounting and Public Policy 105. 120, 125

[489] In 2000, Andersen was paid $ 25 million in audit fee and $ 27 million for non-audit consulting. See: ibid.

[490] John C. Coffee (n 72).Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1536

stock-based compensation aimed to align the interest of directors and shareholders.[491] In reality, the equity interests had strongly incentivised directors, but the equity stake through their annual stock-based compensation. With the accumulating stake, the directors' independence would be undermined since the CEO's influence over director retention.[492]

After 2002, the wave of independent director reform was driven by the failure of Enron, WorldCom, etc. These high-profile corporate collapses highlighted significant weaknesses in board oversight, prompting renewed initiatives to enhance director independence. This push for stronger independence was especially crucial as boards were increasingly expected to take on dual responsibilities—not just in monitoring corporate performance, but also in overseeing internal controls.

3.3.2.5 Regulatory Response to the Rising of Monitoring Board

NYSE took the first step in promoting a monitoring model at the request of the SEC. In 1978, NYSE amended its listing requirements, mandating that all companies listed on the exchange establish audit committees composed solely of independent directors.[493] Courts further reinforced the managerial independent monitoring board model through several judicial decisions. Under the business judgment rule, it is assumed that the board acts in "good faith," adhering to the fiduciary duties of loyalty, prudence, and care owed to stakeholders. Unless there is clear evidence that the board has significantly breached a conduct rule, courts will not scrutinize or challenge their decisions. The Delaware Supreme Court ruled that transactions approved by a board with independent directors indicate good faith and a reasonable investigation,[494] which established the practice of avoiding the interference of the corporate business in substance, only looking at the decision-making process of the company. While not explicitly mandating independent directors, these rulings strongly encouraged their presence. This development established the foundation for independent directors to become central to the American corporate governance model.

The investigation of Enron, WorldCom, and Tyco and similar cases revealed the substantive social and professional connections between directors and senior management, leading to the implementation of stricter standards for independent directors to ensure effective oversight and accountability. However, these qualifications often overlook other sources of social connections, such as similar educational backgrounds or shared industry environments, which can also compromise a director's impartiality.[495] In response to such governance problems, the SOA

[491] Eliezer M Fich and Anil Shivdasani, 'The Impact of Stock-Option Compensation for Outside Directors on Firm Value' (2005) 78 The Journal of Business 2229 <https://www.jstor.org/stable/10.1086/497048> accessed 22 June 2018.

[492] Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (n 2). 1536

[493] Committee on Corporate Laws, 'The Overview Committees of the Board of Directors' (1979) 34 The Business Lawyer 1837 <http://www.jstor.org/stable/40686156>. 1839

[494] *Unocal v. Mesa Petroleum Co.* (n 64).

[495] *Zapata Corp v Maldonado* 430 A.2d 779 (Del. 1981).

intended to emphasize the board's role, especially the independent director, to check on insider abuse.[496] Looking at the provisions regarding the duties of the directors and senior management and accountability of the auditors and legal consultants, it seems that the provisions intended to ensure directors' impartial monitoring by reducing conflicts of interests or interpersonal pressures and to increase directors' self-awareness and diligence, or the incentive to act on behalf of the shareholders.[497] The highlight of the SOA reform was the establishment of stricter independence standards, requiring a majority of independent directors on the board, the formation of a fully independent audit committee, and an increased role for the board in overseeing internal controls. This underscored the SOA's intention to bolster the monitoring function of the board. Following the 2008 Global Financial Crisis, the Dodd-Frank Act further reinforced board independence by mandating an independent compensation committee.

Corporate directors operate within a network of social norms and relationships, both explicit and implicit, making it unrealistic for the law to assume that directors can fully disregard these influences.[498] Therefore, it is impractical for listing standards to list every potential conflict of interest or material relationship that may arise between directors and the company. Allowing boards to evaluate the independence of directors by considering a broader set of circumstances, including any affiliated relationships, is a more feasible approach for addressing these challenges in the current governance landscape.

The SOA brought about significant changes in accounting and financial disclosure regulations, requiring the formation of audit committees composed entirely of independent directors.[499] Additionally, the NYSE, NASDAQ, and AMEX amended their regulations to emphasize the importance of independent directors on corporate boards, requiring listed companies to have a majority of independent directors and raising the standards for independence.[500] Furthermore, nomination and compensation committees also became mandatory, consisting solely of independent directors. However, these independence requirements apply only to widely-held corporations, exempting controlled companies—where a single shareholder or group holds 50% or more of voting shares.[501] As a result of these reforms, the boards of large US companies

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[496] Larry E Ribstein, 'Market v.s Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (2002) 28 J. Corp. L. 1. 26

[497] Robert Charles Clark, 'Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too' (2005) 22 Georgia State University Law Review 251 <https://heinonline.org/HOL/Page?handle=hein.journals/gslr22&id=267&div=40&collection=journals> accessed 28 November 2020. 267

[498] *In re Oracle Corp Derivative Litigation BT - A 2d* (2003) 824 917.

[499] Clark (n 83) 267.

[500] Clarke (n 5) 90–91.

[501] NYSE Listed Company Manual 2016 § 303A; Bainbridge (n 1) 84.

now typically include only one or two inside members, with a "supermajority"[502] of independent directors.

3.3.3 Legal Framework of Independent Directors

3.3.3.1 State Corporate Law

The U.S. state common law does not have an abstract definition of independent directors but focus on the role of "disinterested" directors in scenarios involving related-party transactions or conflicts of interest between the company and its board members or senior management.[503] In this sense, "disinterested" directors are those who are not personally involved in the transactions in question. The approval of related-party or conflict-of-interest transactions by the majority of well-informed disinterested directors enables such transactions to be exempt from judicial review, which incents corporations' having independent directors on the board. Courts' decisions have shown their attitudes toward independent directors. With regarding to the anti-takeover defences, the Delaware Court confirmed the approval of the independent board would materially enhance the validity of the defences.[504] Things are similar to going private transactions of the controlling shareholders in public companies. The Delaware court required an independent negotiating committee composed of outside directors to negotiate with the buyer after the independent board of directors' conduct to ensure the fairness of dealing with the controlling shareholders.[505]

In state corporate law, such as Delaware corporate law, assess director independence based on personal or other relationships with the management. Unlike the simple standards provided by the state law, the listing standards provides the "bright-line" disqualification for independence from multiple aspects including being employed or the auditor or the executive officer, receiving compensation or property or services payments.[506]

[502] Sanjai Bhagat and Bernard Black, 'The Non-Correlation Between Board Indpendence and Long-Term Firm Performance' (2002) 27 Journal of Corporation Law 231 <https://heinonline.org/HOL/Page?handle=hein.journals/jcorl27&id=241&div=18&collection=journals> accessed 31 July 2020.

[503] Delaware General Corporation Law s 144(a).

[504] *Marciano v Nakash - A 2d* (1987) 535 400.

[505] *Weinberger v UOP, Inc - A 2d* (1983) 457 701.

[506] NYSE Listed Company Manual. Section 303A.

• Director is, or has been within the last three years, an employee of company or an immediate family member of director is, or has been within the last three years, an executive officer of company;

• Director has received, or has an immediate family member who is an executive officer of company and has received, during any twelve-month period within the last three years, more than $120,000 compensation directly from company (not including compensation received for director service, pension plan payments or deferred compensation for prior service not contingent on continued service);

3.3.3.2 Listing Rules

Listing rules provide the qualification for independent directors, mostly focusing on the absence of financial and familiar connections between independent directors and the corporation. For example, NYSE requires independent director should have "no relationship to the company that may interfere with the exercise of their independence from management and the company."[507] The director's independence forecloses if (1) the director has been employed by the company or its affiliates in the past three years, (2) an immediate family member of the director has held an executive position in the company or its affiliates. Within the same timeframe, (3) the director has served as an executive in another company where any executive of the issuer was a member of the compensation committee, or (4) the director has a business relationship with the company, or has been a partner, shareholder, or executive officer of an organization with such a relationship, unless the corporate board explicitly determines that this association does not impede the director's independent judgment.[508]

• Director or an immediate family member is a current partner of company's internal or external auditor; director is a current employee of the auditor; an immediate family member is a current employee of the auditor and personally works on company's audit; or director or an immediate family member was within the last three years a partner or employee of the auditor and personally worked on company's audit within that time;

• Director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of listed company's present executive officers at the same time serves or served on that company's compensation committee; or

• Director is a current employee, or an immediate family member is a current executive officer, of an organization that has made to or received from the company payments for property or services in an amount which, in any of the last three fiscal years, exceeds greater of 2% of such other company's consolidated gross revenues or $1 million Charitable contributions not considered "payments" for purposes of this prohibition but contributions meeting these thresholds must be disclosed on company's website or in its annual proxy statement or annual report on Form 10-K.

507 ibid.

508 ibid.

Requirement	NYSE	NASDAQ
Majority of Independent Directors	Independent directors must comprise majority of board	Same requirement
Cure	No specific cure provisions NYSE's general procedures for listing standard violations apply	At least 180-day cure period for failure to comply due to a board vacancy or because a director is no longer independent for reasons beyond the director's reasonable control, and must notify Nasdaq upon learning of non-compliance
Executive Sessions	Non-management directors must meet in regularly scheduled executive sessions (without members of management present) If these executive sessions include non-independent directors, an executive session with only independent directors must be scheduled at least once a year Company may choose to hold regular sessions of independent directors only	Independent directors must meet regularly in executive session (without members of management present) Executive sessions should occur at least twice a year
Presiding Directors	Non-management director must preside at executive sessions, although same director not required to preside at all executive sessions . Name of director presiding at executive sessions, or procedure by which presiding director is selected for each executive session, must be disclosed on company's website or in proxy statement (or, if company does not file proxy statement, in company's annual report on Form 10-K), with information about how interested parties can communicate with presiding director or non-management directors as a group.	Not addressed

Exemptions	The following are not required to have a majority of independent directors or hold executive sessions: • ICA-registered management investment companies; • passive investment organizations in the form of trusts; • listed derivatives and special purpose securities; and • FPIs (see "Applicability to Foreign Private Issuers") The following are not required to have a majority of independent directors or hold executive sessions: • limited partnerships; • ICA-registered management investment companies; • asset-backed issuers and other passive issuers; • cooperatives; and • FPIs (see "Applicability to Foreign Private Issuers") The following are not required to have a majority of independent directors but are required to hold executive sessions: • controlled companies; • limited partnerships; and • companies in bankruptcy proceedings	The following are not required to have a majority of independent directors or hold executive sessions: • limited partnerships; • ICA-registered management investment companies; • asset-backed issuers and other passive issuers; • cooperatives; and • FPIs (see "Applicability to Foreign Private Issuers") Controlled companies are not required to have a majority of independent directors but are required to hold executive sessions
Independent Committees	Subject to applicable exemptions, the board must have: • an independent audit committee; • an independent compensation committee; and • an independent nominating/corporate governance committee	Subject to applicable exemptions, board must have: • an independent audit committee; • an independent compensation committee; and • director nominees selected or recommended for board's selection by independent nominating committee or by majority of the independent directors

Table 3-1 Comparing the Role and Authority of Independent Directors of Listing Standard[509]

3.3.3.3 Sarbanes-Oxley Act and Dodd-Frank Act

As the regulatory response to a series of corporate governance scandals, SOA aims to address the defects of the corporate accounting and auditing procedures. It provides the audit committee to have substantial authorities, including the sole authority to hire, oversee, compensate and fire the outside auditor. In section 301, which is consistent with the aim of reform, provides that each member of the audit committee to be independent. To fulfill the independence, the director cannot "(i) accept any consulting, advisory, or other compensatory

[509] Weil Public Company Advisory Group, 'Requirements for Public Company Boards Including IPO Transition Rules' (2022) <https://governance.weil.com/featured/requirements-for-public-company-boards-including-ipo-transition-rules-3/>.

fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof." [510] The specific requirements and standards regarding the audit committee were presumably left to the SEC and the stock exchange listing rules.

The Dodd-Frank reform 2010 focused on executive compensation, requiring public companies to have compensation committees composed solely of independent directors. The requirements for independent directors in Dodd-Frank are inspired by a similar provision in the SOA of 2002.

3.3.4 Board Committees

Numerous structural innovations have been introduced, such as the formation of board sub-committees dedicated to specific functions, the establishment of "special committees" to handle particular legal or transactional matters, and the creation of roles like "lead director" and the practice of holding "executive sessions" to limit the CEO's influence over board agendas.

Board sub-committees: The corporate governance best practices since the 1970s recommended the establishment of three key committees: the audit committee, the compensation committee, and the nominating committee, all predominantly composed of independent directors.511 These committees focus on areas where conflicts between the interests of managers and shareholders are likely to arise.

Among these committees, the audit committee has been particularly significant, serving as a major focus for corporate governance reformers. In 1974, the SEC began mandating companies to disclose the existence or absence of an audit committee, and by 1978, it provided general guidelines for their operation.[512] The NYSE began requiring audit committees in 1977, and by 1979, nearly all NYSE-listed firms had audit committees, with 92% of them composed of non-management directors.[513] By the end of the 1980s, both NASDAQ and the Amex had implemented similar requirements. Today, listing rules and the Sarbanes-Oxley Act mandate that all publicly traded companies have audit committees that meet stringent standards of independence and financial expertise.[514] To limit the executive's influence, the SOA grants the audit committee full authority and autonomy in their auditing work, thereby enhancing board independence.

The compensation committee was introduced after the audit committee. Historically, these committees often relied on compensation consultants who also provided broader human resources services to the firm, earning most of their fees from these comprehensive engagements. This dependency on management-retained consultants, whose

[510] The Sarbanes-Oxley Act 2002 s 301.

[511] ABA Commment on Corporate Laws, 'Corporate Director's Guidebook' (1978) 33 Business Lawyer (ABA).

[512] Item 8(e), Schedule 14A, 17 C.F.R. 1978 ss 240.14a–101.

[513] American Law Institute, 'Principles of Corporate Governance : Analysis and Recommendations' s 3A.05 n.1.

[514] See Table 3-1

recommendations were unlikely to upset senior management, diminished the committee's ability to act independently. The SEC only began requiring disclosures about the existence and composition of compensation committees in 1992. Throughout much of this period, it was common for management directors to serve on compensation committees, although independent directors usually held the majority. The NYSE and NASDAQ listing rules have provided the independent compensation committee requirement. However, this preexisting independence rule was finally codified by the Dodd-Frank Act in 2010.[515]

Finally, nominating committees, driven by pressure from institutional investors, also became more common, and both compensation and nominating committees are now required by NYSE listing standards to be staffed by independent directors.

Special committees: Boards often establish special committees in scenarios where a decision must be made or a negotiation conducted that involves actual or potential conflicts of interest for certain directors, such as the manager buyout, corporate control selling transactions, freezeout merger, or shareholder derivative lawsuits.[516] In such instances, the board delegates authority to these special committees to address the delicate issue at hand. This approach is crucial because, depending on the nature of the transaction, a special committee of impartial directors can safeguard the interests of the company's shareholders and assist board members in effectively fulfilling their fiduciary responsibilities.

However, the special committee has been criticized for its limited influence on board decision-making, typically being convened at the final stage, which often led to the company's dissolution. Moreover, corporate management strongly resisted allowing these committees or the board at large to hire independent consultants because the management deems it as a potential power shift.[517]

Non-management executive sessions: Another key structural element was the practice of holding executive sessions—meetings where the board convenes without senior management present, often led by a "lead director."[518] Under the requirement of NYSE listing rules, the board are formally required to have regularly scheduled executive sessions, which enables them to have discussions without requiring special initiation from directors, which could otherwise be perceived against the senior executives.

The "lead director" is an independent director who leads board meetings in cases where the chair is also a senior executive, typically the CEO. When the CEO's actions are under scrutiny,

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[515] Bernice Grant, 'Independent yet Captured: Compensation Committee Independence after Dodd-Frank' (2013) 65 Hastings Law Journal 761, s 770.

[516] Elizabeth Pollman, 'Strengthening Special Committees' (2008) 9 UC Davis Busines Law Journal 137, 141–44.

[517] American Law Institute (n 99) s 3.04 comment.

[518] NYSE Listed Company Manual s 303A.03.

e.g. involved in questionable transactions, the lead director can lead the board meeting for further corporate governance practices, such as nominating a new CEO.

3.3.5 Independent Directors' Incentive Mechanisms

3.3.5.1 Compensation

Directors' compensation, generally in the form of remuneration and stock options, is the primary incentive for independent directors. Cash compensation at first was the primary form of incentive, whereas, in 1996, stock-based compensation prevailed because of the recommendation of NACD blue ribbon panels.[519] Until the late 2000s, nearly 90% of corporate directors were compensated by stock-based compensation to strengthen the alignment of director and shareholder interests.[520]

Empirical studies show a connection between equity compensation and improved firm performance.[521] However, with the accumulation of their stake, directors' independence will be compromised, especially when the CEO has a say in board member nomination. Moreover, stock-based compensation can potentially result in adverse incentives for directors. When independent directors receive equity compensation in the same way as insiders, they might be inclined to approve aggressive accounting practices rather than risk stock price drops from full disclosure. The governance failure in the early 2000s suggests the weakness of equity-based compensation for directors.[522] Thus, the challenge lies in finding a balanced compensation that is not too low to discourage effective monitoring but also not so high that it aligns them too closely with the management.

3.3.5.2 Judicial sanctions

Both state fiduciary law and federal securities law impose directors with liabilities, particularly monetary liabilities, on directors for breaches of their duties, aiming to incentivize independent directors to focus on corporate business and affairs. In the 1960s, the risk of directors' liability for the breach of duty of care, straightforward self-dealing, and securities fraud in derivative

[519] National Association of Corporate Directors, 'Report of the NACD Blue Ribbon Commission on Directoe Professionalism' (1996).

[520] 'Directors' Compensation and Board Practices in 2007 | The Conference Board' <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=1509> accessed 14 December 2020. 6-8

[521] Laura Lin, 'The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence' (1996) 90 Northwestern University Law Review 898, 945 <http://heinonline.org/HOL/Page?handle=hein.journals/illlr90&id=916&div=34&collection=journals> accessed 8 December 2017.

[522] Jeffrey N Gordon, 'Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley' (2002) 35 Connecticut Law Review 1125.

suits was virtually non-existent. Until the start of the 2000s, liability in duty-of-care cases was still uncommon.

The business judgment rule for state law protects directors from liability for poor business decisions. The business judgement rule is a presumption that "in making a business decision, directors of a corporation acted with informed due care, with good faith belief that the decision will for the best interest of the corporation, the director's judgement will be respected by the courts.[523] Delaware adopted director insulation statutes that eliminate or limit the "personal liability of a director to the corporation or its shareholders for breach of fiduciary duty as a director".[524]

However, after the exposure of the Enron scandals, it appeared that the Delaware courts became more open to the director's monetary sanction for the director's failure of inquiry and oversight of the insider's wrongful behaviours.[525] The ground for the director's liability is that the director's misconduct is not in good faith. In the Walt Disney derivative litigation, the Delaware Supreme Court held that the "gross negligence (including a failure to inform oneself of available material facts), without more", does not constitute bad faith, which may require "intentional dereliction of duty, a conscious disregard for one's responsibilities."[526] In the *Caremark* decision, the court held that only the "sustained or systematic failure" of the directors to exercise oversight, such as "utter failure to attempt to assure a reasonable information and reporting system exists", will constitute the lack of good faith that leads to the director's liability.[527] It made it clear that such "lack of good faith" was the condition for liability for the breach of duty of loyalty rather than the independent condition for the director's liability and signalled the courts' reluctance to broaden the directors' oversight liability.

Under federal securities law, liability for directors is limited by a "scienter" standard, requiring knowledge or recklessness regarding wrongful disclosures. For public offerings, directors have a "due diligence" obligation to verify the accuracy of disclosed information. Even though managers' misconduct constitutes a disclosure violation, the director is liable only when showing good knowledge of the wrongful disclosure or being informed of the misconduct.[528]

In sum, although the risk of directors' liability remains low, their perception of the risk has increased over time. Directors' fear of litigation incentivizes them to establish an honest, integrity-filled, and compliant board and to be active monitors and advisors.

3.3.5.3 Reputation Capital

523 Aronson v Lewis 473 A.2d 805.

524 Smith v Van Gorkom 488 A.2d 858 (Del. 1985).

525 William B Chandler III and Leo E Strine Jr, 'The New Federalism of The American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State' (2003) 152 University of Pennsylvania Law Review 953.

526 In re Walt Disney Co Derivative Litig. 960A.2d at 64-65

527 In re Caremark Intern Inc Deriv Lit BT - A 2d (1996) 698 959.

528 Ernst & Ernst v Hochfelder 425 U.S. 185 (1976).

Reputational capital, which includes the psychological rewards of prestige and recognition, motivates individuals to pursue distinction, influence and high social status, as these accomplishments not only enhance their standing but also create pathways for future achievements.[529] Directors generally prefer to be associated with well-performing leading companies rather than those underperformed or tainted by scandals.[530] It also goes beyond the potential business opportunities, such as additional board positions, that a strong reputation can bring.

For the state common law, Delaware courts remain hesitant to impose financial penalties on directors; thus, the primary method the Court prefers is relying on the reputation market rather than the monetary consequences.

However, empirical tests suggest no significant evidence of the reputational effects of independent directors.[531] Reputational motivation does not necessarily compel them to commit extensive time and effort to meet significant performance standards. For one thing, independent directors are often busy individuals with substantial responsibilities in their primary roles within their own organizations. For another, effective monitoring of management is a demanding task that requires dedicated and constructive effort from independent directors. Thus, reputational capital alone may not be a sufficient incentive for rigorous monitoring.

3.3.5 Criticism of Independent Directors

The debate over the effectiveness of independent directors has never suspended. Scholars used variable measurement index to evaluate corporate performance, including accounting variables, stock price return, and market value, however reported mixed results.

The early work of Baysinger and Butler reported a positive but lagged effect of independent directors on corporate performance, noting that the increase of independent directors in the early 1970s was correlated with the stock return in the 1980s.[532] However, the long period measurement of firm performance may lead to noisy data, making it challenging to tease out the effect of independent directors from other factors that influence performance over such an

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[529] Wenge Wang, 'Board Independence of Listed Companies in the US and China' (2018) 9 Asian Journal of Law and Economics 20180014, 12.

[530] Robert A.G.Monks and Neil Minow, *Corporate Governance* (Third, Blackwell Publishing Ltd 1995) 361.

[531] Ronald J Gilson and Reinier Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Reinventing the Outside Director: An Agenda for Institutional Investors Investors' (1991) 43 Stanford Law Review 863, 876 <https://scholarship.law.columbia.edu/faculty_scholarship/891> accessed 8 June 2020.

[532] Baysinger and Butler (n 14). For more long-term measurement studies, see: SP Kothari and Jerold B Warner, 'Measuring Long-Horizon Security Price Performance' (1997) 43 Journal of financial economics 301.Brad M Barber and John D Lyon, 'Detecting Long-Run Abnormal Stock Returns: The Empirical Power and Specification of Test Statistics' (1997) 43 Journal of financial economics 341.Brad M Barber and John D Lyon, 'Detecting Abnormal Operating Performance: The Empirical Power and Specification of Test Statistics' (1996) 41 Journal of financial Economics 359.

extended period.[533] Rosenstein and Wyatt found an increase in shareholder value after the announcement of appointing independent directors and noted a positive correlation between independent directors and firm performance.[534] However, many studies failed to find any significant evidence on the relationship between independent directors and firm performance,[535] with some reporting adverse effects.[536] For instance, research by Yermack, Agrawal and Knoeber, Hermalin and Weibach reported a negative correlation between board independence and Tobin's Q[537]. Klein found that board independence was negatively correlated with market value of equity, suggesting that an increase in insiders on the board could improve firm performance.[538] As for other financial ratios, Yermack found no correlation

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[533] Sanjai Bhagat and Bernard Black, 'The Uncertain Relationship between Board Composition and Firm Performance' [1999] The Business Lawyer 921.

[534] Stuart Rosenstein and Jeffrey G Wyatt, 'Outside Directors, Board Independence, and Shareholder Wealth' (1990) 26 Journal of Financial Economics 175 <https://www.sciencedirect.com/science/article/pii/0304405X9090002H> accessed 8 February 2018. For more similar results, see: John A Pearce and Shaker A Zahra, 'Board Composition from a Strategic Contingency Perspective' (1992) 29 Journal of Management Studies 411 <http://doi.wiley.com/10.1111/j.1467-6486.1992.tb00672.x> accessed 6 April 2018.Michael H Schellenger, David D Wood and Ahmad Tashakori, 'Board of Director Composition, Shareholder Wealth, and Dividend Policy' (1989) 15 Journal of Management 457 <http://journals.sagepub.com/doi/10.1177/014920638901500308> accessed 6 April 2018.

[535] Benjamin E Hermalin and Michael S Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance' (1991) 20 Financial Management 101 <http://doi.wiley.com/10.2307/3665716> accessed 15 May 2018; April Klein, 'Firm Performance and Board Committee Structure' (1998) 41 The Journal of Law and Economics 275 <https://www.journals.uchicago.edu/doi/10.1086/467391> accessed 27 May 2018.

[536] Shaker A Zahra and Wilbur W Stanton, 'The Implications of Board of Directors Composition for Corporate Strategy and Performance' (1988) 5 International journal of management 229.Hermalin and Weisbach (n 121).Anup Agrawal and Charles R Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31 The Journal of Financial and Quantitative Analysis 377 <https://www.jstor.org/stable/2331397?origin=crossref> accessed 8 April 2018.Sanjai Bhagat and Bernard Black, 'Do Independent Directors Matter?' (1997) 52 Journal of Finance 1212.Klein (n 121).Ronald C Anderson and others, 'Corporate Governance and Firm Diversification' (2000) 29 Financial Management 5 <http://doi.wiley.com/10.2307/3666358> accessed 26 May 2018; Stefan Beiner and others, 'Is Board Size an Independent Corporate Governance Mechanism?' (2004) 57 Kyklos 327 <http://doi.wiley.com/10.1111/j.0023-5962.2004.00257.x> accessed 27 May 2018; Sanjai Bhagat and Brian Bolton, 'Corporate Governance and Firm Performance' (2008) 14 Journal of Corporate Finance 257 <https://www.sciencedirect.com/science/article/pii/S0929119908000242> accessed 27 May 2018.

[537] Tobin's q, also known as Q ratio, created by Nicholas Kaldor and popularized by James Tobin. $Tobin's\ q = \frac{Equity\ Market\ Value}{Equity\ Book\ Value}$. Tobin's q is used to measure the management performance since higher Tobin's q means more market value produced from same assets. David Yermack, 'Higher Market Valuation of Companies with a Small Board of Directors' (1996) 40 Journal of financial economics 185.Agrawal and Knoeber (n 122).Hermalin and Weisbach (n 121).

[538] Klein (n 121).

according to variables including asset turnover ratio, ROA (Return on Assets), and ROS (Return on Sales).[539]

Since the emphasis on board independence in the SOA reform, various studies have attempted to determine whether independent directors have improved firm performance. The results, however, remain mixed.

Bhagat and Bolton found a negative relationship between independent directors and firm performance before the 2002 period, which was reserved in the post-2000 period.[540] On the other hand, Coles *et al.*, Ferris, and Yan reported an unclear correlation between board independence and firm performance.[541] Overall, there is no clear, solid evidence to firmly support the existence of a direct link between board independence and overall corporate performance.[542]

Critics argue that flaws in the independent director system contribute to these inconsistent findings and offer insights into the issue.

Firstly, the current criteria for defining “independence” are considered overly narrow, primarily focusing mainly on the absence of familial and business connections while neglecting other social ties with management that could compromise directors’ independence.[543] Conversely, stringent independence standards make it challenging for companies to find directors who possess both independence and the necessary expertise about the firm.[544] These standards

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539 Yermack (n 123). $Asset\ Turn = \frac{Assets}{Sales}$; ROA=$\frac{Operating\ Income}{Assets}$; ROS=$\frac{Operating\ Income}{Sales}$

540 Sanjai Bhagat and Brian Bolton, ‘Director Ownership, Governance, and Performance’ [2013] Journal of Financial and Quantitative Analysis.

541 Jeffrey L Coles, Naveen D Daniel and Lalitha Naveen, ‘Boards: Does One Size Fit All?’ [2008] Journal of Financial Economics.Stephen P Ferris and Xuemin Sterling Yan, ‘Do Independent Directors and Chairmen Matter? The Role of Boards of Directors in Mutual Fund Governance’ (2007) 13 Journal of Corporate Finance 392.

542 Baysinger and Butler (n 14); Hermalin and Weisbach (n 121).Paul W MacAvoy and others, ‘ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis’ [1983] Statement of the Business Roundtable on the American Law Institute’s Proposed “Principles of Corporate Governance and Structure: Restatement and Recommendation.” New York: Business Roundtable. Bhagat and Black, ‘The Uncertain Relationship between Board Composition and Firm Performance’ (n 119).N Foster, ‘Transmigration and Transferability of Commercial Law in a Globalized World’ 55.Sanjai Bhagat and Bernard Black, ‘The Non-Correlation between Board Independence and Long-Term Firm Performance’ (2001) 27 Journal of Corporation Law <https://heinonline.org/HOL/Page?handle=hein.journals/jcorl27&id=241&div=18&collection=journals> accessed 31 July 2020.

543 Wolf Georg Ringe, ‘Independent Directors: After the Crisis’ (2013) 14 European Business Organization Law Review 401; Frederick Tung, ‘The Puzzle of Independent Directors: New Learning’ (2011) 91 Boston University Law Review 1175.

544 Grant Kirkpatrick, ‘The Corporate Governance Lessons from The Financial Crisis’ (2009) 2009 OECD Journal: Financial Market Trends 61, 22; Suzanne Le Mire, ‘Independent Directors: Partnering Expertise with Independence’

reduce the pool of eligible directors, excluding those with valuable industry-specific knowledge. Some scholars suggest that the financial crisis was attributed to the increasingly prioritizing independence over competence, particularly post-SOA.[545] The firm-specific knowledge and expertise, particularly in accounting, are more crucial than independence.[546]

Secondly, independent directors' appointment process is often flawed. When top executives retain significant influence over the director recruitment, independent directors lack strong incentives to diligently fulfil their monitoring roles.[547] This renewal process for board members does not guarantee genuine independence if the CEO has substantial control over nominations.

Thirdly, independent directors' poor performance can also be attributed to information asymmetry. These directors rely on insiders for information, creating a dependency on the very individuals they are supposed to monitor. This information gap is particularly problematic in companies with high information costs, reducing the effectiveness of independent directors.[548]

Fourthly, independent directors who hold other demanding roles, such as CEOs of other companies or non-executive members of multiple boards, often devote insufficient time to their responsibilities.[549] Additionally, the remuneration mechanisms and the liability for independent directors are not reasonable. On the one hand, the remuneration mechanisms for independent directors does not align well with shareholders' interests. On the other hand, under the business judgement rule, independent directors are provided extensive protection, which fails to incentivize directors' diligent monitoring.[550]

Despite these limitations and the widespread dissatisfaction with their practical impact, independent directors continue to dominate board seats in the US and the U.K., where their presence is widely regarded as a crucial element of contemporary corporate governance systems.

(2016) 16 Journal of Corporate Law Studies 1 <http://www.tandfonline.com/doi/full/10.1080/14735970.2015.1090139> accessed 11 September 2018.

[545] Bainbridge (n 1).

[546] Bernard S Sharfman, 'Enhancing the Efficiency of Board Decision Making: Lessons Learned from the Financial Crisis of 2008' (2009) 34 Del. J. Corp. L. 813.

[547] Cheryl L Wade, 'What Independent Directors Should Expect from Inside Directors: Smith v. Van Gorkom as a Guide to Intra-Firm Governance' (2005) 45 Washburn Law Journal 367.

[548] Beng Wee Goh and others, 'The Effect of Board Independence on Information Asymmetry' (2016) 25 European Accounting Review 155; Tung (n 129) 1187.

[549] Jonathan H Gabriel, 'Misdirected-Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud' (2004) 38 Suffolk University Law Review 641.

[550] Lisa M Fairfax, 'The Uneasy Case for the Inside Director' (2010) 96 Iowa Law Review 127, 168 <https://heinonline.org/HOL/Page?handle=hein.journals/ilr96&id=129&div=6&collection=journals> accessed 27 November 2020.

3.3.6 Independent Directors in the U.K.

The introduction of non-executive independent directors in the U.K. originated with the Cadbury Report in 1992, which drew inspiration from the U.S. model. The report recommended that boards of listed companies should have at least three non-executive directors, with a majority being independent from the company.[551] It also emphasized the separation of the roles of chairman and CEO to ensure a balanced distribution of power. The primary responsibilities of these non-executive independent directors included overseeing corporate management and scrutinizing transactions involving conflicts of interest. The report also advocated for the establishment of board committees comprising non-executive independent directors.[552]

The significance of independent directors in the U.K. was further underscored following the Enron scandal. The Higgs Report of 2003 proposed increasing the presence of independent directors on both boards and committees.[553] Finally, the 2006 Combined Code on Corporate Governance incorporated the recommendations of these reports that boards should consist of a mix of executive and non-executive directors, ideally with a majority being independent.[554] The Code further specified that independent directors should not have any familial or business affiliations with the company and should not represent major shareholders.[555]

The corporate governance in the U.S. and U.K. were often viewed with similar practices for their common legal system and one-tier board of directors with supervision on corporate strategic direction and senior executives.[556] This led to the term “Anglo-American corporate governance” becoming a common phrase referring corporate governance practices in both countries. However, although U.K. borrowed the U.S. concept of independent director, their regulations on independent directors were not identical.

One notable difference lies in the U.K. Combined Code, which requires that independent directors be free from ties to both management and significant shareholders, thereby diverging from the American definition of independence.[557] This definition of independence was more comprehensive than the US standard which does not consider relationships with major

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551 ‘ Report of the Committee On the Financial Aspects of Corporate Governance’ §§ 4.11, 4.12 <http://www.ecgi.org/codes/documents/cadbury.pdf> accessed 2 November 2017.

552 ibid §§ 4.30, 4.35(b), 4.42,.Cadbury report recommended the nomination committee consisting of a majority of non-executive directors, the audit committee consisting non-executive directors and a majority of non-executives should be independent, the remuneration committee consisting wholly or mainly of non-executive directors a chaired by a non-executive director.

553 ‘ Higgs Report-Review of the Role and Effectiveness of Non-Executive Directors’ (January 2003) ch 6 <https://www.icaew.com/technical/corporate-governance/codes-and-reports/higgs-report> accessed 31 July 2021.

554 The Combined Code on Corporate Governance 2006 Principle A.3.

555 ibid B.1.1.

556 Allison Dabbs Garrett, ‘A Comparison of United Kingdom and United States Approaches to Board Structure’ (2007) 3 Corp. Governance L. Rev. 93, 93.

557 The Combined Code on Corporate Governance A.3.1.

shareholders. However, the U.K. Combined Code is based on "comply or explain" approach, functioning as a flexible soft-law instrument, which makes it less binding than US regulations.[558]

Moreover, revisions to the Combined Code in the aftermath of financial crises marked a departure from the US approach by relaxing independence requirements in favor of emphasizing directors' skills and expertise. The revised Code suggests that boards and committees should maintain a suitable balance of skills, knowledge, and independence.[559] Similarly, the Walker Review in 2009 emphasized the need for directors with expertise rather than just independence.[560] Consequently, the new policy recommendation allows companies to abandon the fifty percent requirement of independent directors if increasing the number of non-independent directors is necessary to achieve the desired level of board expertise.[561]

3.4 Transplantation of Independent Directors

Independent directors have gained popularity worldwide since the 1990s with the growing emphasis on corporate governance. The U.K. Cadbury Report introduced independent directors drawing inspiration from the US model, which appears to have laid the groundwork for EU member states. Today, the idea of including independent non-executive directors on corporate boards is widely accepted across EU countries. Independent directors are also widespread in various Asian jurisdictions including China, Japan, Singapore, etc.

This section examines the transplantation of independent directors from the U.S. to other jurisdictions and explores the differences in how independent directors have been adopted in various legal regimes. This thesis focuses on the adoption of independent directors in Germany, Japan, and Singapore for the following reasons:

Firstly, during the formulation of China's Company Law in the early 1990s, the legislator drew inspiration from both American and continental legal frameworks. The foundational aspects of China's Company Law, particularly regarding the types of companies it governs and its corporate governance principles, are closely aligned with the continental model. Germany represents a classic civil law jurisdiction with concentrated ownership structures, significant state involvement in corporate governance, and a two-tier board system. By examining Germany, the thesis aims to explore how independent directors function within a regulatory and institutional framework similar in many respects to China's, particularly regarding supervisory boards and concentrated ownership dynamics.

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[558] Garrett (n 142) 94.

[559] The Combined Code on Corporate Governance Principle B.1.

[560] Marc Moore and Martin Petrin, *Corporate Governance: Law, Regulation and Theory* (Macmillan International Higher Education 2017) 182.

[561] Paul L Davies and Klaus J Hopt, 'Corporate Boards in Europe—Accountability and Convergence' (2013) 61 The American Journal of Comparative Law 301, 326.

Secondly, Japan was selected because it offers an example of a major Asian economy with concentrated ownership and strong informal governance mechanisms that initially resisted the adoption of independent directors. Japan's recent efforts at governance reform provide valuable insights into how Asian economies struggle with the tensions between imported governance practices and deeply rooted domestic institutions

Thirdly, Singapore provides a unique example of successful adoption of independent directors within state-linked corporations and family-controlled firms. Given China's extensive state ownership and emerging private family-controlled enterprises, Singapore's model is particularly instructive. It demonstrates how independent directors can be structured effectively in contexts involving significant state and private-family control.

A comparative analysis of the independent director system across multiple jurisdictions provides critical insights for understanding the complexity of its transplantation and operation in China. By examining the experiences of the U.K., Germany, Japan, and Singapore, the thesis highlights key factors that shape whether transplanted governance models function effectively. Each jurisdiction was strategically selected to reflect different governance structures, legal families (common and civil law), ownership concentrations, and institutional environments—all relevant to China's corporate landscape. This comparative framework offers essential context for identifying why China's independent director system has faced persistent challenges.

3.4.1 Germany

3.4.1.1 Overview

In 2005, the European Commission aimed to enhance the corporate governance standards among listed companies by recommending that boards maintain a suitable balance between executive/managing and non-executive/supervisory directors.[562] This balance is intended to prevent any single person or small group from exerting excessive influence over decision-making processes. Similar to the Cadbury Report, the European Commission adopted a "comply-or-explain" approach. Today, most European countries have established formal codes outlining best practices in corporate governance, including specific guidelines on board composition and independence, and companies across Europe generally adhere to these standards.[563]

According to the EU Recommendation, the independent non-executive director or supervisory directors should be "free of any material conflict of interest", meaning they must not have any

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[562] Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board 2005.

[563] Marcello Bianchi and others, 'Comply or Explain: Investor Protection through the Italian Corporate Governance Code' (2011) 23 Journal of Applied Corporate Finance 107.

significant business, family, or other relationships with the company, its controlling shareholders, or its management that could impair their judgment due to conflicts of interest.[564]

While the EU Recommendation provides a clear stance on independence, the German Corporate Governance Code (GCGC) and the German Stock Corporation Act (GSCA) do not clearly define committee independence or a general definition of independence. The GCGC only stipulates that shareholder representatives on the supervisory board should include an adequate number of independent directors, reflecting Germany's cautious approach towards mandating independent directors.[565]

3.4.1.2 Board Committees

Compared to the U.K. and the U.S., board committees are less prevalent in Germany. However, there is a significant and growing trend towards establishing nomination, remuneration, and audit committees and the majority of large, listed companies have already implemented these committees.[566]

The EU Recommendation recommends these committees have at least a majority of their members to be independent. The audit committee, a sub-committee under the supervisory board, is responsible for overseeing audit activities, monitoring the integrity of financial reporting, annually reviewing internal controls and risk management systems, and ensuring the effectiveness of the internal audit function.[567]

The nomination committee plays a crucial role in identifying and recommending candidates for board positions, assessing the board's structure and performance, evaluating directors' skills and experience, considering succession planning, and reviewing policies for selecting senior management.[568]

Meanwhile, the remuneration committee proposes and monitors remuneration policies for executives and senior management, ensuring alignment with shareholder interests and compliance with disclosure rules. It also advises on stock options and share-based incentives.[569]

[564] Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board s 13.1.

[565] German Corporate Governance Code 2013 s 5.4.2.

[566] Mary Keegan and F Degeorge, 'Corporate Governance Reports' (1998) 6 Corporate Governance: An International Review 116.

[567] Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board 61–62; German Corporate Governance Code s 107.

[568] Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board 59.

[569] ibid 59–60.

Independent directors, based on the EU recommendation, should have roles in the board committee based on the recommendation. The board committees are empowered to perform their roles, however, always only in the advisory capacity and doing the preparation work for the supervisory board. Notably, the GCGC does not mandate or recommend the formation of nomination and remuneration committees; instead, it merely encourages the creation of a nomination committee composed solely of shareholder representatives, without mentioning a remuneration committee.[570]

3.4.1.3 Monitoring Related-Party Transactions

A key responsibility of independent directors is overseeing related-party transactions. However, the GCGC does not outline a specific role for independent directors in this regard. In Germany, conflict-of-interest rules primarily govern transactions between the corporation and its supervisory and management board members, leaving other related-party transactions outside this regulatory framework.[571]

German law has stringent procedural rules for self-dealing transactions. GCGC suggests that significant related-party transactions should be approved by the supervisory board.[572] Although there are no direct sanctions for violating the GCGC, supervisory boards can be held liable for failing to impose appropriate rules if it results in corporate damage.[573] Furthermore, management board members face civil and possibly criminal liability for actions that harm the corporation. Despite these measures, the procedural requirements for successful litigation in cases of managerial self-dealing are quite high, making enforcement challenging.[574]

Thus, German law on managerial self-dealing lacks clear and precise definitions and relies heavily on the approval of directors who may only be nominally independent in control transactions, potentially undermining the intended safeguards against conflicts of interests.

3.4.1.4 Liability and Enforcement

Under German law, liability for breaches of duty of care or loyalty is typically directed toward the corporation rather than individual shareholders, since directors' employment contracts are with the corporation. Directors are accountable not just to shareholders but also to other stakeholders, including employees, creditors, and the public

Compensation for damages to the corporation benefits the corporation itself, which indirectly benefits all shareholders but does not provide a direct incentive for individual shareholders to

[570] German Corporate Governance Code s 5.3.3.

[571] Theodor Baums and Kenneth E Scott, 'Taking Shareholder Protection Seriously-Corporate Governance in the United States and Germany' (2005) 53 Am. J. Comp. L. 31.

[572] German Corporate Governance Code s 4.3.4.

[573] German Stock Corporation Act (Aktiengesetz) s 116.

[574] ibid 93.

take action. When the corporation seeks to enforce liability against a management board member, the supervisory board acts on behalf of the corporation.[575] However, supervisory boards are often reluctant to initiate such actions because it might imply their failure to oversee the management board.[576]

To address this problem, German legislation allows shareholders to vote to compel the corporation to take action against a board member.[577] Additionally, the German Stock Corporation Act enables shareholders who collectively hold more than one percent of the company's share capital or shares with a nominal value exceeding €100,000 to bring a lawsuit if there is evidence of illegal conducts or significant violations.[578] However, the court need to assess the case's merits by a demand requirement, judicial review, and preliminary hearings. If the court permits a full trial, the company covers the costs, even if the plaintiff does not win the case.

Despite these measures, shareholders still face significant challenges in initiating such actions. German law imposes great obstacles for shareholders attempting to successfully pursue enforcement actions against management and supervisory board members. The plaintiff bears all costs and risks, there is no special compensation for successful lawsuits, and free-riding shareholders benefit equally from any favarouble judgment, which further discourages the legal action.

3.4.1.5 Misuse of Independent Directors

The German corporate legal framework, including the Corporate Act, the code of best practices, etc, shows that independent directors are primarily to safeguard shareholders against managers rather than against other shareholders.

In corporations with controlling shareholders, independent directors are often added to the board with the general task of overseeing managers. However, this role is largely superficial and ineffective, as the real issues in corporations with concentrated ownership stem from minority shareholder expropriation rather than managerial misconduct. In such contexts, independent directors have a limited role because controlling shareholders do not require external monitors to oversee managers they can directly appoint and supervise. The controlling shareholder has both the capacity and the incentives to effectively monitor their investment, while other shareholders benefit from their oversight without contributing.

In controlled companies, the corporate major decisions are often made directly by controlling shareholders or through their representatives on the board. As a result, the board's role is

[575] ibid 112.

[576] Baums and Scott (n 157) 52.

[577] German Stock Corporation Act (Aktiengesetz) s 147.

[578] ibid 148.

typically limited to ratifying proposals pre-negotiated by the controlling shareholders with the executives, which leaves less space for directors to do their job.

3.4.2 Japan

3.4.2.1 Overview

Before the early 2000s, independent directors were scarcely present in Japanese corporate governance. The revision of the Special Provisions Act (SPA) in 2002 marked Japan's first legislative effort to increase the use of independent directors,[579] drawing inspiration from U.S. corporate governance practices.The goal of the revision was to improve management oversight and restore profitability after the long economic downturn following the collapse of the bubble economy.[580]

The 2002 SPA introduced a nonobligatory governance structure, namely the three designated committees, the nomination committee, remuneration committee and audit committee.[581] Under this governance structure, the daily corporate management was delegated to the executive officers, while the board of directors, still primarily composed of management members, was legally obligated to monitor executive activities. The three board sub-committees undertook the monitoring functions, and each committee was required to have at least three directors with a majority of outside directors.[582] Companies adopting this model were therefore required to appoint at least two outside directors, defined as individuals who had not served as executive directors, executive officers, or employees of the company or its subsidiaries.[583]

Despite the intention to promote this flexible structure, there was no mandate for outside directors to constitute a majority on the board, nor were there stringent independence criteria. As a result, adoption was limited, with only 2.5 percent of listed companies implementing the new structure by its peak in 2006. The limited adoption was partly due to the voluntariness of the outside director requirement.

2.4.2.2 New Governance and Board Independence

The 2014 revision of Companies Act (*Kaishahō*), the Tokyo Stock Exchange (TSE) Listing Rules, and the Japanese Corporate Governance Code (JCGC) introduce the new corporate

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[579] Act on Special Provisions to the Commercial Code Concerning the Audit of Companies 1974 Law No.22.

[580] Gen Goto, Manabu Matsunaka and Souichirou Kozuka, 'Japan's Gradual Reception of Independent Directors: An Empirical and Political-Economic Analysis' in Dan W Puchniak, Harald Baum and Luke Nottage (eds), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (Cambridge University Press 2017) <https://www.cambridge.org/core/product/4FE6D70FD3EE55CA08FE52AEE986E2B0>.

[581] Act on Special Provisions to the Commercial Code Concerning the Audit of Companies Act. 1-2(3).

[582] ibid Act. 21-8(4).

[583] Shoho (Commercial Code of Japan) Act No. 48 of 1899 Art. 188(2)(vii-ii).

governance structure and offer an important the role of independent directors. Thus, there are three optional governance structure for Japanese companies to choose.

Governance Structure		Board /Committees	Board/Committee Members
Traditional Governance Structure	Company with a board of statutory auditors	Board of directors Board of statutory auditors	Directors and Statutory auditors
	Company with three committees (nominating and other committees)	The board of directors Board sub-committees: Nomination committee, remuneration committee Audit committee	Board sub-committees have a majority number of outside directors
New Governance Structure	Company with an audit committee	Board of directors	Directors
		Audit-plus committee	Majority number of outside directors

Table 3-2 Governance Structures under the Japanese Companies Act

According to the Companies Act, companies were allowed to adopt a new governance model known as company with audit-plus committee (Kansa-tou Iinnka). This committee must include at least three directors, with a majority of its members, though not the entire board being outside directors.[584] This committee, appointed by the shareholder meeting, not only audits accounts and monitor breaches of the law, but can also challenge management decisions and express opinions on matters such as the appointment, dismissal, resignation, and compensation of directors.[585] As shareholders determine the total remuneration for this committee, its members effectively serve as representatives of the shareholders.[586]

The revised Company Act provides stricter standards for “outside” directors, which is different from “independent” directors. Prior to 2014 Companies Act, the qualified outside directors were defined as those who had never been executive directors or employees of the company or its subsidiaries.[587] However, this standard of outsideness is loose because it does not disqualify the director with affiliations to company managers, major business partners, or parent companies. The 2014 reform provides stricter standards of independence. It disqualified three additional groups from serving: controlling shareholders (individuals who influence the company’s financial and business policies), directors, executive officers, and employees of the

[584] Japanese Companies Act Act.2 (xi-ii); Gen Goto, ‘Recent Boardroom Reforms in Japan and the Roles of Outside/Independent Directors’ [2018] Published in Hiroshi Oda (ed.), Comparative Corporate Governance: The Case of Japan, Journal of Japanese Law, Special 41.

[585] Japanese Companies Act Act.329(2).

[586] Goto (n 170) 41–43.

[587] Japanese Companies Act Art.2 para.15.

company's parent or sister company, as well as spouses or close relatives of directors, executive officers, or key employees of the company or its controlling shareholders.[588]

The 2014 Companies Act adopts the "comply or explain" principle, which mandates that listed companies without an outside director must provide a clear explanation of why appointing one is not suitable for their situation. Companies must detail the specific reasons why appointing a single outside director would not be appropriate. Since providing a convincing explanation is often challenging, this requirement is viewed as effectively mandating the appointment of at least one outside director,[589] heavily favoring compliance over explanation

In contrast, the JCGC represents a purely "comply or explain" regime. The TSE Listing Rules and the JCGC mandate listed companies to appoint independent outside director, providing that independent outside director who "have no conflict of interest with general shareholders". It is the violation of the independent outside director standard if these individuals hold senior positions in major trading partners, act as consultants, accountants, or lawyers receiving substantial fees from the company, serve as executives at the company's parent or sister company, or are family members of executive directors or officers of the company or its subsidiaries.[590]

3.4.2.3 Functions

The JCGC clearly defines the mediating role of independent outside directors.[591] These directors are expected to provide guidance on business policies, monitor managerial decisions, oversee conflicts of interest, and advocate for the perspectives of minority shareholders and other stakeholders, thereby promoting sustainable corporate growth and long-term value.[592]

In companies with three committees, outside directors on the audit committee are tasked with auditing the company's accounts, ensuring compliance with laws and regulations, initiating liability suits on behalf of the corporation against both executive and non-executive directors, and convening shareholder meetings in exceptional circumstances.[593] The nomination committee is responsible for selecting and proposing candidates for director positions, then presenting a list of director nominees to shareholders for approval.[594] The compensation

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588 ibid Art.2 xiv(c)(d).

589 Goto (n 170).

590 Guidelines concerning Listed Company Compliance Art.5(3).

591 Andrew Johnston and Kohei Miyamoto, 'Independent Directors and Team Production in Japanese Corporate Governance' (2023) 10 Asian Journal of Law and Society 272, 300.

592 Japanese Corporate Governance Code Principle 4.7.

593 Japanese Companies Act Art.404 para.1.

594 ibid Art.404, para 2.

committee designs the compensation packages for directors and executive officers, aligning remuneration structures with the company's goals and performance.[595]

Notably, independent directors do not have specific role in dealing with conflict of interested transactions provided by the Companies Act. All board members have a general duty of loyalty to address related-party transactions involving controlling shareholders.[596] The Companies Act impose the restrictions on competition and conflicted interest transactions, requiring directors to disclose relevant material facts at the shareholder meeting and to obtain the approval of the shareholder meeting or the disinterested directors.[597] This applies to transactions involving the company that compete with the company's business or create conflicts of interest between the director and the company.[598]

3.4.2.4 Summary

Unlike many corporate governance reforms aimed at enhancing board independence, such as the Sarbanes-Oxley Act enacted in response to the Enron scandal, Japanese reforms were not driven by major corporate scandals. Instead, increasing board independence as part of broader corporate governance reform was to revitalize the Japanese economy and increase corporate value.[599] Although inspired by the US practice, Japanese corporate governance reforms diverge from the US approach. Thus, Japanese company law's the "comply-or-explain" approach and not requiring the majority of independent directors are the reflection of this intention. However, this approach further raises questions about the efficacy of introducing a single outside director in achieving meaningful governance changes as, for example, it remains challenging to remove an underperforming CEO against the resistance of the CEO and other inside directors.[600]

3.4.3 Singapore

3.4.3.1 Overview

The adoption of independent directors in Singapore was initially motivated by the need to bolster corporate governance post the Asian financial Crisis. In 2001, inspired by the U.K. Corporate Governance Code but the US concept at its core, Singapore issued the Corporate

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595 ibid Art.404, para 3.

596 Nobuo Nakamura, 'Japan: Listed Companies' Corporate Governance' in Andreas M Fleckner and Klaus J Hopt (eds), *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge University Press 2013) 250–52 <https://www.cambridge.org/core/product/D15B06521D8BD905289117D0CA4312B5>.

597 Japanese Companies Act Art.365,365.

598 ibid Art.356.

599 ' Japan Revitalization Strategy-Japan's Challenge for the Future' <https://policy.asiapacificenergy.org/node/1322#:~:text=JAPAN%3A Japan Revitalization Strategy%3A Japan's Challenge for the Future&text=Overall Summary%3A,the country's %22earning power%22.>.

600 Goto (n 170) 48.

Governance Code (SCGC) to adopt the independent directors on a "comply or explain" basis. The majority of listed companies in Singapore have highly concentrated block-shareholding structures in either family firms or government-owned companies, and these structures have become even more concentrated over time.[601] Prior to the implementation of the 2001 SCGC, Singapore company law has never included provisions that mandate a certain level of independence from significant shareholders within corporate boards regardless of the criteria used to define independence. However, shortly after the SCGC came into effect in 2003, 96 percent of companies listed on Singapore reported full compliance with the recommendation that at least one-third of the board members are independent directors.[602] Shortly thereafter, compliance rose to 98 percent, with the majority of directors being classified as "independent."[603]

3.4.3.2 Directors independence

The SCGC recommends that the board of directors should include a significant independent component, with independent directors making up at least one-third of the board. An "independent" director is defined as someone who has no relationships with the company, its affiliated entities, or its officers that could interfere, or appear to interfere, with their independent business judgment in the company's best interests. Directors lose their independence if specific conditions are met: (1) if the director or an immediate family member has been employed by the company or its affiliates within the past three financial years; (2) if the director has received any compensation from the company or its affiliates, apart from board service, within the current or previous financial year; (3) if the director holds a substantial ownership (5% or more) or executive position in any for-profit organization that has made or received significant payments (over S$200,000) to or from the company within the current or previous financial year.[604]

Additionally, independent directors are required in board committees. The board is encouraged to establish a remuneration committee predominantly composed of non-executive directors who are independent of management and free from relationships that could impede their independent judgment, to mitigate potential conflicts of interest.[605] The remuneration committee's chairperson should be an independent non-executive director, and the committee should include at least one member knowledgeable about executive compensation.[606] If no such member is available, the committee should seek external expert advice.[607] Similarly, the nomination and audit committees should each consist of at least three directors, with a majority,

[601] Tan Cheng-Han, Dan W Puchniak and Umakanth Varottil, 'State-Owned Enterprises in Singapore: Historical Insights into a Potential Model for Reform' (2014) 28 Colum. J. Asian L. 61, 66.

[602] Hans Tjio, Yee Wan Wai and Hon Yee Kwok, *Principles and Practice of Securities Regulation in Singapore* (LexisNexis 2004) ch 5.24.

[603] ibid.

[604] Singapore Corporate Governance Code 2001 Principle 2.

[605] ibid Principle 7.

[606] ibid.

[607] ibid.

including the chair, being independent, [608] though specific criteria for independence are not stipulated.

The role of independent directors in the audit committee was already established under the Singapore Companies Act of 1989, which requires the committee to have at least three members, with a majority being independent of the company's executive directors and capable of exercising independent judgment.[609]

3.4.3.3 Independent Directors in Family Firms

In contrast to the managerial monitoring role in the US governance model, independent directors introduced in Singapore act the limited role as the monitor, but as the complementary role of other governance institutions. Puchniak and Lan argued that though both are controlled companies, the function of independent directors is different in family firms and government-linked companies (GLCs) because of the different identity of corporate controller.[610]

In Singapore family firms, the ownership is highly concentrated. The top five owners control an average stake of 65.9 percent in family firms, and with 38.3 percent directly owned by family members.[611] Additionally, the top twenty largest shareholders control 80.5 percent of the shares, which indicates the actual control of family members overs the firms through the voting rights.[612] Family controllers often use this influence on secure senior executive and board positions or appoint professional managers under their oversight. In scenarios where family members occupy key roles as senior executives and board members, independent directors cannot effectively monitor family-member controlling shareholders. The empirical evidence shows that in Singapore, independent directors need to build high levels of trust and credibility, often achieved through personal connections with family members, particularly the patriarch who often serves as Chairperson.[613] However, the close ties to the family-member controllers significantly hinder independent director's effectiveness as the monitor. In the circumstance where professional managers are appointed, family-member controllers typically have enough information, resources, and power to monitor or replace underperforming managers, reducing the necessity for independent directors to act as managerial monitors. [614] Additionally, Singapore company law allows directors to be removed at any time without cause though a

[608] ibid Principle 4.

[609] Singapore Companies Act 1989 201B.

[610] Dan W Puchniak and Luh Luh Lan, 'Independent Directors in Singapore: Puzzling Compliance Requiring Explanation' (2017) 65 The American Journal of Comparative Law 265.

[611] Marleen Dieleman, Jungwook Shim and Muhammad Ibrahim, 'Success and Succession: A Study of SGX-Listed Family Firms' 21,24.

[612] ibid 21.

[613] Wilson Ng and John Roberts, '"Helping the Family": The Mediating Role of Outside Directors in Ethnic Chinese Family Firms' (2007) 60 Human Relations 285, 303.

[614] ibid 289.

majority shareholder vote.[615] This rule significantly undermines the capacity of independent directors to act as effective overseers of controlling shareholders within family-run companies.

Instead, independent directors in family firms arguably serves as the signal of good governance and regulatory compliance to international markets, adhering to global norms.[616] However, the requirement of having more than one-third of the board composed of independent directors does not substantially impact the control of the family member, as Singapore company law empowers firm controller ultimate control on independent director's directorship.[617] In other words, the integration of independent directors combined with strong significant voting rights of the firm controller, creates an optimal environment for signaling sound corporate governance while maintaining the dominance of family controllers.

Additionally, as noted above, independent directors develop close relationship with the family chairman to find ways to work, which helps independent directors serve effectively in mediating the disputes, arguably balancing the competing interests between various corporate parties.[618]

3.4.3.4 Independent directors in Government-Linked companies (GLCs)

Singapore's Temasek Holding Private Limited ("Temasek") is an investment company wholly owned by Singapore's Ministry of Finance (SMOF). The People's Action Party (PAP) initiated the government's active investment in the private sector during the post-independence period to address the lack of skilled entrepreneurs and private capital. Temasek was established in 1974 to manage the government's investments portfolio, aiming to create a formal separation between government and business operations to avoid undue political influence.[619] Through the holding of Temasek, Singapore government is the controlling shareholder of twenty-three Singapore's largest public listed companies, known as GLCs who collectively account for 37 percent of Singapore's total market value.[620] Temasek has become an active investor and achieves successful performance.

The PAP is cautious about the risk that Temasek and GLCs becoming political automatons instead of successful commercial entities. The stringent regulatory regime has been designed to prevent political interference and ensure commercial success. First, restricting SMOF's shareholder rights. The SMOF cannot appoint or remove Temasek's directors without the President's approval, ensuring decisions are free from undue political influence.[621] Temasek's board, not the SMOF, has the ultimate authority to decide on dividend payments, preventing

[615] Singapore Companies Act Act.152.

[616] Cheng-Han, Puchniak and Varottil (n 187) 5–6.

[617] Singapore Companies Act Act.152.

[618] Ng and Roberts (n 199) 299.

[619] 'History of Temasek - Temasek' <https://www.temasek.com.sg/en/about-us/history-of-temasek> accessed 1 July 2024.

[620] Isabel Sim, Steen Thomson and Gerard Yeong, 'The State as Shareholder' [2014] The Case of Singapore 6.

[621] ibid 16.

wealth tunneling for political purposes.[622] Second, Temasek's board must ensure all transactions are at fair market value and seek the President's approval to use reserves accumulated before the incumbent government, which aims to ensure Temasek board decisions are commercially driven.[623] Third, Temasek's role in GLCs are strictly restricted. Temasek's governance policy, as outlined in the Temasek Charter, emphasizes promoting good corporate governance in its GLCs without direct management involvement.[624] While Temasek can suggest qualified candidates for directorial positions for GLCs, the individual boards retain the final decision-making power, maintaining Temasek's voting rights in director elections.[625] Fourth, Temasek adheres to rigorous audit and disclosure standards, providing annual financial statements audited by an international firm and publishing comprehensive financial summaries in its annual Temasek Review, earning it high transparency ratings among sovereign wealth funds.[626]

Temasek has achieved notably economic success and largely insulated from political influence.[627] However, the stock regulations that limit the government's and Temasek's shareholder rights to intervene in the management of GLCs serve a dual purpose: they reduce the likelihood of political gains being extracted from GLCs, but they also restrict the government's capacity to effectively oversee or manage these companies. As a result, independent directors have been introduced to monitor management, supplementing the limited oversight role of the government as a shareholder.

The 2022 annual report of Temasek and GLCs reveals that the majority (86%) of board of directors are non-executive independent directors, with a wholly independent audit committee.[628] This proportion is well above the "one-third" recommendation of the JCGC. However, while the independent directors in the board of Temasek are not tied to the management, many have past or current affiliations with the Singapore government, raising concerns about their true independence.[629] Despite their important role, the effectiveness of independent directors in GLCs is occasionally scrutinized due to this political connection. Nevertheless, Singapore's selection process for independent directors is highly meritocratic. Many of the appointed independent directors have distinguished careers in the public or private sectors, ensuring they possess the skills and expertise needed for effective oversight. Their

[622] ibid.

[623] ibid.

[624] 'Background and Context of Temasek Charter' <https://www.temasek.com.sg/content/dam/temasek-corporate/news-and-views/news/files/Charter_2009_-_Background_and_Context.pdf> accessed 1 July 2024.

[625] 'How Does Temasek Work with Its Portfolio Companies?-Temasek' <https://www.temasek.com.sg/en/about-us/faqs#portfolio-companies>.

[626] 'Temasek Review - Temasek' <https://www.temasek.com.sg/en/our-financials/library/temasek-review> accessed 2 July 2024; Sim, Thomson and Yeong (n 207).

[627] 'Temasek Review - Temasek' (n 213).

[628] 'Board of Directors - Institution | Temasek Review 2022' <https://tr22.temasekreview.com.sg/institution/board-of-directors.html> accessed 2 July 2024.

[629] Puchniak and Lan (n 196) 39–40.

backgrounds in government or related fields often reflect their competence and not undue political influence.

In sum, independent directors in Singapore’s Temasek and GLCs are essential to maintain good governance and ensure commercial success. They provide critical oversight and help mitigate the risks of political interference. Singapore’s regulatory framework, along with its emphasis on transparency and meritocracy, further strengthens the role of independent directors in these entities.

Concluding remarks

This chapter has explored the origins, functions, and global diffusion of the independent director system, emphasizing its diverse adaptations across different jurisdictions. By examining the historical and regulatory evolution of independent directors in the U.S, U.K., Germany, Japan, and Singapore, this chapter provides a critical comparative foundation that informs the thesis's investigation into China's adoption of independent directors.

The analysis highlights several important themes. Firstly, independent directors emerged initially in the U.S. as a corporate governance response to specific institutional pressures such as dispersed ownership structures, corporate scandals, and evolving regulatory frameworks. The chapter then demonstrated that despite the widespread international adoption of independent directors, substantial differences remain in how this governance mechanism operates across jurisdictions due to variations in ownership concentration, legal traditions (common law vs civil law), regulatory environments, and local institutional norms.

Germany and Japan provide essential insights into the constraints independent directors face in civil law jurisdictions with concentrated ownership structures—challenges similar to those encountered in China. In contrast, Singapore illustrates that independent directors can successfully function within a context of significant state ownership and family control, provided they are integrated into a broader governance framework designed to mitigate conflicts of interest. The U.K.'s flexible regulatory approach underscores the importance of adaptability, highlighting how context-sensitive governance mechanisms can enhance board effectiveness.

Collectively, these comparative analyses clarify the complexity involved in transplanting the independent director system into diverse corporate governance contexts. They underscore that legal transplantation is not merely about formal adoption but necessitates substantive adaptation aligned with the local institutional environment.

This comparative foundation is critical for the subsequent analysis of China’s independent director system presented in Chapter 4. By situating China within this broader international context, the thesis can better identify why China's independent director regime, despite formal alignment with global governance standards, has persistently struggled with operational effectiveness.

Chapter 4 Corporate Governance and Independent Directors in China

Introduction

This chapter explores the evolution of corporate governance in China, with a specific focus on the role and implementation of independent directors. In contrast to the well-established practices seen in Anglo-American markets, where independent directors are crucial in ensuring accountability and protecting investors' interests, the adoption of independent directors in China presents unique challenges. These challenges arise from China's distinct corporate landscape, which is characterized by concentrated ownership, significant state influence, and a rapidly evolving legal framework. This chapter provides a comprehensive examination of how independent directors—an institution borrowed from Western corporate governance models—have been adapted within the Chinese context, highlighting the complexities and nuances of this legal transplant.

Section 4.1 explores the historical origins of corporate governance in China, tracing its development from the early 20th century through the significant transition from a centrally planned economy to a market-driven one. Section 4.2 discusses the progressive development of corporate governance following China's "Open Door" policy, outlining five distinct stages of reform from 1978 to the present. Section 4.3 examines the legal framework underpinning corporate governance in China, focusing on key legislation such as the Company Law, Securities Law, and the Code of Corporate Governance for Listed Companies. Section 4.4 addresses the ongoing challenges and issues within Chinese corporate governance, including the prevalence of concentrated ownership, the complexities of state control, and the exploitation of minority shareholders by large shareholders. Section 4.5 introduces the concept of independent directors in China, detailing the process of their establishment, the qualifications required, their roles and responsibilities on boards and committees, and the mechanisms for their nomination, appointment, and remuneration. This section also outlines the specific obligations and special powers granted to independent directors within the Chinese context. Section 4.6 and 4.7 critically assesses the effectiveness of independent directors in China and explores the barriers that impede the successful implementation of independent directors in China.

4.1 Historical Origin of Corporate Governance in China

Corporate governance in China appeared during China's transition from a planned economy to a market economy.[630] The origins of Chinese corporate governance can be traced back to the early 20th century with the enactment of the Company Code of Great Qing (Daqing Gongsi Lv)[631] on January 21, 1904, by the Ministry of Commerce during the late Qing dynasty. The 1904 Company Law promulgates the modern Western-style corporate governance elements,

[630] China Securities Regulatory Commission, *Corporate Governance of Listed Companies in China* (OECD 2011) 13 <https://www.oecd-ilibrary.org/governance/governance-of-listed-companies-in-china_9789264119208-en>.

[631] Thereafter Company Law 1904.

such as limited liability, separation of ownership and control, and requirements for annual audits and financial reporting.[632] Despite these features, most industrial enterprises were primarily government-sponsored managed through government patronage. The 1904 Company Law failed to shift control from empowered managers to shareholders and not fostering an active domestic share market.[633] The ROC's corporate legislation, influenced by the German model, led to the enactment of the Company Law of 1929. Notably, the 1929 law sought to protect minority shareholders and limit the rights of large shareholders, except for those held by the government.[634]

In 1949, the Communist Party took control of China, establishing the People's Republic of China and abolishing previous corporate laws. The government implemented a centrally controlled economic system, eliminating free markets and converting most private companies into state enterprises.[635] Between 1949 and 1978, China's economy was modeled on the Soviet Union's planned economy, where most enterprises were state-owned. Such planned economy has the following features: (1) SOEs were wholly owned and operated by the state as government-affiliated administrative departments("work unit" or "danwei"); (2) the production targets were decided and assigned by the government according to the national's plans, the resources, goods, and the output of production were directly allocated by the state;(3) product prices were not allowed to serve as indicators to guide company production decisions, instead, the government controlled prices to direct resources across various sectors which was part of a broader strategy to drive large-scale industrialization efforts; (4) the Party controlled the managerial career paths that the Party appointed managers of SOEs;[636] (5) profits were remitted to the state, losses were absorbed by the government; (6) managerial performance was measured by meeting planned-targets rather than market outcomes; (7) managers' salaries were set in accordance with the industries they belonged and the position they had.[637] Political entitlement was the primary source of incentive for managers and employees.[638]

[632] William Goetzmann and Elisabeth Köll, '2. The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control', *A history of corporate governance around the world* (University of Chicago Press 2007) 150.

[633] ibid 151.

[634] 1929 Company Law of Republic of China, Art 129.

[635] K Matthew Wong, 'Securities Regulations in China and Their Corporate Finance Implications on State Enterprise Reform' (1996) 65 Fordham Law Review 1221, 1221 <https://heinonline.org/HOL/Page?handle=hein.journals/flr65&id=1239&div=54&collection=journals> accessed 13 September 2021.

[636] Barry J Naughton, *The Chinese Economy: Transitions and Growth* (MIT Press 2006) 59; Ligang Song, 'State-Owned Enterprise Reform in China: Past, Present and Prospects', *China's 40 Years of Reform and Development: How Reform Captured China's Demographic Dividend* (Australian National University Press 2018).

[637] Naughton (n 7); Song (n 7); China Securities Regulatory Commission, *Corporate Governance of Listed Companies in China* (n 1).

[638] China Securities Regulatory Commission, *Corporate Governance of Listed Companies in China* (n 1).

Chinese Marxists believed that this system would maximize productivity and efficiency and prevent "blind competition" and byproducts such as unemployment and depression in a free market economy.[639] However, the state-run economy did not provide market-driven incentives for managers and workers to focus on efficiency, nor did it hold them accountable for profits or losses. As a result, SOEs struggled with inefficiency and underperformance,[640] leading to persistent waste and significant financial losses within the industrial sector.[641]

In 1978, following the Third Plenary Session of the 11th Central Committee of the CCP, the government began reforming the economic system, particularly in urban areas.[642] A key focus of these reforms was the restructuring of traditional SOEs to enhance their efficiency. As SOEs were gradually transformed into modern enterprises and the stock market was established, corporate governance began to gain increasing attention and evolved significantly over the subsequent decades.

By the early 21st century, corporate governance had emerged as a prominent issue, especially in light of financial scandals involving fabricated reports, market manipulation, and insider trading, as seen in cases like YinGuangXia[643] and Yi'an Keji[644]. These incidents severely impacted the interests of minority shareholders in China, highlighting collusion between dominant shareholders and senior management and exposing the deficiencies in corporate oversight within Chinese listed companies.

Since the 2000s, corporate governance has increasingly emphasized the role of independent directors.[645] Recognized globally as a key indicator of corporate governance quality, independent directors have been adopted in numerous countries and are often used by international organizations and consulting firms to assess governance performance.[646] China's accession to the World Trade Organization (WTO) in 2001 brought new opportunities and

639 Wong (n 6); Robert C Art and Minkang Gu, 'China Incorporated: The First Corporation Law of the People's Republic of China ' (1995) 20 Yale Journal of International Law 273 <https://heinonline.org/HOL/P?h=hein.journals/yjil20&i=285>.

640 Song (n 7) 346.

641 Art and Gu (n 10) 277.

642 Database of the National Congress of the Communist Party of China (in Chinese), 'Report of the Third Plenary Session of the 11th Central Committee of the Communist Party of China' (1978) <http://cpc.people.com.cn/GB/64162/64168/64563/65371/4441902.html>.

643 Huawei Ling, Haili Cao and Fan Zhou, 'Tang Wanxin: The Villian (Xiaoxiong Tang Wanxin)' [2006] *Caijing*.

644 Jing Li, 'Who Is Manipulating Yi'an Keji? (Shuizai Caozong Yi'an Keji?)' [2001] *Caijing*.

645 Jeffrey N Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (2010) 59 Stanford Law Review <https://heinonline.org/HOL/Page?handle=hein.journals/stflr59&id=1477&div=46&collection=journals> accessed 9 April 2018.

646 E.g. 'U.S. Spencer Stuart Board Index' <https://www.spencerstuart.com/research-and-insight/us-board-index>; 'ESG Ratings - MSCI' <https://www.msci.com/our-solutions/esg-investing/esg-ratings>.

challenges for Chinese companies in the global market, making it essential for them to align with international standards and fulfill WTO obligations to remain competitive.[647]

The rising prominence of independent directors attracted the attention of Chinese policymakers. In response, the CSRC issued the Independent Director Guideline in Listed Companies in August 2001. This initiative aimed to enhance corporate governance by incorporating Independent Directors into listed companies, as part of a broader effort to modernize China's legal and regulatory frameworks by adopting practices and lessons from other jurisdictions.[648]

4.2 The Development of Corporate Governance Since The "Open Door."

The evolution of corporate governance in China is associated with the process of SOEs reform, which experienced five stages: 1) 1978-1984 expanding the enterprises' management autonomy; 2) 1984-1992 Implementing contract responsibility system; 3) 1992-2003 socialist market economy and modern enterprise system; 4) 2003-2013 establishment of modern corporate governance system; 5) 2013 to the present deepening SOE reform.

4.2.1 Stage 1: 1978-1984 Expanding Enterprises' Management Autonomy Under the Planned Economy

During this initial phase, the primary focus was on increasing the decision-making autonomy of SOEs within the planned economy framework.

The reform started in the Sichuan province in October 1978, and soon expanded nationwide under the direction of the State Economy Commission. This reform allowed SOEs to retain part of the profits, and once they met production targets, they were permitted to distribute bonuses to workers. Managers of SOEs gained greater authority to make business decisions and engage in production beyond the state's national plans, thereby reducing direct administrative control by the state and introducing economic incentives.

In addition, several pilot reform programmes were launched during the period to further explore SOEs reforms. In 1981, the State Council approved a pilot initiative involving eight SOEs that adopted the Contract Responsibility System (CRS). Under CRS, SOE managers entered into contracts with the government and were granted operating rights. This system allowed SOEs to keep surplus profits after paying a predetermined amount to the government and provided managers with the autonomy to make decisions related to marketing, technological innovation, and production beyond the assigned targets.[649]

[647] Naughton (n 7) 104.

[648] Ling Zhou, 'The Independent Director System and Its Legal Transplant into China' (2011) 6 Journal of Company Law 262.

[649] Song (n 7) 349.

In 1983, another pilot reform known as “li gai shui” was introduced, allowing SOEs to pay taxes instead of remitting profits directly to the state.[650] Initially, profits and taxes coexisted, with an income tax rate of 55 percent for SOEs, while the remaining 45 percent of profits were retained according to an agreed-upon proportion between the state and the SOEs. Over time, this approach evolved, and the remittance of profits was generally replaced by the payment of income tax, further aligning SOE operations with market principles.[651]

4.2.2 Stage 2: 1984-1992 Contract Responsibility System

In 1984, the Third Plenary Session of the 12th Central Committee of the Communist Party of China(CCCCP) decided on further economic reform in the urban area, emphasizing that energizing enterprises was key to the process. This called for a clear separation between ownership and operational rights, along with a restructuring of profit distribution within SOEs.[652] Building on the early successes of the pilot CRS, the policy was rapidly expanded across SOEs, and by the end of 1988, CRS had been implemented in 93 percent of these enterprises. Typically, contracts between the government and SOE managers were set for a term of three to five years.[653]

In 1988, the Law of the PRC of Industrial Enterprises Owned by the Whole People was enacted, establishing the foundation of China’s corporate governance system. The statute affirmed the separation of ownership and operational rights, thereby providing the legal basis for CRS implementation.[654] It also provided the manager accountability system in SOEs, which stipulated the ultimate leadership of managers in SOEs operation and management.[655] Under the law, the new leadership structure has been established with managers’ overall responsibility, the party’s supervision, and employees’ democratic management.[656] Additionally, labor unions operated independently to safeguard workers’ interests.[657] Collectively, the party committee, the employee representative assembly, and the labor union—referred to as the “Old Three Committees”—formed the governance structure for SOEs under the planned economy.

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[650] ‘Big Events of Communist Party of China (1983)’ <http://cpc.people.com.cn/GB/64162/64164/4416129.html>. On 21st March 1983, the State Council held the National Industry and Transportation Conference, expressed that starting “li gai shui” reform. On 24th April 1983, “li gai shui” was piloted, and on 1st June, it was promulgated nationwide in SOEs.

[651] Trial Measures for the Reform of Profits to Taxes for State-owned Enterprises 1983.

[652] Database of the National Congress of the Communist Party of China (in Chinese), ‘Decision of the Central Committee of the Communist Party of China on Economic System Reform’ <http://cpc.people.com.cn/GB/64162/64168/64565/65378/4429522.html>.

[653] John Hassard, Jackie Sheehan and Jonathan Morris, ‘Enterprise Reform in Post-Deng China’ (1999) 29 International Studies of Management & Organization 54, 57–58 <https://doi.org/10.1080/00208825.1999.11656771>.

[654] Law of the People’s Republic of China on Industrial Enterprises Owned by the Whole People. Art 2

[655] ibid. Art 45

[656] ibid. Art 7-10

[657] ibid. Art 11

While the CRS and separation of ownership and operational rights did have its positive effects such as increased autonomy and incentives for SOEs and their employees, they also had significant drawbacks. The three-to-five-year contract fostered a short-term focus among managers, who, armed with greater power and authority, were more likely to bargain profit remittance with the government for more personal benefits and pursue short-term profits, such as misappropriating the production development fund for employee rewards instead of improving the productivity.[658] By the early 1990s, around one-third of SOEs were operating at a loss, highlighting that while managers and employees reaped the benefits of the reform policies, the state was left to absorb the negative consequences.[659]

4.2.3 Stage 3: 1992-2003 Socialist Market Economy And Modern Enterprise System

In 1992, during the "Southern Tour," Deng Xiaoping delivered pivotal speeches that emphasized the market's crucial role in driving economic development. Later that year, the 14th National Congress of the CCP endorsed the establishment of a socialist market economy as the primary objective of economic reforms.[660] The main focus of SOE reforms during this period was to build a modern enterprise system aligned with the socialist market economy, characterized by clear distinctions in ownership, defined rights and responsibilities, autonomy from the government, and a scientific approach to leadership and organizational management.[661]

By 1997, the 15th National Congress of the CCP had articulated the fundamental economic system as one centered on public ownership while encouraging the development of diverse ownership forms.[662] This shift led to the adoption of the "grasp the large and let go of the small" strategy (zhua da fang xiao). Under this policy, the state maintained control over key, strategically significant industries such as defense, energy, telecommunications, and transportation, while small and medium-sized SOEs were allowed to chart their own courses, resulting in widespread privatization. These smaller enterprises were privatized through various methods, including buyouts by managers or employees, sales to external parties, reorganizations, mergers, leasing, contracting, and joint ventures.

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658 Notice of the State Council on Strengthening the management of State-owned Assets.

659 Mary M Shirley and Lixin Colin Xu, 'Empirical Effects of Performance Contracts: Evidence from China' (2001) 17 Journal of Law, Economics, and Organization 168.

660 Database of the National Congress of the Communist Party of China (in Chinese), 'Resolution of the 14th National Congress of the Communist Party of China on the Report of the 13th Central Committee' (18 October 1992) <http://cpc.people.com.cn/GB/64162/64168/64567/65446/4441716.html> accessed 27 June 2021.

661 'Decision of the Central Committee of the Communist Party of China on Several Issues Concerning the Establishment of a Socialist Market Economic System (Approved at the Third Plenary Session of the 14th Central Committee of the Communist Party of China)' (1993) <http://www.people.com.cn/item/20years/newfiles/b1080.html> accessed 28 June 2021.

662 '15th National Congress of Chinese Communist Party' (1997).

During this phase of SOE reform, insider privatization was prevalent, with managers and employees becoming shareholders in the newly restructured companies.[663] However, the privatization process was often marred by widespread irregularities, including the stripping and misappropriation of state assets by managers for personal gain and the manipulation of asset valuations, pricing, and transfers in joint venture formations. These practices sparked significant public debate and scrutiny over the privatization process.[664]

In line with the policy, traditional SOEs were restructured and transformed into shareholding companies, adopting organizational structure similar to public companies, such as joint stock companies or limited liability companies. These new entities featured general shareholders' meetings, boards of directors, and boards of supervisors. State-operated enterprises were subsequently referred to as state-owned enterprises (SOEs). The development of capital markets and the enactment of the Company Law and Securities Law greatly advanced SOE reforms.[665] The establishment of the Shanghai and Shenzhen stock exchanges in the early 1990s provided platforms for these restructured enterprises to list and secure financing. The Company Law, promulgated in 1993 and effective from July 1, 1994, provided a legal framework for the modern corporate system and laid the foundation for corporate governance in China.[666] It outlined the responsibilities and liabilities of key corporate actors, mirroring practices in other jurisdictions, particularly those of Anglo-American countries. This new governance structure, known as the "New Three Committees" (general shareholders' meetings, boards of directors, and boards of supervisors), coexisted with the traditional "Old Three Committees" (employee representative assemblies, party committees, and labor unions). The Securities Law, the first economic legislation drafted by the People's Congress, established foundational rules and principles to guide and regulate China's emerging capital markets.[667]

China's entry into the World Trade Organization (WTO) in 2001 further accelerated the evolution of corporate governance. Building on the OECD Principles of Corporate Governance and considering China's unique circumstances, the CSRC and the State Economic and Trade Commission (SETC) jointly issued the Code of Corporate Governance for Listed Companies (Chinese CGC) on January 7, 2002. The Code laid out the core principles of corporate governance, strategies for protecting investor interests, and standards of conduct and ethics

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[663] William P Mako and Chunlin Zhang, 'Why Is China so Different from Other Transition Economies?', *Contemporary Studies in Economic and Financial Analysis*, vol 90 (Emerald Group Publishing Limited 2007) 177.

[664] South China Morning Post, 24th October 1998; Jingji Ribao (Economic Information Daily), Beijing, 26th August 1997; Sohu Caijing, 17th June 2004.

[665] Karen Jingrong Lin and others, 'State-Owned Enterprises in China: A Review of 40 Years of Research and Practice' (2020) 13 China Journal of Accounting Research 31, 38.

[666] China Securities Regulatory Commission, *Corporate Governance of Listed Companies in China* (n 1).

[667] Cao Fengqi, 'The Promulgation Process of Securities Law and Its Great Significance to Market Development (Zhengquan Fa Chuyai Guocheng Ji Dui Shichang Fazhan de Zhongda Yiyi)' [1990] zhengquan shichang daobao <http://whu.keyan123.cn/rwt/401/https/N36GP6BPMNYGX4JPN3TYE/kcms/detail?v=3uoqIhG8C46NmWw7YpEsKGnELgMhkVEZt0-uD-MSJVgQcDjlGJUxCkSTwVK_DLdD6WjLUona9eYF9GzXxqdtV0ZurWvqoptl&uniplatform=NZKPT>.

for directors, supervisors, managers, and senior executives.[668] However, like corporate governance codes in many other countries, the Chinese CGC employed broad and general language rather than precise, detailed regulations.[669]

4.2.4 Stage 4: 2003-2013 State Asset Management System and Enhancement of Legal Institutions in Corporate Governance

Following the restructuring of SOEs, government ownership was redefined through a shareholding structure. In June 2003, the Third Plenary of 16th CCCCP decided to develop the modern property right system to strengthen the public sector economy, emphasizing that "property rights" were central to ownership.[670] However, there lacked an organization to exercise the government's property rights in large and strategically important SOEs. To address this, the State-owned Assets Supervision and Administration Commission (SASAC) was established in March 2003 under the authority of the State Council at both central and local level. By separating the government's role as a shareholder from its broader societal managerial functions, SASAC acted as the representative owner of state assets, with a primary focus on preserving and increasing the value of state-owned assets and consolidating SOEs through ownership reforms.[671]

SASAC initiated corporatization reforms, including the pilot board reforms of central SOEs starting in 2004, with a goal of establishing boards of directors in all central SOEs by the end of 2007.[672] In line with the requirements of the Company Law and the Interim Regulations on the Supervision and Administration of State-owned Assets of Enterprises, the board of directors were established in major central SOEs, and the presence of outside directors was increased to enhance oversight of corporate activities.[673] While the results of these board reforms were mixed, the foundational mechanisms were successfully implemented in central SOEs.[674]

Revised legal frameworks during this period played a crucial role in shaping China's corporate governance structure. The 2005 comprehensive revision of the Company Law reinforced

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668 Code of Corporate Governance of Listed Companies 2002.

669 Fuxiu Jiang and Kenneth A Kim, 'Corporate Governance in China: A Modern Perspective' (2015) 32 Journal of Corporate Finance 190, 194.

670 Database of the National Congress of the Communist Party of China (in Chinese), 'Decision of the Central Committee of the Communist Party of China on Several Issues Concerning the Improvement of a Socialist Market Economic System (Approved at the Third Plenary Session of the 16th Central Committee of the Communist Party of China)' (2003).

671 Naughton (n 7) 316; Song (n 7) 356.

672 SASAC's Guideline Opinion On Establishing and Improving the Board of Director in Central SOEs (Trial)(guowuyuan guoyouzichan jiandu guanli weiyuan hui guanyu guoyou duzi gongsi dongshihui jianshe de zhidao yijian, shixing) 2004.

673 ibid.

674 Hu Daoyong, 'The Construction of Board of Directors at This Stage in Solely State-Owned Enterprises in China' [2007] State Assets Management 52.

shareholder primacy, especially focusing on the protection of small and medium shareholders.[675] It clarified shareholders' rights to information, provided judicial support for shareholders seeking access to financial records, and established mechanisms allowing shareholders to sue directors and senior management when their interests were harmed.[676] The law also specified qualifications and fiduciary duties for directors, supervisors, and senior executives, and set conditions for shareholders to pursue derivative lawsuits.[677] The 2005 revision strengthened internal supervisory mechanisms and mandated the independent director system for all listed companies.[678]

The 2005 Securities Law laid the groundwork for the development of a multi-tiered capital market.[679] The recommendation and sponsor system for listing[680] was established with a stricter examination of security insurance. Enhancements in the Securities Law focused on protecting investors, particularly minority shareholders, and established legal consequences for misconduct by those in control of the company, including directors, supervisors, and senior executives.[681] Concurrently, amendments to the Criminal Law introduced criminal liabilities for violations of securities laws.[682]

4.2.5 Stage 5: 2013 - the present. Deepening SOEs Reform and Strengthening Party Leadership

The SOE reforms initiated in 2013 were grounded in a mixed ownership approach, aimed at incorporating non-state capital into SOEs to enhance market discipline and corporate governance practices.[683] In 2015, the CCCCP and the State Council jointly released the

[675] Company Law of People's Republic of China, Revised at the 18th Meeting of the 10th National People's Congress of the PRC on 27th Oct 2005. (hereafter "2005 Company Law") Art 106，122， 151，152

[676] 2005 Company Law 2005. Art 34. 151

[677] ibid. Art 11, 142, 147-150, 152

[678] ibid. Art 123.

[679] Up to now, Chinese capital market has can be divided into Stock Exchange Market (the Main Board Market, the Growth Enterprises Market, the Science and Technology Innovation Board Market), and the National Equities Exchange and Quotations (the Third Board Market for Small and Medium Enterprises and the Fourth Board Market for regional equity trading).

[680] Securities Law. Art.11

[681] Securities Law. Art. 94

[682] Sixth Amendments to the Criminal Law of the People's Republic of China, Promulgated by the Standing Committee of National People's Congress on 29th June 2006. Art 161-163, 169, 182

[683] Lauren Yu-Hsin Lin and Curtis J Milhaupt, 'Party Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance' (2021) 50 https://doi.org/10.1086/713189 187, 188 <https://www.journals.uchicago.edu/doi/abs/10.1086/713189> accessed 23 July 2021.

"Guiding Opinion on Deepening Reform of the State-Owned Enterprises," outlining a detailed plan for further SOE reforms, [684] which included seven key areas:

Further Corporatization of SOEs: This involved refining the roles of the board of directors and supervisory boards within corporate governance, clearly defining their duties and responsibilities, empowering corporate boards to make independent decisions, and improving personnel management and market-based compensation systems for SOE executives.

Empowering SOE Boards: The state committed to granting SOE boards greater authority over the appointment and dismissal of senior executives.

Promoting Market Competition: To enhance competition in the domestic market, the state pledged to reduce entry barriers for private sector investments and gradually eliminate price controls in non-strategic industries.

Classification of SOEs: SOEs were categorized into commercial SOEs and public welfare SOEs, each evaluated by different criteria. Competitive state enterprises were given greater operational autonomy.

Development of the Mixed-Ownership Model: This involved encouraging non-state capital participation in SOE reforms through various means, such as capital contributions, acquisitions, convertible bonds, equity swaps, and state capital investments in non-state enterprises through joint ventures and reorganizations.

Enhancing Supervision Systems: The oversight mechanisms were strengthened, including internal supervision (e.g., supervisory boards, audits, and discipline inspections) and external supervision (through laws and regulations) of SOEs.

Reinforcing Party Leadership: A key component of the reforms was to bolster the leadership role of the Communist Party within SOEs, ensuring alignment with party policies and objectives.

Since 2010, the influence of the Party committee in corporate governance has been progressively reinforced. The Party has focused on enhancing its role in collective decision-making on key matters within enterprises, particularly those related to "decision-making on significant issues, the appointment and removal of key personnel, investments in major projects, and the allocation of substantial funds," collectively known as the "Three Important, One Large."[685]

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[684] CPC Central Committee and State Council, 'Guiding Opinion on Deepening Reform of the State-Owned Enterprises' <http://www.gov.cn/zhengce/2015-09/13/content_2930377.htm>. 24th August 2015. (hereinafter "SOE Reform Guiding Opinions", or "Guiding Opinions")

[685] Opinions on Further Improving the Implementation of Decision-Making System of the 'Three Important, One Large' in SOEs 2010.

Table: 4.1 The major stages of SOEs reform

Period	Objectives and achievements of SOEs at each stage
1949-1977	✧ Central controlled economy ✧ SOEs are "work unit" of administrative departments ✧ Profits and losses are both borne by the state
1978-1984	✧ Granting autonomy and sharing profit (fangquan rangli)
1984-1992	✧ Changing profits into taxes (li gai shui) ✧ Contract responsibility system
1993-2003	✧ Establish a modern enterprise system based on the socialist market economy, featuring clearly defined ownership, rights, and responsibilities, separated from the government, and a scientific leadership institution and organizational management system. ✧ Privatisation of small and medium SOEs ✧ Partial privatisation of large SOEs by incorporation ✧ Establishment of corporate governance system
2003-2013	✧ State Assets Management System. Separating the state's shareholder role and state governance role. ✧ Revision of legal institutions to improve the corporate governance structure and initiating board reform in SOEs
2013-present	✧ Deepening SOEs reform ✧ Mixed ownership ✧ Transforming from enterprise management to capital management ✧ Classified management according to the purpose of SOEs ✧ Strengthening Party leadership

With Xi Jinping's rise to power in 2012, a new phase of state-led SOE reforms was initiated, further tightening the Party's control over these enterprises. This was underscored by a series of policy directives from the CCP, the State Council and the SASAC. In 2013, the Central Organization Department of the CCP and the SASAC issued their opinion to clarify the political central role of the Party committee within the modern enterprise system and emphasize the leadership of the Party in personnel management, Party member cadre supervision, and ideological and political work.[686] In 2015, the Guiding Opinion on SOE Reform advocated for cross-appointments between Party committee members and the boards of directors, supervisors, and senior management, further embedding the Party's influence within corporate governance structures.[687]

In 2016, Xi Jinping publicly promoted a movement for intensified Party integration within SOEs, stating that Party leadership and its foundational role are the "root" and "soul" of Chinese state enterprises, and that the "primary task and responsibility" of SOE senior executives is to serve the Party.[688] That same year, SASAC first proposed an "ex-ante procedure", which required Party committees to formally deliberate on and approve major decisions before they were presented to the board of directors.[689] During the Conference on Party Building in SOEs in 2016, Xi articulated that the core objective of Party building (dangjian) was to weave Party leadership into every aspect of corporate governance and to clearly define the Party's legitimate role within the governance framework.[690]

In 2017, the State Council recommended that Party building be incorporated into the corporate charters of companies, emphasizing the Party's authority over the management of SOE cadres. Subsequent guidance from SASAC and the Ministry of Finance outlined specific party-building provisions for SOEs, including those in the financial sector, which involved integrating the CCP constitution into corporate charters, formalizing the Party's decision-making authority, cross-appointments, and oversight of corporate personnel by the Party.

Following these directives and Party documents, a growing number of companies established Party organizations and amended their articles of association to reflect this integration. By the end of 2016, 189,000 private-owned enterprises (91.3 percent of all POEs) and 1.855 million

[686] Opinions of the Central Organization Department of the CPC and the SASAC of the State Council on the Party Committee of Central SOEs in Giving Full Play to the Political Central Role under the Modern Enterprise System 2013.

[687] Committee and State Council (n 55) Art. 24.

[688] Xinhua Net, 'XI Emphasised Party's Unwaveing Leadership over SOEs at the National SOEs Party Building Work Conference（习近平在全国国有企业党的建设工作会议上强调:坚持党对国企的领导不动摇）' (2016) <http://www.xinhuanet.com//politics/2016-10/11/c_1119697415.htm> accessed 21 February 2021.

[689] Party Committee of SASAC, 'Promote Party Building While Comprehensively Deepening SOE Reform' [2016] Qiushi <http://www.qstheory.cn/dukan/qs/2016-05/31/c_1118938354.htm>.

[690] ' National State-Owned Enterprise Party Building Conference' (10 October 2016) <https://www.12371.cn/special/xjpgqdjjh/>.

non-POEs (67.9 percent of all non-POEs) had set up Party organizations.[691] Between late 2015 and mid-2017, approximately 180 publicly listed companies revised their articles of association to formally incorporate Party organizations into their corporate governance structures.[692]

4.3 Legal framework of corporate governance in China

The legal framework of corporate governance in China operates under the broader Constitutional Law and follows a hierarchical structure from top to bottom. At the highest level are the laws enacted by the National People's Congress and its Standing Committee, which carry universal binding authority. These include the Company Law, the Securities Law, and the Laws of State-Owned Assets of Enterprises (SOA Enterprises Law). Next in the hierarchy are administrative regulations formulated by the State Council to implement these laws and manage the stock market. Below these are the departmental rules issued by various State Council ministries and commissions, such as the CSRC, SASAC, and the People's Bank of China, which provide specific guidance on the application of laws and regulations. Further down are local regulations issued by the people's congresses and their standing committees at the provincial level. Additionally, there are disciplinary rules created by relevant departments or organizations that govern conduct and order within specific industries or sectors.

The core of China's corporate governance framework consists of the Company Law, the Securities Law, Chinese CGC issued by the CSRC and SETC, and the Guidelines on Independent Directors provided by the CSRC. Together, these legal instruments form the backbone of corporate governance in China.

The legal framework of corporate governance primarily includes the Company Law, the Securities, the Chinese CGC issued by CSRC and SETC, and the independent director related regulations issued by the CSRC. These legal rules constitute the backbone of China's corporate governance system.

4.3.1 Company Law

4.3.1.1 Corporate Governance Structure

The 1993 Company Law marked China's initial step towards creating a modern economic framework since 1949. However, the substantial revisions made in the 2005 Company Law laid the foundation for the current corporate governance structure in China. The 2005 version established the three main statutory governing bodies within corporations: the shareholders' general meeting, the board of directors, and the board of supervisors. This governance

[691] Organization Department of Central Committee of the Communist Party of China, '2016 Communist Party of China Statistical Bulletin' (*Xinhua Net*, 30 June 2017) <http://www.xinhuanet.com/politics/2017-06/30/c_1121242478.htm>.

[692] The data from Institutional Shareholder Service (ISS) cited in: Jamie Allen and Rui (Nana Li) Li, 'Awakening Governance: The Evolution of Corporate Governance in China | ACGA | Asian Corporate Governance Association' (2018) <https://www.acga-asia.org/advocacy-detail.php?id=158&sk=&sa=>.

framework was intended to standardize corporate organization and operations, protect the lawful rights and interests of companies, shareholders, and creditors, maintain social and economic order, and support the growth of the socialist market economy.[693] The Company Law underwent further amendments in 2013 and 2018, with the most recent revision occurring in 2023, which took effect in July 2024.[694]

Chinese Company Law recognizes two types of corporate entities: limited liability companies and joint stock companies.[695] The law also outlines specific rules for SOEs and foreign-invested companies.[696]

China's governance structure blends elements from both Anglo-American and German models, utilizing a two-tier board system composed of a board of directors and a board of supervisors. This structure aims to create a balanced system of governance that integrates oversight and accountability, aligning corporate actions with the interests of shareholders and other stakeholders. The internal corporate governance structure defined by the Company Law includes:

The shareholder's general meeting (shareholders meeting). Known as the "power organ" of the company, this body has the authority to elect directors and supervisors, make decisions on major business policies and investment plans, review and approve reports from the board of directors and board of supervisors, endorse annual financial budgets, determine profit distribution and loss coverage, and resolve matters such as increasing or decreasing registered capital, issuing company bonds, amending the company's articles of association, and approving mergers, divisions, transformations, dissolutions, and liquidations.[697]

The Board of Directors. *This body is responsible for appointing managers to oversee daily operations and make decisions within the scope of authority granted by the shareholders' general meeting.*[698]

The Board of Supervisors*. This board is tasked with monitoring the conduct of directors and managers, ensuring they adhere to their legal duties and comply with the company's articles of association.*[699]

4.3.1.2 Central Leadership of the Party Committee

[693] 2005 Company Law Art.1.

[694] Due to the writing timeline of this thesis, the content does not cover this newly amended Company Law.

[695] 2005 Company Law Art.2.

[696] Foreign companies refer to Chinese-foreign equity joint venture, Chinese-foreign contractual joint venture, or wholly foreign-invested enterprises.

[697] 2005 Company Law Art.38.

[698] ibid Art.47.

[699] ibid Art.54.

A unique feature of Chinese corporate governance is the presence of Party committees or Party organizations within companies. During the SOEs reforms of the 1980s, a modern enterprise system was established featuring the "New Three Committees" (the general shareholders meeting, the board of directors, and the board of supervisors) as the main internal governance bodies. Although the Old Three Committees (Party committee, employee representative assembly, and the labor union) remained, their influence was significantly reduced. The CCP has explicitly pointed to relieving the party's leadership in enterprises and separating the business operation and political intervention.[700] A comprehensive investigation conducted across the country in 2000 revealed that although the private sector was growing swiftly, a mere 1.9 percent, equivalent to 464,000 of all party members were drawn from private sector.[701] It was also discovered that a significant majority—around 82 percent—of private enterprises lacked any form of Party organization altogether.[702] Therefore the party control in enterprises, even in SOEs, was weak.[703]

With the introduction of mixed-ownership reforms in SOEs beginning in 2013, private capital began to play a larger role in these enterprises. To balance this influence and maintain Party-state control, a renewed focus on Party-building policies emerged, ensuring that the Party's leadership was entrenched within corporate governance.[704] Amendments to corporate charters were required to explicitly state the leadership role and legal status of Party committees, leading to blurred lines between Party organizations and other governance structures such as the board of directors, board of supervisors, and management. The Party committee's governance role encompasses three main areas: (1) political leadership and oversight: the Party committee is responsible for organizing ideological and political initiatives, ensuring that company operations align with the decisions of leading Party members as well as the legal framework and corporate charters.[705] (2) major decision-making: before key decisions are made, the board of directors and management must consult the Party committee,[706] which grants the Party committee substantial authority as an internal governance entity. (3) Personnel management : The Party exercises control over the nomination of directors and top management, oversees Party cadres and managers, and enables cross-appointments between

[700] 1987, the 13th National Congress of CCP

[701] David L Shambaugh and Joseph J Brinley, *China's Communist Party: Atrophy and Adaptation* (University of California Press 2008) 136.

[702] ibid.

[703] ibid; Eric C Chang and Sonia ML Wong, 'Political Control and Performance in China's Listed Firms' (2004) 32 Journal of Comparative Economics 617, 628; Sujuan Xie and others, 'Ultimate Parent Board Reform and Corporate Overinvestment: A Quasi-natural Experiment Study' (2019) 58 Accounting & Finance 1469.

[704] Lin and Milhaupt (n 54) 188.

[705] Opinions of the Central Organization Department of the CPC and the SASAC of the State Council on the Party Committee of Central SOEs in Giving Full Play to the Political Central Role under the Modern Enterprise System; 'CCP Leading Party Members Groups Work Regulations'.

[706] SASAC (n 60).

Party members and corporate boards and senior management positions (shuangxiangjinru, jiaocha ruzhi)[707]

In response to the party-building policy, from 2015 to 2018, 90 per cent of SOEs (the total of 1,046 non-financial A-share listed companies), followed the model template of charter amendments that gave the party' s leadership and legitimised party committee's governance inside the company. Among these, 6 percent of POEs amend their charters because of their political connections though they were not required to do so.

Between 2015 and 2018, in alignment with the Party-building policy, approximately 90 percent of SOEs,[708] which included 1,046 non-financial A-share listed companies,[709] adhered to a standardized model for amending their charters. These amendments were designed to formalize and legitimize the leadership role of the Party committee within their corporate governance structures. Notably, about 6 percent of POEs also modified their charters to reflect Party involvement, even though they were not legally obligated to do so, largely due to their political affiliations and connections.[710]

4.3.1.3 Board of Supervisors

Chinese Company Law mandates the establishment of a board of supervisors (BOS) within corporations, though there are distinct differences in its structure and function compared to the German system. According to Chinese law, the BOS must have at least three members, including shareholder representatives and a requisite number of employee representatives, with the latter making up at least one-third of the board. Directors and senior management are prohibited from concurrently serving on the BOS to prevent conflicts of interest.[711]

One key distinction is that Chinese Company Law requires both joint-stock and limited liability companies to have a BOS,[712] whereas German law mandates a supervisory board only for large, publicly listed companies.

The relationship between the management board and the BOS also varies significantly between the two systems. In Germany, the management board (Vorstand) operates under the oversight of the supervisory board (Aufsichtsrat), which is responsible for reviewing the annual financial

[707] Committee and State Council (n 55) Art. 24.

[708] Central and local SOEs

[709] Lin and Milhaupt (n 54) 203. The financial enterprises were excluded due to their highly regulated status and distinctive characteristics.

[710] ibid 204.

[711] 2005 Company Law Art.118.

[712] ibid Art.52, 124. The 2023 Company Law revised the provision regarding board of supervisors in limited liability company. In Article 83: "A limited liability company that is small or has a small number of shareholders is not required to establish a board of supervisors, and may either have one supervisor who exercises the functions of the board of supervisors specified in this Law or have no supervisor with the unanimous consent of all shareholders."

statements, reports, and proposals from the management board and has the authority to approve them.[713] The German supervisory board is generally insulated from day-to-day management decisions, stepping in only for specific transactions that require its approval.[714] Additionally, it has the power to appoint and dismiss members of the management board,[715] negotiate employment terms,[716] and represent the company in dealings with the management board.[717] Its primary function is to oversee and supervise the company's management.

In contrast, the Chinese BOS does not wield the same level of authority. While it can inspect the company's financial health and demand corrective actions from management,[718] it does not participate in the decision-making process and lacks voting rights at board meetings,[719] limiting its role mainly to oversight and advisement.

Regarding the independence of the supervisory board, it is comprised of two types of supervisors: shareholder supervisors and employee supervisors. In Chinese companies, this means that the supervisory board includes representatives from both shareholders and employees. For restructured SOEs, it is mandatory to have employee representatives on the supervisory board. As SOEs represent the primary vehicle for public ownership within the state-controlled economy, they are expected to embody socialist characteristics. In line with Article 1 of the Constitution of China, which declares that China is a socialist nation under the leadership of the working class,[720] the Company Law places significant emphasis on the involvement of employees in the supervisory mechanism, underscoring their critical role in corporate governance.

However, unlike German law, which grants supervisory boards the authority to appoint and dismiss management board members and participate in decisions of major significance to the company,[721] the Chinese system adopts a model similar to the Japanese approach. This model restricts the supervisory board from appointing management board members or engaging directly in corporate management and business operations. This structure offers some benefits, such as allowing employees to provide firsthand insights from their positions on the frontline, thereby enriching the decision-making process. However, the close ties between employee representatives and labor unions, which often have direct or indirect connections with the Party and government bodies, can lead to increased political influence. This potential for political

[713] German Stock Corporation Act (Aktiengesetz) §30(172).

[714] ibid §111(4).

[715] ibid §84(1).

[716] ibid §112.

[717] ibid §90.

[718] 2005 Company Law Art.54(1).

[719] ibid Art.126(5).

[720] Constitution of The People's Republic of China Art.1.

[721] German Corporate Governance Code 2013 ss 5.1.1 & 5.1.2.

interference could run counter to the intended reforms of traditional SOEs, as it challenges the drive towards reducing political involvement in corporate operations.

Although company law restricts employees from directly participating in corporate decision-making, the supervisory board is still predominantly composed of shareholder-representative supervisors. These supervisors are tasked with representing the interests of shareholders, typically favoring the dominant shareholders.[722] In SOEs where the government holds a controlling stake, shareholder supervisors are usually appointed by the SASAC.[723] Within the administrative and compensation structure in China, the chair of the BOS often ranks below the chair of the board of directors in many SOEs, with the latter holding the authority over the appointment and compensation of the BOS chair.[724] Employee supervisors, usually representing labor unions or staff and workers congresses linked to the Party committee, often lack genuine independence as they are appointed by the very entities they are meant to oversee.[725] As a result, these supervisors lack genuine independence because they are chosen and appointed by the same entities they are supposed to oversee, leading to ineffective oversight by the BOS.[726] Furthermore, in scenarios where the shareholding is heavily concentrated—whether controlled by the state or other major shareholders—the BOS often functions as a "censored watchdog," with limited capacity to oppose or scrutinize decisions made by the controlling shareholder or the state.[727] This lack of independence and oversight power significantly undermines the BOS's ability to serve as an effective governance mechanism.

As a result, the BOS's role in listed companies is often ambiguous, leaving it unclear whose interests it represents and what its exact oversight functions are. It frequently fails to fulfill its intended supervisory role over management, leading to a perception that it provides only an illusion of checks and balances in corporate governance.[728] The BOS in Chinese companies is generally viewed as a weak internal governance mechanism that does not adequately

[722] China Association for Public Companies, 'Report on the Performance of Board of Supervisors of Listed Companies' (2014) <https://www.capco.org.cn/zxzx/jgxx/201909/20190901/j_2019090115220300015689591749345631.html>.

[723] Jiangyu Wang, 'Corporate Governance in China: The Law and Its Political Logic', *Routledge Handbook of Corporate Law* (Routledge 2016) 201.

[724] Shanghai Stock Exchange Research Center, *Corporate Governance Report 2004* (Fudan University Press, Shanghai 2004) 44.

[725] Donald C Clarke, 'Lost in Translation? Corporate Legal Transplants in China' [2006] Corporate Legal Transplants in China (July 3, 2006). GWU Law School Public Law Research Paper 6–7.

[726] China Association for Public Companies (n 93).

[727] Jay Dahya and others, 'The Usefulness of the Supervisory Board Report in China' (2003) 11 Corporate governance: An international review 308, 315.

[728] Laura M. Cha, 'The Future of China's Capital Markets and the Role of Corporate Governance', *Luncheon Speech at China Business Summit* (2001) <http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69189.html>.

monitor the board of directors or management, thus failing to enhance corporate governance effectively.[729]

4.3.1.3 Board of Directors

Under company law, the board of directors is accountable to the shareholders' meeting,[730] with its responsibilities generally categorized into three main areas: making decisions on significant matters,[731] appointing senior executives, and overseeing these executives' performance.[732] However, there is considerable overlap between the roles and authority of the board of directors and the shareholders' general meeting. For instance, both bodies have the power to make decisions regarding the company's business strategies and investment plans, but the company law does not clearly delineate these responsibilities between the two, leading to ambiguity in their respective functions.[733]

In the realm of corporate governance practice in most countries, the management of a company's business is typically entrusted to the board of directors and senior management.[734] In contrast, Chinese corporate governance practice deviates from this norm by allocating such business management authority to the shareholder's meeting. This arrangement is often viewed as beneficial to restructured SOEs, where the state holds a dominant share, thereby reinforcing state control over the company.[735] The involvement of the shareholders' general meeting, particularly when the state hold a dominant share, can compromise the board's independence in decision-making processes.[736] Moreover, when the state exerts influence over business operations and favors state-driven corporate decisions, it can negatively impact

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[729] On Kit Tam, *The Development of Corporate Governance in China* (Edward Elgar Publishing 1999); Jay Dahya, Yusuf Karbhari and Jayson Zezong Xiao, 'The Supervisory Board in Chinese Listed Companies: Problems, Causes, Consequences and Remedies' (2002) 9 Asia Pacific business review 118.

[730] 2005 Company Law Art.46,108.

[731] ibid Art.46."(1) Convening shareholders' meetings and presenting reports thereto; (2) Implementing the resolutions made at the shareholders' meetings; Determining the company's business and investment plans; (4) Working out the company's annual financial budget plans and final account plans; (5) Working out the company's profit distribution plans and loss recovery plans; (6) Working out the company's plans on the increase or reduction of registered capital, as well as on the issuance of corporate bonds; (7) Working out the company's plans on merger, split, change of the company form, or dissolution, etc.;"

[732] ibid. "(8) Making decisions on the establishment of the company's internal management departments; (9) Making decisions on hiring or dismissing the company's manager and his salary and compensation, and, according to the nomination of the manager, deciding on the hiring or dismissal of vice manager(s) and the persons in charge of finance as well as their salaries and compensations; (10) Working out the company's basic management system;…"

[733] Mathias M Siems, *Convergence in Shareholder Law* (Cambridge University Press 2007) 154.

[734] ibid 153.

[735] ibid 154–55.

[736] Wang, 'Corporate Governance in China: The Law and Its Political Logic' (n 94) 197.

the interests of minority shareholders, intensifying the risk of expropriation by the state as the controlling shareholder.[737]

4.3.1.4 Fiduciary Duties

In 2005, China incorporated fiduciary duties into its Company Law,[738] drawing from Anglo-American corporate governance practices, and systematically established the framework for their enforcement.[739] Under the revised Company Law, senior corporate personnel—namely directors, supervisors, and senior executives (collectively referred to as “dong jian gao”)—are obligated to adhere to laws, administrative regulations, and company bylaws, and are required to uphold duties of loyalty and diligence towards the company.[740] Similarly, the Code of Corporate Governance mandates that directors act in the best interests of the company and its shareholders, performing their roles with loyalty, integrity, and diligence.[741]

The Company Law outlines proscribed circumstances of corporate senior personnel, including accepting bribes, misappropriating the company's funds, exploiting company business opportunities for personal interests, engaging in unauthorized transactions with the company, operating competing businesses, and disclosing confidential information.[742] Should directors, supervisors, or senior executives breach these laws or regulations, causing harm to the company, they are held liable for compensation.[743] Additionally, the 2005 amendments introduced derivative actions, allowing qualified shareholders[744] to initiate legal proceedings against directors, supervisors, or senior executives if their actions harm the company,[745] thus providing shareholders with a mechanism to protect their own interests.

Fiduciary duties serve as an ex-post enforcement mechanism, deterring directors and senior executives from engaging in opportunistic behavior, thereby helping to reduce agency costs.[746]

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[737] Siems (n 104) 155.

[738] Craig Anderson and Bingna Guo, ‘Corporate Governance under the New Company Law (Part 1) : Fiduciary Duties and Minority Shareholder Protection’ (2006) 20 China law and practice 17, 3–4.

[739] 2005 Company Law Art. 147-153.

[740] ibid Art.148.

[741] Code of Corporate Governance of Listed Companies Art 33.

[742] 2005 Company Law Art.148,149.

[743] ibid Art.150.

[744] a shareholder or a group of shareholders of a limited liability company or a company limited by shares holding 1% or more of shares in the company for 180 days consecutively

[745] 2005 Company Law Art.152.

[746] Guangdong Xu and others, ‘Directors’ Duties in China’ (2013) 14 European Business Organization Law Review (EBOR) 57 <https://www.cambridge.org/core/journals/european-business-organization-law-review-ebor/article/abs/directors-duties-in-china/D3E8C099128F0FB0A668AEFB2A72F0C3> accessed 12 March 2021.Cheng Han Tan, ‘Corporate Governance and Independent Directors’ (2003) 15 Singapore Academy of Law Journal 355, 364 <https://heinonline.org/HOL/Page?handle=hein.journals/saclj15&id=369&div=18&collection=journals> accessed 17 February 2021.

However, empirical data from cases studied by Guangdong Xu et al. between 2006 and 2012 indicate that the enforcement of these duties has been limited. During this period, only 34 cases related to breaches of the duty of loyalty and just one case concerning the duty of diligence were adjudicated by the courts, all involving closely held companies rather than publicly listed firms.[747] The low number of derivative actions filed for breaches of fiduciary duties can be attributed to legislative gaps, such as stringent standing requirements and ambiguities in the demand rule, which have posed significant barriers to shareholder litigation.[748]

4.3.2 Securities Law

China's Securities Law was initially passed in December 1998 and came into effect in July 1999. Its primary objectives are to regulate the issuance and trading of securities, safeguard the legal rights and interests of investors, and ensure social and economic stability and public interest.[749] Under the provisions of the Securities Law, state auditing bodies are mandated to oversee and conduct audits of securities exchanges, securities firms, securities registration and clearing organizations, as well as regulatory authorities in the securities market.[750] The law imposes strict prohibitions on several forms of trading misconduct, including insider trading, market manipulation, false statements, and other fraudulent activities.

Despite the establishment of the Securities Law, major corporate scandals still surfaced in 2001, prompting a response from the CSRC and other state regulators to tighten governance standards among listed companies in China.

One infamous case was that of YinGuangXia, which became notorious for issuing false statements.[751] Investigations revealed that the company's reported high performance was built on fraudulent activities, ultimately leading to its swift downfall. In 1999, YinGuangXia artificially increased its reported net profit by 125 percent through its subsidiary, Tianjin GuangXia. by creating fake sales, purchase contracts, invoices, and forging financial documents, such as bank notes, customs declarations, and tax exemption papers. The following year, the company again reported a 12.5 percent artificial profit increase using similar deceitful methods. The following year, the company again reported a 12.5 percent artificial profit increase using similar

[747] Xu and others (n 117).

[748] Hui Huang, 'The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform' (2007) 4 Berkeley Business Law Journal <https://heinonline.org/HOL/Page?handle=hein.journals/berkbusj4&id=233&div=12&collection=journals> accessed 17 February 2021; Shaowei Lin, 'Derivative Actions in China: Case Analysis' (2014) 44 Hong Kong Law Journal <https://heinonline.org/HOL/Page?handle=hein.journals/honkon44&id=623&div=37&collection=journals> accessed 17 February 2021.

[749] 2005 Securities Law.

[750] ibid.

[751] Yuan Ding, Hua Zhang and Honghui Zhu, 'Accounting Failures in Chinese Listed Firms: Origins and Typology' (2005) 2 International Journal of Disclosure and Governance 395, 402.

deceitful methods. This fraudulent claim added US$3.22 million to YinGuangXia's reported profit in 2000, representing 6.4 percent of its total net profit that year.

Another notable scandal involved Yi'an Keji, which was implicated in market manipulation [752] Since October 1999, four major shareholders of Yi'an manipulated the market by using 627 fabricated individual accounts and three corporate accounts to trade their shares, artificially inflating the stock price to lure unsuspecting investors. Yi'an initially issued its shares at RMB 7.55 each, but by February 15, 2000, the share price had skyrocketed to RMB 126.31—a nearly 17-fold increase from the original price.

These cases highlighted widespread fraudulent activities among listed companies, including profit inflation, fictitious transactions, false disclosures, and the misappropriation of assets from minority shareholders.[753] Such market fraud exposed significant weaknesses in oversight by both state regulatory authorities and internal corporate governance mechanisms. In response, revisions to the Securities Law and the Company Law were aimed at strengthening corporate supervision and enhancing the integrity of China's financial markets.

4.3.3 Code of Corporate Governance for Listed Companies (Chinese CGC)

China's commitment to market liberalization and corporate reform was significantly bolstered following its accession to the WTO in December 2001. In line with this commitment, the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission (SETC) jointly issued the Code of Corporate Governance for Listed Companies (Chinese CGC) in 2002. This code was formulated based on the provisions of the Chinese Company Law and Securities Law, while also drawing on international best practices. The primary objectives of the CGC are to standardize corporate operations, enhance governance structures, protect investor rights, and promote the stable development of the capital market. It applies to all companies established under the Company Law and listed on Chinese stock exchanges, urging them to adopt sound governance practices and safeguard shareholders' rights while ensuring fair treatment for all. [754]

The Code places a strong emphasis on protecting shareholder rights and ensuring fair treatment for minority and foreign shareholders.[755] It underscores the importance of board independence in decision-making and calls for transparency in the decision-making process, advocating for the inclusion of independent directors on corporate boards.[756] Further, the supervisory boards should act independently to monitor the company's financial and

[752] Cheng Wei-qi, 'Protection of Minority Shareholders after the New Company Law: 26 Case Studies' (2010) 52 International Journal of Law and Management 283, 294.

[753] Gongmeng Chen and others, 'Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions' (2005) 24 Journal of Accounting and Public Policy 451, 456.

[754] Code of Corporate Governance of Listed Companies(2002) Art. 2,3.

[755] ibid Ch.2.

[756] ibid Ch.3.

operational activities. The CGC also stresses that controlling shareholders and actual controllers have a duty of good faith to the company and other shareholders,[757] insisting that they maintain independence in matters related to the company's personnel, assets, and financial affairs, avoiding undue interference in operations or misappropriation of company assets.[758] Additionally, the Code mandates the accurate, complete, and timely disclosure of material information, with independent directors playing a key role in auditing financial statements.[759]

As the principal guideline for evaluating the governance practices of listed companies, the Chinese CGC serves as the standard by which companies are measured. Therefore, all listed companies are expected to adhere to the principles laid out in the PRC Corporate Governance Code as they strive to elevate their governance standards.

4.3.4 A Series of Independent Directors Rules issued by CSRC

On August 16, 2001, the CSRC issued the "Guideline Opinion for Introducing Independent Directors to the Board of Directors of Listed Companies" (referred to as the Independent Director Guideline). This guideline formally acknowledged the integration of U.S. corporate governance practices, specifically the independent director system, into Chinese listed companies. The Independent Director Guideline applies universally to all companies listed on Chinese stock exchanges and marks one of the most comprehensive efforts by the CSRC or any Chinese government body to enhance internal corporate governance through the independent director framework. The guideline's primary rule mandated that listed companies amend their articles of association to incorporate independent directors, including at least one independent director with an accounting background.[760] It set specific deadlines: by June 30, 2002, companies were required to have at least two independent directors, and by June 30, 2003, independent directors were to constitute at least one-third of the board. The 2005 Company Law further solidified the status of independent directors, establishing them as a legally required component of corporate governance.

In January 2022, the CSRC consolidated various regulations concerning the independent director system into a single document titled the "Rules for Independent Directors of Listed Companies," comprising seven chapters and thirty articles. This consolidation aimed to provide a regulatory foundation that maximizes the role of independent directors in corporate governance while ensuring they diligently perform their responsibilities. The Rules systematically address the definition of independent directors, criteria for independence, essential qualifications, nomination and election processes, powers, and the safeguards

[757] ibid Ch.6.

[758] ibid Ch.6 Art.70.

[759] ibid Ch.9.

[760] Guideline Opinion for Introducing Independent Directors to the Board of Directors of Listed Companies 2001 s 1(3).

necessary for performing their duties effectively. This consolidation also sought to streamline the regulations, reducing redundancy and resolving inconsistencies within existing rules.

In April 2023, the State Council issued the “Opinions on the Reform of the Independent Director System for Listed Companies” (Reform Opinions), launching a reform initiative for the independent director system and outlining eight key tasks for the reform process. To implement these Reform Opinions and optimize the independent director framework, the CSRC issued the “Measures for the Administration of Independent Directors of Listed Companies” (Independent Directors Administration Measures) on August 4, 2023, which came into effect on September 4, 2023. The following section of this thesis will explore in detail the specific requirements and functions of independent directors.

4.4 Chinese Corporate Governance Problems

4.4.1 An Overview of Ownership Structure in Chinese Listed Companies

4.4.1.1 Chinese Share Classes

The Shanghai Stock Exchange, established on November 26, 1990, and the Shenzhen Stock Exchange, founded on December 1, 1990, were primarily created to support the reform of SOEs. These enterprises underwent significant transformation, restructuring from traditional formats into legal entities governed by company law, such as limited liability companies or joint-stock companies. The stock exchanges served as platforms for these restructured entities to raise capital from the public and facilitate the trading of their securities.

However, from the outset, a split share structure was implemented, dividing shares into circulating and non-circulating categories, which were further classified based on ownership and trading restrictions. Circulating shares refer to those that are publicly listed and can be traded without restrictions. This category includes A-shares, which are owned and traded among domestic individuals, entities, and select approved foreign institutional investors; B-shares, which are held by foreign individuals and institutions; and H-shares, N-shares, and L-shares, which are listed in Hong Kong, New York, and London, respectively.

On the other hand, not all types of equity are freely tradable. A specific sub-category of A-shares includes state or state-owned legal person shares (guojia gu / guoyou faren gu) and non-state-owned legal person shares (fei guoyou faren gu). The trading of these shares is subject to approval by the CSRC, reflecting additional layers of regulatory oversight and restrictions compared to their freely tradable counterparts.

Table 4.1 Share classification by listing location and availability of investors[761]

Share Class	Incorporation Location	Listing Location	Trading Currency	Availability to Mainland Chinese Investors	Availability to International Investors
A-Share	Mainland China	Mainland China	CNY	Yes	Yes, for QFI / Stock Connect programs
B-Share	Mainland China	Mainland China	USD (Shanghai) HKD (Shenzhen)	Yes, if Investors have appropriate currency accounts	Yes
H-Share	Mainland China	Hong Kong	HKD	Yes, if QDII approved or under Stock Connect programs	Yes
Red Chip	Non-mainland China	Hong Kong	HKD	Yes, if QDII approved or under Stock Connect programs	Yes
P-Chip	Non-mainland China	Hong Kong	HKD	Yes, if QDII approved or under Stock Connect programs	Yes
S-Chip	Non-mainland China	Singapore	SGD	Yes, if QDII approved	Yes
N-Share	Non-mainland China	United States	USD	Yes, if QDII approved	Yes

Source: FTSE Russell, 'Guide to Chinese Share Classes' (2021)

Table 4.2 : Share classification by identity

[761] QFI (Qualified Foreign Investor) refers to both the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII), which went into force in November 2020. QFI is the quota /approval-based inbound investment programmes launched by the Chinese government; Stock Connect is a Mutual Market Access programme through which investors in the Mainland China and Hong Kong can trade and settle shares listed on the other market via the stock exchanges and clearing houses in their home market.

<table>
<tr><th colspan="3">Share Class</th><th>Shareholder</th><th>Transferability</th></tr>
<tr><td rowspan="2">State-owned Share[1]</td><td colspan="2">State Share</td><td>Held by the state and its varied ministries, bureaus, and regional governments, in exchange for the capital contribution made by the state</td><td rowspan="3">Transferable to other institutions under the approval of CSRC</td></tr>
<tr><td colspan="2">State-owned Legal Person Share</td><td>Held by state-owned enterprises, institutions and other units with legal personality</td></tr>
<tr><td colspan="3">Non-state-owned Legal Person Share</td><td>Held by domestic institutions, defined as non-individual legal entity; commercial banks excluded by law</td></tr>
<tr><td rowspan="3">General Public Share</td><td colspan="2">Domestic natural person share</td><td rowspan="3">Held by natural persons or institutions</td><td rowspan="3">Transferable with no restriction</td></tr>
<tr><td rowspan="2">Foreign</td><td>Individual share</td></tr>
<tr><td>Institutional share</td></tr>
</table>

State-owned shares result from the restructuring and incorporation of traditional SOEs into joint-stock entities under corporate law. These shares mainly include state shares and state-owned legal person shares, each derived from specific restructuring processes. State shares encompass several scenarios: (1) shares derived from the total net assets of SOEs that were originally set up by authorized state institutions or government departments and then transformed into joint-stock limited liability companies; (2) shares derived from more than 50 percent of the net assets of such SOEs that underwent similar restructuring; and (3) shares issued by newly established joint-stock limited liability companies that are directly created by authorized state institutions or government entities.[762] State-owned legal person shares include: (1) shares converted from less than 50% of the net assets of SOEs established by authorized institutions or government departments and reorganized into joint-stock limited liability companies; (2) shares arising from the restructuring of enterprises initially set up by state-owned legal persons, where the joint-stock companies were formed with all or part of their net assets; and (3) shares in newly established joint-stock companies where investments were

[762] Interim Measures for the Administration of State-Owned Equity of Joint Stock Limited Companies (expired on 31th Jan, 2008) 1994 Art.8.

directly made by SOEs or their wholly-owned or controlled subsidiaries using their legally held assets.[763]

4.4.1.2 Ownership Concentration and Split Share Reform

In case of the loss of state-owned assets and maintaining the state control over the companies during SOEs privatization and listing process, the majority of the equity was retained by the government or its parent enterprise. During the privatization and listing of state-owned enterprises (SOEs), the government retained the majority of equity to maintain state control and prevent the loss of state-owned assets. These shares were not freely tradable or transferable in the open market. By the end of 2002, only 34.67 percent of shares (including B-shares and H-shares) were freely tradable, while 58.51 percent were non-tradable and held by the government (47.2 percent) and legal entities (11.31 percent), which included parent companies of listed firms or entities specifically set up to manage government shares.[764]

Ownership concentration, particularly with a strong state presence, has been a long-standing characteristic of Chinese listed companies. In 1997, 97 percent of all listed companies in both Chinese stock exchanges were state-owned, state-controlled, or state ownership, accounting for a significant proportion of outstanding shares.[765] Moreover, 75 percent of all the outstanding shares (listed and non-listed) were under the state's direct or indirect control (e.g., government-controlled legal persons).[766] According to the dataset provided by Jiang et al., by the end of 2004, the top five shareholders of listed companies held, on average, 60 percent of total shares, while the top five A-shareholders held only 2.5 percent.[767]

Since the state-owned and legal person shares are non-circulating in the market, their price is based on the book value of assets rather than the market price. This structure limited the government's ability to benefit from the increased value of shares, thereby reducing incentives

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763 Including their wholly owned or controlled subsidiaries.ibid Art. 8.

764 Lv Hui and Wu Xinming, 'The Stock Ownership Structure and Corporate Governance of Listed Companies (Shangshi Gongsi Guquan Jiegou Yu Gongsi Zhili)' (2004) 000 Reform of the Economic System (Jingji Tizhi Gaige) 88, 88.

765 Cyril Lin, 'Corporatisation and Corporate Governance in China's Economic Transition' (2001) 34 Economics of Planning 5 <https://link.springer.com/article/10.1023/A:1017596315273>.

766 ibid.

767 Bing Bing Jiang, James Laurenceson and Kam Ki Tang, 'Share Reform and the Performance of China's Listed Companies' (2008) 19 China Economic Review 489, 490.

to enhance corporate performance.[768] The split share structure constituted major problems and hindered market growth and expansion, which the Chinese government recognized.[769]

In 2001, the government initiated the first-round split share reform, which involved selling down state-owned shares. This effort included a requirement to allocate 10 percent of all new listings to benefit the social security fund and improve disclosure practices. However, implementing such measures led to a continuous market decline for the next few years, driven by two main factors: first, the issuance of new shares with the same market demand led to a decrease in the value of existing shares; second, increased disclosure revealed market abuses and manipulation, which dampened investor confidence.[770]

The second round of split share reform launched in 2005, aimed to lift trading restrictions on the non-circulating shares. Each listed company was allowed to institute their respective non-circulating share status converting plan. In practice, as the price for converting trading status, non-circulating shareholders must compensate circulating shareholders with bonus shares at agreed-upon prices. By the end of 2007, most listed companies had completed their split share reform plan.[771] However, even after conversion, previously non-circulating shares were still subject to trading restrictions, including 24-month or 36-month lockup periods during which only limited trading was allowed.[772]

To mitigate the stock market instability caused by the split share reform, CSRC issued guiding opinions that imposed further restrictions on the free trading and transfer of these previously non-circulating shares.[773] In response, many controlling state shareholders extended the agreed lock-up period for their non-circulating shares or purchased additional shares to maintain their controlling positions.

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[768] Xiaohong Huang, Rezaul Kabir and Lingling Zhang, 'Government Ownership and the Capital Structure of Firms: Analysis of an Institutional Context from China' (2018) 11 China Journal of Accounting Research 171, 173.

[769] The speech by Shang Fulin, Chairman of China Securities Regulatory Committee, at the press conference held by the State Council Information Office on 27th June 2005. Sina Finance, 'Chairman of China Securities Regulatory Committee at the Press Conference' <http://finance.sina.com.cn/nz/sflxwfb/index.shtml> accessed 30 April 2021.

[770] Naughton (n 7) 474.

[771] Bin Qi, 'China Capital Markets Development Report: China Securities Regulation Commission'.

[772] Measures for the Administration of the Share-trading Reform of Listed Companies 2005. The Measures provides: (1) The non-tradable shares may not be listed for trading or be transferred within twelve months as of the day when the reform scheme is implemented; (2) The holders of original non-tradable shares holding 5% or more of the shares of a listed company that sell their original non-tradable shares through listing in a stock exchange after the time limit as prescribed in the preceding item expires may not sell 5% or more of the total shares of the company within *12 months* and may not sell 10% or more of the total shares of the company within *24 months*.

[773] Guiding Opinions on the Listed Companies' Transfer of Original Shares Released from Trading Restrictions 2008; China Securities Regulatory Commission, 'China Capital Markets Development Report' (2008) <http://en.pkulaw.cn.sheffield.idm.oclc.org/display.aspx?cgid=4d4d882a15cc6a56bdfb&lib=law> accessed 2 May 2021.

The increase in the controlling shareholders' stakes was both explicitly and implicitly encouraged by the CSRS, the SASAC, and other government departments.[774] Wang provided statistical evidence showing that, from 2003 to 2011, the state, as the largest shareholder, held an average of 43.67 percent of shares in companies, compared to other types of shareholdings: domestic legal persons (33.74 percent), foreign shares (38.21 percent), and individual shares (28.46 percent).[775] This data indicates that state ownership remains prevalent among Chinese listed companies.[776]

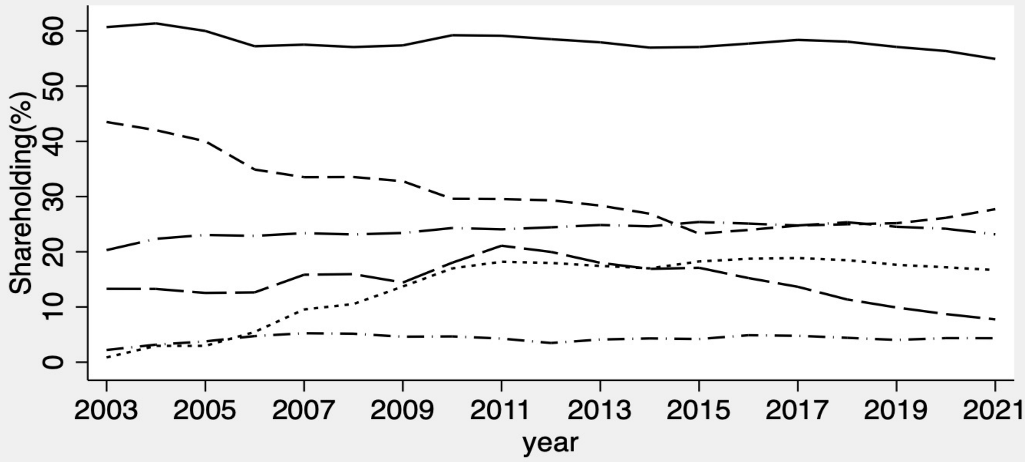
Additionally, Figure 1 illustrates the average shareholding by standard share type among the top ten largest shareholders, based on data from the CSMAR database. The figure shows that in Chinese listed companies, the top ten shareholders typically hold about 60 percent of outstanding shares, with a decline to a minimum of 55 percent by 2021, indicating a persistent concentration of ownership even after the split share reforms. Except for the period from 2015 to 2019, state shares consistently represent the largest portion of the top ten shareholders' total holdings, peaking at 44 percent in 2003 and dropping to a low of 23 percent in 2015.

Figure 1: The average shareholding by identity of top ten shareholders of Chinese listed companies

[774] For example, according to the stock exchange rules of both SHSE and SZSE, the "window period" has been cut down to 10 days for the announcement of the company's performance briefing or the regular report. During this period, the shareholder and its concerted parties shall not increase their shares in the company. SHSE and SZSE issues the Guidelines of the Increase of Shares by Shareholders and Their Concerted Parties of Listed Companies in April 2008.

[775] Wenge Wang, 'Ownership Concentration and Corporate Control in Chinese Listed Companies' (2014) 11 US-China Law Review 57, 82.

[776] ibid.



Source: edited and calculated from CSMAR database

4.4.1.3 Ownership Structure of POEs

China's economic reform signifies a shift from a planned economy towards market-oriented, characterized by the relative decline of the state-owned sector and the expansion of private enterprises. Over time, private firms have played an increasingly vital role in driving China's rapid economic growth. Beginning in 1992, with the listing of the first POE on the Chinese stock market, the number of POEs on the stock exchanges has steadily risen.[777] By 2008, POEs had invested RMB 11.18 trillion (approximately $1.7 trillion) in fixed capital, which constituted 64.9 percent of the total investment made by SOEs, foreign investors, and POEs combined.[778] A significant portion of these private firms are family-owned or family-controlled, estimated to make up 80-90 percent of the private sector, thereby substantially contributing to China's economic surge in recent decades.[779] By the end of 2009, family firms were the dominant entities on the Third Board for Small and Medium Enterprises on the Shenzhen Stock Exchange,

[777] Jing Zhou, On Kit Tam and Ping Yu, 'An Investigation of the Role of Family Ownership, Control and Management in Listed Chinese Family Firms' (2013) 12 Asian Business & Management 197; Yuan Ding, Hua Zhang and Junxi Zhang, 'Private vs State Ownership and Earnings Management: Evidence from Chinese Listed Companies' (2007) 15 Corporate Governance: An International Review 223 <https://doi.org/10.1111/j.1467-8683.2007.00556.x>.

[778] 'National Bureau of Statistics of China'. State-affiliated businesses and solely state-owned enterprises are not included in the estimation.

[779] HY Zhang, LZ Ming and C. Liang, *Development Report of Chinese Private Enterprises* (Beijing, China: Social Sciences Academic Press 2001).

and by 2012,[780] they represented 55 percent (1,373 out of 2,460) of all listed companies in China.[781]

Chinese family firms typically exhibit highly concentrated ownership structures, with control often amplified through pyramid schemes and cross-holdings among affiliated firms.[782] This results in voting rights that exceed their direct cash-flow rights. Based on Cheng's empirical study of sample firms on the two stock exchanges from 2003 to 2012, the average family ownership was found to be 34.59 per cent, with average voting rights at 36.44 per cent and cash flow rights at 28.32 per cent (considering the pyramid structure). In contrast, Chen *et al.'s* study revealed that the average family ownership of the S&P 1500 firms was 18 per cent.[783] Among Fortune 500 companies, family firms typically held 16.1 percent of shares and 20.3 percent of voting rights.[784] This comparison highlights that Chinese family firms have much higher ownership concentration and a greater separation between cash flow and voting rights than their counterparts in Anglo-American countries.

4.4.1.4 Institutional Investors

Another notable feature of the ownership structure in Chinese listed companies is the relatively low shareholding by institutional investors. Between 2003 and 2008, institutional investors, including those in both SOEs and POEs, held an average of just 4.87 percent of shares.[785] Regulatory guidelines from the CSRC impose strict limitations: (1) the market value of securities issued by a single company held by a single fund cannot exceed 10 percent of the fund's net asset value, and (2) the total number of securities issued by a single company held across all funds managed by the same fund manager must not exceed 10 percent of the company's securities.[786] These rules indicate the government's intention to limit the influence of institutional investors in corporate governance, despite various empirical studies demonstrating

[780] Zhou, Tam and Yu (n 148) 198–99.

[781] Yingqiu Liu, 'Development of Private Entrepreneurship in China: Process, Problems and Countermeasures' [2001] Social Sciences Academic Press (China).

[782] Stijn Claessens, Simeon Djankov and Larry HP Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 Journal of Financial Economics 81, 82 <https://www.sciencedirect.com/science/article/pii/S0304405X00000672>.

[783] Shuping Chen, Xia Chen and Qiang Cheng, 'Do Family Firms Provide More or Less Voluntary Disclosure?' (2008) 46 Journal of accounting research 499, 533.

[784] Belén Villalonga and Raphael Amit, 'How Are U.S. Family Firms Controlled?' (2009) 22 The Review of Financial Studies 3047, 3067–68 <https://doi.org/10.1093/rfs/hhn080>.

[785] Wu Xiaoling and Zhai Minglei, 'Empirical Study on Influence of Ownership Structure on Dividend Policy -Based on Ownership Structure Changes after Equity Division Reform (Shangshi Gongsi Guquan Jiegou Dui Xianjin Guli Zhengce de Yingxiang)' (2013) 35 Journal of Shanxi Finance and Economics University (Shanxi Caijing Daxue Xuebao) 84, 89–90.

[786] Measures for the Administration of the Operations of Publicly Offered Securities Investment Funds 2014. Art. 32(1)(2)

the positive impact institutional investors can have.[787] Institutional investors are more likely to engage actively in corporate governance when they hold a substantial shareholding that justifies the cost-benefit analysis of such involvement. [788] However, due to their relatively minor stakes, institutional investors in China typically lack the capacity to act as a counterbalance to majority shareholders and have limited incentives to participate meaningfully in governance activities.[789] As a result, their presence does little to constrain majority control or to ensure effective checks and balances within companies.

4.4.2 Large Shareholder Exploitation of Minority Shareholders

While concentrated ownership can empower controlling shareholders to effectively oversee management, it also sets the stage for conflicts with minority shareholders. Controlling shareholders wield significant influence over shareholders' general meetings and the composition of boards of directors, often resulting in overlapping roles between board members and management. This overlap fosters a culture of insider control where power is abused by selecting board members and executives who are loyal to the controlling shareholders. These handpicked individuals frequently make decisions that favor the interests of the dominant shareholders, often at the expense of the minority stakeholders.[790] Tang *et al.* empirical study indicated that large shareholders primarily extract corporate benefits by obtaining control of listed companies.[791] When large shareholders cannot secure absolute control through equity ownership alone, they tend to dominate the board to steer company operations in their favor, thereby exploiting minority shareholders. This dominance by the largest shareholder over the board can serve as a substitute for equity control, enabling them to manipulate the company's decisions and siphon off benefits.

Such practices have led to significant financial losses for small and medium-sized shareholders, as large shareholders abuse their authority to extract company resources. The typical way of exploitation by large shareholders is known as "tunnelling"[792], referring to the transfer of assets and profits out of the company to benefit the controlling shareholders. This can take various

[787] Zhao Guoyu and Zhai Qiuling, 'Institutional Investor's Shareholding, Executive Incentive and Tunneling Inhibition of Major Shareholders(Jigou Touzi Zhe Chigu, Gaoguan Jili Yu Da Gudong Taokong Yizhi)' [2020] Financial Theory & Practice(Jinrong Lilun Yu Shijian) 88.

[788] Wang Xuerong and Wei Dong, 'Empirical Analysis of Impact of Institutional Ownership on Corporate Operating Performance (Zhongguo Shangshi Gongsi Jigou Touzi Zhe Dui Gongsi Jixiao Yingxiang de Shizheng Fenxi)' [2009] Chinese Journal of Management Science 19.

[789] Xin Tang, 'Facts and Reform Proposals' [2017] Independent Directors in Asia: A Historical, Contextual and Comparative Approach 208, 211–12.

[790] Lay Hong Tan and Jiangyu Wang, 'Proposing a Model for Corporate Governance in China's Listed Companies: Problems and Prospects' [2004] Available at SSRN 526942 19.

[791] Tang Jianxin, Li Yonghua and Lu Jianlong, 'Equity Ownership Structure, the Characteristics of Board and Tunneling:Empirical Evidence from China's Listed Companies (Guquan Jiegou Dongshihui Tezheng Yu Da Gudong Taokong-Laizi Minying Shangshi Gongsi de Jingyan Zhengju)' (2013) 000 Economic Review (Jingji Pinglun) 86.

[792] Simon Johnson and others, 'Tunneling' (2000) 90 American economic review 22.

forms, including favourable transfer pricing for related entities, excessive compensation for executives, dilutive share issuances, and insider trading.[793] Tunneling is widespread among Chinese listed companies, and due to its covert nature, it is often analyzed through related-party transactions (RPTs). Common tunneling methods employed by large shareholders in these companies include intercorporate loans,[794] sales to related parties,[795] acquisitions of assets from related entities,[796] and loan guarantees.[797]

The intercorporate loan is a widely used but concealed form of tunnelling used by controlling shareholders to divert funds from publicly listed companies, partucularly in the early 2000s. Jiang *et al.* found that from 1996 to 2006, controlling shareholders extracted tens of billions of RMB from hundreds of Chinese listed companies through such practices.[798] A notable example is Fenghua Co. (stock code 600615). On December 31, 2002, its controlling shareholder and affiliated entities borrowed 198.6 million RMB from the company, surpassing the firm's total equity of 116.21 million RMB.[799] Following this, the controlling shareholder went bankrupt, leading to a significant portion of these loans being written off. These loans were commonly recorded under the "Other Receivables" (OREC) on the balance sheets of numerous Chinese companies, making up a considerable share of their assets and market value. OREC is a unique accounting item in China, often used to record related party transactions or to obscure unfair transactions with associated parties. Companies typically divert assets through OREC

[793] Zhihua Wei and others, 'Family Control, Institutional Environment and Cash Dividend Policy: Evidence from China' (2011) 4 China Journal of Accounting Research 29, 32.

[794] Guohua Jiang, Pingui Rao and Heng Yue, 'Tunneling through Non-Operational Fund Occupancy: An Investigation Based on Officially Identified Activities' (2015) 32 Journal of Corporate Finance 295; Meijun Qian and Bernard Y Yeung, 'Bank Financing and Corporate Governance' (2015) 32 Journal of Corporate Finance 258; Qigui Liu and Gary Tian, 'Controlling Shareholder, Expropriations and Firm's Leverage Decision: Evidence from Chinese Non-Tradable Share Reform' (2012) 18 Journal of Corporate finance 782; Guohua Jiang, Charles MC Lee and Heng Yue, 'Tunneling through Intercorporate Loans: The China Experience' (2010) 98 Journal of financial economics 1.

[795] Qiao Liu and Zhou Joe Lu, 'Corporate Governance and Earnings Management in the Chinese Listed Companies: A Tunneling Perspective' (2007) 13 Journal of Corporate Finance 881; Agnes WY Lo, Raymond MK Wong and Michael Firth, 'Tax, Financial Reporting, and Tunneling Incentives for Income Shifting: An Empirical Analysis of the Transfer Pricing Behavior of Chinese-Listed Companies' (2010) 32 Journal of the American Taxation Association 1; Agnes WY Lo and Raymond MK Wong, 'An Empirical Study of Voluntary Transfer Pricing Disclosures in China' (2011) 30 Journal of Accounting and Public Policy 607; Terry Shevlin, Tanya YH Tang and Ryan J Wilson, 'Domestic Income Shifting by Chinese Listed Firms' (2012) 34 Journal of the American Taxation Association 1.

[796] Winnie Qian Peng, KC John Wei and Zhishu Yang, 'Tunneling or Propping: Evidence from Connected Transactions in China' (2011) 17 Journal of Corporate Finance 306.

[797] Henk Berkman, Rebel A Cole and Lawrence J Fu, 'Expropriation through Loan Guarantees to Related Parties: Evidence from China' (2009) 33 Journal of Banking & Finance 141; Wei Huang, 'Tunneling through Related-Party Loan Guarantees: Evidence from a Quasi-Experiment in China' (2016) 47 Review of Quantitative Finance and Accounting 857.

[798] Jiang, Lee and Yue (n 165) 2.

[799] Jiang, Rao and Yue (n 165) 296.

for non-operational purposes.[800] In their analysis, Jiang et al. found that OREC balances averaged 8.1 percent of total assets.[801] By examining a detailed sample, they traced a substantial share—between 30 percent and 40 percent of total OREC in the top three deciles—back to controlling shareholders or their affiliated companies. Most of these intercorporate loans were non-interest-bearing, and in cases where interest was supposed to accrue, neither the interest nor the principal was usually repaid.[802] Through manipulation of intercorporate loans via OREC, large shareholders systematically exploited the interests of minority shareholders.

Efforts to address this form of tunnelling began in 2001 when the CSRC requested listed companies to cease lending to controlling shareholders. By August 2003, the CSRC issued explicit instructions to halt such loans and mandated a 30 percent annual reduction in OREC balances. However, enforcement by the CSRC was lackluster, and many companies largely disregarded these regulations. In 2004, the State Council issued Directive 2004-3, which granted the CSRC authority to take measures against controlling shareholders who were embezzling funds. Subsequently, in July 2004, the CSRC proposed “Debt for Equity Swaps” to facilitate repayments, and in June 2005, introduced penalties for non-compliance, including public disclosure of significant defaulters. The State Council’s November 2005 Directive further targeted controlling shareholders, threatening personal punishment for non-payment. In 2006, CSRC officially named this “Non-operational Fund Occupancy” (NOFO), which is illegal and detrimental to minority shareholders. By November 2006, a joint announcement from eight government ministries mandated severe disciplinary actions for non-compliance. As a result, 39 billion RMB in OREC balances were resolved by 399 listed companies, and top managers in non-compliant firms faced arrests. This form of tunnelling was finally eliminated and strictly prohibited by laws and regulations.

Nonetheless, controlling shareholders continue to exploit other forms of tunnelling through RPTs to siphon resources from minority shareholders. The newly established stock market enables enterprises to raise public funds through initial public offerings to address their financial struggles and enhance operational performance. According to the SHSE Stock Listing Rules, IPO candidates must demonstrate profitability over the previous three years.[803] However, as the quality of enterprises' assets varies widely, many enterprises restructure and carve out their profitable units and assets for IPO while leaving non-profitable businesses, assets and excess workforce in the remaining enterprises. This carve-out aims to increase the likelihood of successful listings for the new company. The original enterprises (parent company) typically maintain a controlling interest or become the largest shareholder of the listed company. Despite being spun off, these listed companies maintain close business connections with their parent companies, which often continue to rely on them for various forms of support.

[800] ibid.

[801] Jiang, Lee and Yue (n 165) 2.

[802] ibid.

[803] Shenzhen Stock Exchange Listing Rules 2006 ch 5.

Rather than operating as independent entities, these listed companies typically form business conglomerates with their parent companies, resulting in frequent RPTs between the listed companies and their controlling groups.

Loan guarantees provided by listed companies to their affiliated entities, such as parent companies, function as either alternatives to or complements of intercorporate loans. A loan guarantee to a related party involves one entity, typically the listed company, assuring the repayment of a loan that a third party, usually a bank, extends to a related entity. In this arrangement, the listed company, acting as the guarantor, pledges its own assets as collateral for the loan taken out by a related entity, which is often either a significant shareholder of the listed company or an entity under the control of that shareholder.[804] This arrangement benefits the controlling shareholder in two primary ways: firstly, it allows them to secure financing at a lower interest rate than they might otherwise obtain; secondly, it provides the option for the controlling shareholder to default on the loan, thereby transferring the responsibility of repayment to the listed company.

It has been shown that loan guarantees extended to related parties can have adverse impacts on the interests of minority shareholders. A notable example is Monkey King Co., Ltd. (stock code: ST000535), a case involving loan guarantees. Established on November 18, 1992, Monkey King Co., Ltd. was a subsidiary of the Monkey King Group. The company was listed on the main board of the SZSE on November 30, 1993. By the end of its first year on the exchange, Monkey King Co., Ltd. had total assets amounting to RMB 300 million, with RMB 110 million raised through the stock market. The company reported primary operating revenue of RMB 394 million, reflecting strong performance at the time.[805]

Over the years, Monkey King Group made numerous investments but suffered continuous losses. Specifically, it invested in 30 welding rod joint ventures in other regions, resulting in a loss of RMB 487 million; it invested in five hotels, losing RMB 70 million; and it invested in 19 other enterprises and units, incurring a loss of RMB 131 million. Between 1994 and 1996, Monkey King Group’s direct losses from stock speculation amounted to 259.6 million yuan, and it overdrew RMB 240 million from various securities companies for stock trading, totaling over RMB 500 million in losses. As the largest shareholder, Monkey King Group began diverting the assets of Monkey King Co., Ltd. since 1994 through directly taking money from the listed company, borrowing funds in the name of the listed company for its own use, or having the listed company provide loan guarantees on its behalf. Through these methods, the group tunneled substantial funds from the listed company. By 1999, the accumulated diverted amount had reached RMB 890 million. Additionally, Monkey King Group secured RMB 370 million in bank loans using related-party loan guarantees from Monkey King Co., Ltd. as collateral.

[804] Berkman, Cole and Fu (n 168) 144.

[805] Sheng Xiao and Shan Zhao, ‘How Do Agency Costs Affect Firm Value? Evidence from China’ (2009) 1 Journal of economic literature 1, 20–22.

The performance of Monkey King Co., Ltd. deteriorated over the years, with prime revenue dropping to RMB 422.9 million in 2000. The financial statement for that year showed a net asset value of RMB -376 million, with losses amounting to RMB 689 million, a stark contrast to the gain of RMB 328 million in 1993. Key financial metrics such as earnings per share and return on equity also fell sharply, from RMB 0.57 and 19.56 percent in 1993 to RMB -2.28 and -183.16 percent in 2000, respectively.

On 27 February 2001 Monkey King Group (parent company) declared bankruptcy and was unable to repay the large sums of money it had diverted from the listed company. As a result, on 7 March 2001, Monkey King Co., Ltd. was subject to special treatment (ST) by the SZSE as Monkey King Group entered bankruptcy liquidation, prompting Monkey King Co., Ltd. to initiate a restructuring of its assets and liabilities.

By the time of bankruptcy proceedings, Monkey King Co., Ltd. had outstanding loans to its parent company amounting to RMB 890 million and had also guaranteed its parent's debt for a total of RMB 244 million. Monkey King Group owed Monkey King Co., Ltd. a total debt of RMB 1 billion. The Monkey King suffers the loss and the liability for the loan guarantee, which has exposed both minority shareholders and creditors to significant risk due to the parent company's potential default.

The lack of robust regulations enforcing mandatory disclosure of RPTs in China has created opportunities for listed companies and their controlling shareholders to engage in harmful tunneling practices. To safeguard the rights of minority shareholders, it is crucial to establish stringent rules that govern the disclosure of such transactions. Effective corporate governance necessitates that both the board of directors and the board of supervisors closely monitor the disclosure process of these transactions. However, because the disclosure of information often involves direct or indirect ties between the directors and the company, it is important to strike a balance between transparency and the need to protect shareholders' rights while also respecting the confidentiality of directors and shareholders.

Controlling shareholders might have motives to manipulate the disclosure process in order to obscure tunneling activities. Generally, a company's articles of association reflect the interests or are heavily influenced by the controlling shareholder. Consequently, companies may opt to limit the scope of information disclosed about RPTs. This allows controlling shareholders to resist disclosure requirements they find unfavorable or overly revealing, thereby avoiding potential negative repercussions in the market.

4.4.3 Corporate Governance Problems of Chinese SOEs

China's economy is in transition, evolving from a centrally planned system to a market-oriented one. The state sector plays a significant role in this economy, with SOEs being some of the largest and most influential companies in the country. Since the establishment of the SASAC, which oversees SOEs on behalf of the state, tunnelling, within SOEs can largely be traced back to agency conflicts among three key groups: (1) the state as the controlling shareholder versus minority shareholders, (2) SOE managers versus minority shareholders, and (3) the state shareholder versus SOE managers.

4.4.3.1 State Controlling Shareholder vs. Minority Shareholders

Chinese SOEs are driven by two primary goals: (1) profit generation and (2) providing public services and maintaining the stability of society.[806] A major issue arises from the conflicting interests between the state, which is the controlling shareholder, and the minority shareholders. The state often extracts resources from SOEs to fulfill its political and social objectives.[807] Empirical studies have shown that when SOEs prioritize political and social missions, it tends to negatively impact their financial performance.[808] Although the continuous reform aims to improve the productivity of SOEs, SOEs are still underperformed compared with non-SOEs. For instance, data from 2007 to 2015 indicates that the median return on assets for non-financial SOEs was consistently lower than that of non-SOEs.[809] Essentially, the state's focus on public welfare and social stability often clashes with the profit-maximization goals of small and medium shareholders. The state's policy burdens, which include public welfare initiatives and employment maintenance, often take precedence over profit generation, thereby disadvantaging minority shareholders.[810]

The underperformance of SOEs is not mainly caused by expropriation by the state as the controlling shareholder. Unlike an individual who might gain personal benefits from such actions, the state typically lacks strong motivation to engage in tunnelling.[811]

While the state's focus on preserving social stability can occasionally conflict with the goal of maximizing value, which may adversely affect the interests of minority shareholders, SOEs often receive compensating benefits. These include favorable bank loans and increased government subsidies, which help offset the negative impacts.[812] As a result, the conflict of

[806] Naughton (n 7) 117; Wayne M Morrison, China's Economic Rise: History, Trends, Challenges, and Implications for the United States (Congressional research service Washington, DC 2013).

[807] Gu Gongyun, 'Several Practical Problems That Should Be Solved in a Revision of the Company Law(Gongsi Fa Xiugai Ying Jiejue de Ruogan Wenti)' in Feng Guo and Jian Wang (eds), An All-Around Discussion of Reform of The Company Law(Gongsi Fa Xiugai Zongheng Tan) (2000).

[808] Chang and Wong (n 74) 618.

[809] CSMAR database, citied in: Fuxiu Jiang, Zhan Jiang and Kenneth A Kim, 'Capital Markets, Financial Institutions, and Corporate Finance in China' (2020) 63 Journal of Corporate Finance 101309.

[810] Justin Yifu Lin and Guofu Tan, 'Policy Burdens, Accountability, and the Soft Budget Constraint' (1999) 89 American Economic Review 426, 429; Z Wei, F Xie and S Zhang, 'Ownership Structure and Firm Value in China's Privatized Firms: 1991-2001' (2005) 40 Journal of Financial and Quantitative Analysis 87.

[811] Jiang and Kim (n 40) 205.

[812] Lin and Tan (n 181); Eric C Chang and Sonia ML Wong, 'Governance with Multiple Objectives: Evidence from Top Executive Turnover in China' (2009) 15 Journal of Corporate Finance 230.

interest between the state and minority shareholders tends to be less detrimental to SOEs compared to the agency problems that arise with SOE managers.[813]

4.4.3.2 State Shareholder vs. SOEs Managers

The ownership of SOEs lies with the public at large,with the SASAC acting as the representative of the state shareholder. This arrangement creates a scenario where SOEs effectively lack a clearly defined owner. The state, as the controlling shareholder, delegates its control rights to senior management, including the board chair, CEO, and other key positions such as the chief financial officer or chief legal counsel.[814] Consequently, SOE managers, including the chairperson, hold the primary decision-making authority and should be viewed as insiders within the SOEs.[815] As said, the state as the shareholder is unlikely to extract private benefits from tunnelling as it is not an individual who can directly benefit from such actions.[816] SOE managers, as the agents of the state, usually do not hold any shares or any shares of the company they serve, whose alignment of interests between the corporation and the managers are vastly reduced. This misalignment gives SOE managers, who control the firm's resources, both the incentive and opportunity to engage in tunnelling, using their delegated control rights to pursue individual interests.[817] The unconstraint insider control without adequate supervision and accountability mechanism results in state asset-stripping and stealing.[818] The state assets were stripped from the state sector to the SOE managers' affiliates through controlled, non-transparent transactions or unfair valuation, pricing and transfer procedures.[819] For example, in the SOEs privatisation process, the insiders misrepresent the ownership status when selling state assets to avoid regulatory scrutiny.[820] They sold the state assets at significant discounts compared to market prices and often accompanied by an increase in RPTs, which did not lead to improved profitability as measured by return on assets. Ultimately, SOE managers' actions resulted in harm to both the state and minority shareholders.

In the 1990s, before the establishment of SASAC, state assets' value was often undervalued during the SOE's privatisation because of the need to represent state interests properly. Managers with increasing power over state asset disposal abused their positions by selling

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813 Fuxiu Jiang and Kenneth A Kim, 'Corporate Governance in China: A Survey' (2020) 24 Review of Finance 733 <https://academic.oup.com/rof/article/24/4/733/5824805>.

814 Feng Liu and Linlin Zhang, 'Executive Turnover in China's State-Owned Enterprises: Government-Oriented or Market-Oriented?' (2018) 11 China Journal of Accounting Research 129.

815 Jiang and Kim (n 184) 755.

816 Jiang and Kim (n 40) 205; Curtis J Milhaupt and Mariana Pargendler, 'RPTs in SOEs: Tunneling, Propping, and Policy Channeling' [2018] The Law and Finance of Related Party Transactions (Cambridge University Press, Forthcoming), Stanford Law and Economics Olin Working Paper 2.

817 Jiang and Kim (n 40) 205.

818 Xue Liang Ding, 'The Illicit Asset Stripping of Chinese State Firms' [2000] The China Journal 1, 1.

819 Raymond Fisman and Yongxiang Wang, 'Corruption in Chinese Privatizations' (2015) 31 The Journal of Law, Economics, & Organization 1.

820 ibid 3.

state assets at lower prices. Moreover, asset revaluation was rarely conducted, even though it was, and assets were significantly undervalued, sometimes by more than 70 per cent. In the case of a chemical factory in Nanchang, only 79 per cent of the revalued assets were accounted for as the state share.[821] The SOE managers became the general managers in the new joint venture, while the state assets used were the factory's critical production facilities.[822] This kind of insider control by SOE managers directly undermines the state's interests as the majority shareholder and exacerbates the agency problems between the dominant shareholder and minority shareholders.[823]

4.4.3.3 SOEs Managers vs. Minority Shareholders

According to the current cadre management system of the CCP, the Party plays a pivotal role in appointing all state officials in all state-related institutions, and SOEs, as the extension of the government, are no exception. The senior corporate executives, especially the Party secretary, Chairman and Deputy Chairman of the board, and the CEO of SOEs are appointed and evaluated by the Party's Organization Department.[824] SOEs are integrated into the state's political structure and hold specific bureaucratic ranks, while personnel management is handled according to the bureaucratic level in which the SOE operates. Senior executives of central SOEs at the ministerial or vice-ministerial level are directly appointed by the CCP's Central Organization Department, whereas other central SOE appointments are managed by the SASAC of the State Council. With the advent of the market economy, SOEs are encouraged to combine organizational appointments with market-based hiring practices.[825] Within this framework, the board of directors is responsible for selecting the CEO and senior executives to attract the most capable and competitive individuals.[826] Although SOEs adopted both government-oriented and market-oriented personnel systems, the appointment and dismissal by the Organization Department of the Party remain dominant under the cadre management system in large SOEs, particularly those under direct state oversight.[827]

Therefore, instead of the executive compensation (pay or stock options) adopted in many US companies, the main incentive of SOEs managers is the political promotion.[828] The

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[821] Keun Lee and Hahn Donghoon, 'From Insider-Outsider Collusion to Insider Control in China's SOEs' (2004) 40 Issues and Studies 1, 20.

[822] Chaohua Han, 'The Agency Problem in the State Asset Management System—Lessons from a Case of State Asset Expropriation (Guoyou Zichan Guanli Tizhi Zhong de Daili Wenti—Yige Guoyou Zichan Liushi Anli de Qishi)' (1995) 5 Economic Research (Jingji Yanjiu) 34.

[823] Donald C Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125; Jiang and Kim (n 184).

[824] Liu and Zhang (n 185).

[825] ibid.

[826] Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-Owned Enterprises' (2014) 47 Cornell International Law Journal 631, 659.

[827] Liu and Zhang (n 185).

[828] ibid.

government has implemented various regulations to restrict the salaries of top SOE managers, substituting monetary rewards with perks that aim to align executives' efforts with shareholder interests. However, the evidence shows that perks are more closely tied to managerial power rather than firm performance.[829] Additionally, political promotion with higher governmental positions is associated with compensation and various implicit incentives, such as increased power, status, reputation, and other non-monetary benefits, which motivate SOE managers to seek promotions.[830] Consequently, SOE managers often align closely with the interests of the dominant state shareholders, sometimes to the detriment of minority shareholders.[831] The SOE managers, for the sake of promotion, prioritize the interests of the state shareholders while at the cost of those of the minority.[832] For example, SOE taxes, which serve as a form of dividend to the state as the controlling shareholder, impose a cost on other shareholders. Analysis of publicly listed Chinese firms has shown that SOEs engage in significantly less tax avoidance than their non-SOE counterparts, with this difference being particularly pronounced during years when SOE managers are evaluated for performance.The analysis suggested managerial incentives and tax reporting, as higher tax rates in SOEs are correlated with more frequent managerial promotions.[833] Essentially, when SOE managers prioritize actions that benefit state shareholders to enhance their prospects for promotion, it often comes at the expense of minority shareholders, thereby intensifying the agency conflicts between SOE managers and minority shareholders.

4.5 The Introduction of Independent Directors

China's dual-board corporate governance model has employed the board of supervisors as the checks and balances institution to oversee the managerial board and the senior management. However, Chinese company law only provides the supervisory board's role without granting it significant functional powers or ensuring its structural independence. In most cases, Chinese companies maintain only the minimum number of supervisory board members required by law, rendering the board ineffective as a corporate governance mechanism.[834] Given the dysfunction of the board of supervisors, the CSRC issued the 2001 Independent Director Guidance Opinion. This move aimed to incorporate Independent Directors—derived from

829 W Li and Q Chi, 'Research on the Mechanism of the Effect of Executive Perquisite Consumption on Firm Performance Perspective of Ownership Type' (2015) 4 China Industrial Economics 122.

830 Donghua Chen and others, 'China's Closed Pyramidal Managerial Labor Market and the Stock Price Crash Risk' (2018) 93 The Accounting Review 105, 105 <https://meridian.allenpress.com/accounting-review/article/93/3/105/99486/China-s-Closed-Pyramidal-Managerial-Labor-Market> accessed 6 August 2021.

831 Gongyun (n 178).

832 Jiang and Kim (n 184) 755.

833 Chen and others (n 201) 255.

834 Lin Ling and Dong Hong, 'Legal Person Governance Structure and Operational Results: An Empirical Analysis of High Technology Listed Companies （Faren Zhili Jiegou Yu Jingying Jixiao: Lai Zi Gao Keji Shangshi Gongsi de Shizheng Fenxi）' [2000] Information for Entrepreneurs (Qlye jia xinxi) 62.

Anglo-American corporate governance practices—to complement the role of the BOS and provide effective oversight of both major shareholders and management.

4.5.1 The Development of Independent Directors

The concept of Independent Directors first emerged in Chinese companies in 1993 when Tsingtao Brewery appointed two independent directors to comply with the listing requirements of the Hong Kong Stock Exchange.[835] In 1997, CSRC released the non-compulsory Guidelines for Articles of Association of Listed Companies, which allowed listed companies to appoint independent directors based on their specific needs[836]

By 1999, the State Economy & Trade Commission (SETC)[837] and CSRC jointly released the Opinions for Further Promoting the Standardized Operation and Deep Reform of Overseas Listed Companies, advocating for an increased proportion of external directors on boards. Specifically, it provides that:

"When the board is re-elected, external directors should make up more than half of the board members, with at least two independent directors (independent directors under the Opinion were defined as directors independent from the shareholders and not holding any position in the company). External directors should have sufficient time and the necessary knowledge and skills to fulfil their duties. The company must provide the necessary information and materials for external directors to perform their duties. The opinions expressed by independent directors should be stated in the board resolutions. Related party transactions of the company must be signed by independent directors to be effective. Two or more independent directors can propose to convene an extraordinary general meeting. Independent directors may report directly to the general meeting of shareholders, the China Securities Regulatory Commission, and other relevant departments." [838]

Although these Opinions primarily target companies listed overseas, they represent the initial move towards making independent directors a mandatory feature for listed companies. However, the regulations are overly simplistic, making them difficult to implement. Following this, relevant legislative bodies and stock exchanges have continued to work on refining the regulations.

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[835] Hong Kong Exchange Change, 'Listing Rule of the Stock Exchange of Hong Kong' <https://en-rules.hkex.com.hk/rulebook/310-0>. Rule 3.10

[836] Guidelines for Articles of Association of Listed Companies 1997. Art.116

[837] SETC was the former ministry of the State Council established in March 1993. In March 2003, the 1st session of 10th National Congress of Communist Party of China approved the Proposal for the Institutional Reform of State Council, decided to repeal the SETC and establish Ministry of Commerce

[838] Opinions for Further Promoting the Standardized Operation and Deep Reform of Overseas Listed Companies (Guanyu Jinyibu Cujin Jingwai Shangshi Gongsi Guifan Yunzuo he Shenhua Gaige de Yijian) 1999. Art. 6

In 2000, the General Office of the State Council issued Basic Standards for Large and Medium State-owned Enterprises to Establish a Modern Enterprise System and Strengthen the Management (For Trial Implementation), provided that "the board of directors can introduce independent directors that independent from the shareholders of the company and do not hold any position of the company".[839]

Before the 2000s, no regulatory documents or listing rules mandated an independent director system. In 2000, the Shanghai Stock Exchange (SHSE) Corporate Governance Guidelines introduced the requirement for its listed companies to appoint at least two independent directors, constituting at least 20 percent of the board.[840] Additionally, if the chairperson of the board also served as the legal representative of the controlling shareholders, the proportion of independent directors needed to be 30 percent.[841] This is the first attempt to establish an independent director system in domestic listed companies through explicit regulations, but it is not yet mandatory. In 2001, the Shenzhen Stock Exchange followed suit by issuing the Guidelines for the Implementation of an Independent Director System in Listed Companies, which outlined the qualifications and duties of independent directors.

On 16 August 2001, CSRC issued the Independent Director Guideline. All companies listed on the two Chinese stock exchanges[842] whose board of directors should have one-third of their board members were independent directors by June 30, 2003. This Guideline was the most comprehensive effort by Chinese regulators to enhance internal corporate governance through the independent director system.[843]

Not long before the issuance of the Guidance Opinions, CSRC released the draft "Measures in the Administration of Securities Companies" for public comment on 20 June of the same year, notably introducing a transparent independent director system. The final version was published on 28 December 2001, entitled "Securities Companies Measures", which mandated that all securities companies establish an independent director system. It specified that independent directors must account for at least one-quarter of the board of directors when (1) the chairman and the CEO are the same person; (2) inside directors comprise at least one-fifth of the board; or (3) it is deemed necessary by the department in charge of the company, the shareholders' general meeting, or the CSRC.[844] Thus, CSRC successfully implemented the independent director system in securities companies.

Following the introduction of the Independent Director Opinion, several regulatory documents were released to support its implementation. In 2002, the People's Bank of China (PBOC)

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[839] Basic Norms for the Large and Medium State-owned Enterprises to Establish Modern Enterprise System and Strengthen the management (Trial) 2000.

[840] Guidelines on Corporate Governance of Listed Companies (Draft) 2000.

[841] ibid.

[842] Excluding overseas-listed Chinese companies

[843] Clarke (n 194) 129.

[844] Measures on the Administration of Securities Companies 2001 Art.27.

issued two guiding documents on corporate governance that covered independent directors and external supervisors in joint-stock commercial banks.[845] These guidelines detailed various aspects of independent directors, including their qualifications, selection process, appointment, dismissal, rights, duties, remuneration, and associated expenses.[846] Strengthening governance in joint-stock commercial banks was seen as crucial due to their vital role in the modern capital market, and improving their governance practices was expected to boost competition and positively influence the broader financial system. Consequently, the adoption of an independent director system in China's commercial banks was considered a pivotal step for both the governance of listed companies and the broader establishment of independent directors across the country.

In 2007, the Chinese Insurance Regulatory Commission (CIRC) issued the Interim Measures for the Administration of Insurance Companies' Independent Directors.[847] These regulations mandated the presence of independent directors on insurance company boards and outlined their qualifications, appointment and dismissal procedures, rights, duties, and compensation, reflecting the requirement of the Independent Director Guideline. Beyond specific regulations for independent directors, broader governance documents also referenced their role, such as the Code of Corporate Governance for Listed Companies issued by the CSRC and SETC in 2002,[848] and the Provisions on Strengthening the Protection of the Rights and Interests of Public Shareholders issued by the CSRC in 2004.

The recognition of Independent Directors by Chinese law was the 2005 revision of Company Law, which mandated that listed companies have independent directors, with the State Council tasked with developing detailed measures.[849] Since then, Independent Directors have generally been established in Chinese listed companies as a universal requirement mandated by Chinese corporate law. Recent regulatory developments have continued to include provisions on the responsibilities of independent directors, aiming to enhance their independence. For example, since the first release of the Guidelines of Articles of Association of Listed Companies by CSRC in 2006, the following revisions of the Guidelines in 2014, 2016, and 2019 further extend the scope of Independent Directors' duties and authorities. In addition, in 2014, the China Association for Public Companies (CAPCo) published the Guidelines for the Exercise of Duties of Independent Directors of Public Companies, which contains the general

[845] PBOC issues the two documents: Guidance on Corporate Governance of Joint-Stock Commercial Banks: Guidance on Independent Directors and External Supervisors of Joint-Stock Commercial Banks. The Guidance on Corporate Governance of Joint-Stock Commercial Banks has been repealed.

[846] Guidance on Independent Directors and External Supervisors of Joint-Stock Commercial Banks 2002.

[847] Interim Measures for the Administration of Insurance Companies' Independent Directors 2007.

[848] It was revised in 2018 China Securities Regulatory Commission, 'Code of Corporate Governance of Listed Companies (2018 Revision)' <https://www.pkulaw.com/en_law/7dcbd92ec7fcbe7ebdfb.html>.

[849] 2005 Company Law. Art. 123

principle, duties, authorities and duties of Independent Directors.[850] Although such guidelines are not compulsory, their provisions on Independent Directors have influenced the relevant laws and regulations.

The most recent initiative in reforming the independent director system is the “Opinions on The Reform of Independent Director System in Listed Companies” (Reform Opinions), issued by the General Office of the State Council on April 14, 2023. This document marks the first major reform of the independent director system since the 2001 Guidance Opinions.[851] The Reform Opinions detail eight key tasks, including clarifying independent directors’ roles and responsibilities, defining their methods of duty performance, improving their appointment and management processes, and enhancing supervision and accountability, all aimed at boosting the efficiency and collaboration of the corporate governance supervision system in China.

Subsequently, on August 1, 2023, the CSRC released the “Administrative Measures for Independent Directors of Listed Companies” (Independent Director Measures).[852] The Independent Director Measures were revised to focus on independent directors' roles, specifically in decision-making, supervision, balancing interests, and providing expert consultation. Simultaneously, the stock exchanges updated their listing rules and self-regulatory guidelines to incorporate the significant changes from the Independent Director Measures, including detailed enhancements to the scope of independent directors’ duties.

Reflecting on the establishment of independent directors in China, since their first appearance in the 1990s, Chinese regulatory authorities have issued numerous legal documents and guidelines—including binding and non-binding—constituting the institutional framework of Chinese Independent Directors. As stated above, borrowing independent directors was done to resolve corporate governance problems and improve corporate performance. The following sections will explore the specific provisions related to independent directors within Chinese corporate governance.

4.5.2 Qualifications of Independent Directors

As previously discussed, a key issue that the introduction of independent directors aims to address in Chinese corporate governance is the expropriation of minority shareholders by dominant shareholders. In addition to fulfilling their duty of loyalty and diligence to all shareholders, independent directors are specifically tasked with safeguarding the legitimate

[850] China Association for Public Companies, ‘Guidelines for the Exercise of Duties of Independent Directors of Public Companies’ (2014) <https://www.capco.org.cn/flfg/zlgf/201904/20190418/j_2019041815194200015692231516399023.html>.

[851] General Office of the State Council, ‘Opinions on The Reform of Independent Director System in Listed Companies’ (2023) <https://www.gov.cn/gongbao/content/2023/content_5753315.htm>.

[852] China Securities Regulatory Commission, ‘Administrative Measures for Independent Directors of Listed Companies’ (2023).

interests of medium and small shareholders in listed companies.[853] According to the CSRC's Independent Director Measures, independent directors are defined as those who hold no other position within the company besides their directorship and who have no affiliations with the management or major shareholders that could compromise their ability to make impartial and objective decisions.[854]

To ensure independence, the CSRC's Independent Director Measures utilize both positive and negative criteria to define the qualifications of independent directors, diverging from the transaction-by-transaction approach commonly used in U.S. corporate law. Directors need to meet the positive qualifications that (1) being eligible for directorship as stipulated by the Company Law and other relevant regulations; (2) possessing the independence required by the Independent Director Opinion; (3) having basic knowledge of listed company operations and being familiar with pertinent laws and regulations; (4) having at least five years of professional experience in fields such as law, economics, or other relevant areas necessary for the role of an independent director; and (5) meeting any additional requirements outlined in the company's articles of association.[855]

Meanwhile, according to the Independent Director Opinion, directors will be disqualified from being considered independent if they are involved in any of the following:[856]

(1) Employment relationships: employees of the listed company or its subsidiaries, as well as their immediate family members (spouses, parents, children, and main social relations); or employees of subsidiaries of the company's controlling shareholder or actual controller, along with their immediate family members.

(2) Shareholding and financial interests: individuals who directly or indirectly hold more than 1 per cent of the company's issued shares or are among the top ten individual shareholders, along with their immediate family members; or employees of shareholders who directly or indirectly hold more than 5 per cent of the company's issued shares or are among the top five shareholders, along with their immediate family members.

(3) Business relationships: individuals who have significant business dealings with the company or its controlling shareholder or actual controller or who are employed by entities with such significant business relationships.

(4) Service provider: individuals providing financial, legal, consulting, sponsorship, or other services to the company or its controlling shareholders or actual controller. This includes

[853] Guideline Opinion for Introducing Independent Directors to the Board of Directors of Listed Companies. Art. 1

[854] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.2.

[855] ibid Art. 7.

[856] ibid Art.6.

employees of intermediary agencies, reviewers, signatories, partners, directors, senior management, and key personnel.

(5) Recent affiliations: individuals associated with any of the above situations within the past twelve months.

(6) Legal and regulatory restrictions: any other persons deemed lacking in independence according to laws, administrative regulations, CSRC regulations, stock exchange rules, or the company's articles of association.

The above qualifications suggest that Chinese independent directors, on one hand, are required to have adequate knowledge and expertise; on the other hand, independence focuses on the director's free from any monetary or financial relationships, including shareholding, employment, with the company and its significant shareholders. However, the qualifications for independent directors in China are largely abstract, consisting of a list of conditions for eligibility and ineligibility. This raises concerns about whether true independence can be ensured both at the time of appointment and throughout the director's term, typically three years or up to six years. There are numerous ways to bypass the disqualifying conditions, allowing individuals to technically meet the independence criteria without being genuinely independent. For instance, although the Opinion restricts independent directors to holding no more than five independent directorships "in principle" to ensure they have sufficient time and resources to fulfill their duties,[857] this limitation does not necessarily prevent directors from compromising their independence in practice.

4.5.3 The Proportion and Background of Independent Directors on Board and Committees

The Independent Director Measures mandate that listed companies to have at least one-third of their board composed of independent directors,[858] which remain the same as previously required. A survey by the Asian Corporate Governance Association (ACGA) found that independent directors dominate approximately 20 percent of boards in listed companies.[859] However, a 2017 study on independent directors reported that from 2013 to 2017, the average proportion of independent directors on boards was 37 percent, and by 2017, around 49 percent of listed companies had at least one-third of their board composed of independent directors, thus meeting the minimum regulatory requirement.[860] Given that the average board size in

[857] Guideline Opinion for Introducing Independent Directors to the Board of Directors of Listed Companies. Art. 1

[858] ibid. Art 1

[859] ACGA and KPMG, 'Balancing Rules and Flexibility-A Study of Corporate Governance Requirements across 25 Markets' (2014).

[860] Chen Hao, 'Director Compensation, Independent Director Is the New Breakthrough(Dongshi Xinchou, Duli Dongshi Shi Xin Tupo Kou)' (2017) 10 Board of Directors (Dongshi Hui) 48.

Chinese listed companies is nine members, typically, three independent directors are needed to satisfy the one-third requirement.[861]

Listed companies need more incentive to increase the number of independent directors on their boards. CAPCo reported that 57 per cent of investors rated the performance of independent directors in promoting companies' development as "fair" or "poor". Additionally, only 36 percent of investors were satisfied with independent directors' performance in safeguarding minority shareholders' benefits, indicating a low level of investor satisfaction with independent directors.[862]

The latest 2023 Company Law introduces a significant reform in internal corporate governance structures, allowing companies to choose between the traditional two-tier board system and a one-tier board model. If a company opts for the one-tier structure, the audit committee within the board of directors will replace the supervisory board, with a requirement that independent directors constitute over half of the audit committee, including at least one independent director who is a professional accountant.[863] For listed companies, the Independent Director Measures mandate the establishment of an audit committee composed of directors who do not hold senior management roles within the company, and a majority of these committee members must be independent directors.[864]

In addition to the audit committee, other special committees, such as the nomination committee, remuneration and appraisal committee, and strategy committee, may be set up based on the specific needs of listed companies. The nomination and remuneration and appraisal committees must have a majority of independent directors, and these independent directors should also chair these committees.[865]

The Independent Director Measures further stipulate that boards must include at least one independent director with accounting expertise, and the audit committee chair should be an independent director possessing such expertise.[866] According to data from the SZSE, as of the end of 2012, 42 per cent of independent directors were professors or scholars from academic institutions, 20 per cent came from (accounting or legal) intermediaries, 15 per cent were senior management or had experience in the senior management, 15 per cent were the former party

[861] Allen and Li (n 63) 55,74.

[862] China Association for Public Companies, 'Report on the Performance of Independent Directors of Listed Companies' (2013) <https://www.capco.org.cn/xhdt/xhyw/201904/20190419/j_2019041911330500015688575212440854.html>.

[863] 2023 Company Law Art.121.

[864] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.5.

[865] ibid.

[866] ibid.

and government leaders.[867] However, the background characteristics of independent directors have changed significantly since 2013, following a document issued by the Organizational Department of the CCCCP, which imposed stringent standards on party and government leaders serving in enterprises as part of anti-corruption efforts.[868] Thus, by the end of 2016, the proportion of retired officials serving in listed companies had significantly decreased to 3 percent.[869]

The restriction on party and government leaders serving in enterprises, as reflected in the CCCCP's document, aimed to reduce political influence on listed companies and emphasise the market's fundamental role in resource allocation.[870] Previously, many listed companies, particularly privately-owned enterprises, had recruited retired officials to leverage the advantages linked to their political connections.[871] The importance of having "official independent directors" varied between SOEs and non-SOEs due to the different nature of the ownership. For SOEs, political connections often manifested through direct government intervention or policy obligations, which typically undermined firm value.[872] In contrast, non-SOEs employed official independent directors to establish political connections and expected these directors to provide resources and business opportunities, given governmental officials' significant role in resource distribution in China.[873] However, the effectiveness of these political connections in securing bank loans and government subsidies has decreased as a result of the ongoing anti-corruption campaign,[874] which accounts for the observed shift in the backgrounds of independent directors since 2013.

The primary characteristic of independent directors in Chinese listed companies is the high level of education, with the majority being part-time scholars, professors, and professionals in

[867] Zeng Bin and Chen Bin, 'On the Perfection of China's Independent Director System from the Independent Directors' Voting Situation(Cong Duli Dongshi Biaojue Qingkuang Tan Woguo Duli Dongshi Zhidu de Wanshan)' (2017) 000 Tinghua Financial Review (Qinghua jinrong Pinglun) 47, 48.

[868] Opinions on Further Regulating the Part-time (holding) of Leading Cadres of the Party and Government in Enterprises 2013.

[869] Allen and Li (n 63).

[870] Hu Jintao, 'The Report at 18th National Congress of the Communist Party of China "Firmly March on the Path of Socialism With Chinese Characteristics and Strive to Complete the Building of a Moderately Prosperous Society in All Respects"' (2012).

[871] Lidong Wu and Kai Wang, 'The Change of Independent Director System from "Regulation" to "Awareness"——Evidence from Main Board Listed Companies(Duli Dongshi Zhidu Cong Guizhi Dao Bianqian-Laizi Zhuban Shangshi Gongsi de Zhengju)' (2014) 26 Management Review(Guanli Pinglun) 9.

[872] Joseph PH Fan, TJ Wong and Tianyu Zhang, 'Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms' (2007) 84 Journal of Financial Economics 330.

[873] Zheng Luhang, 'Political Connection of Independent Directors and Firm Performance (Duli Dongshi de Zhengzhi Guanlian Yu Gongsi Jixiao)' (2010) 32 Contemporary Economic Management (dangdai jingji guanli) 20.

[874] Jinsong Liu and Qianwei Ying, 'The Decreasing Value of Non-SOEs' Political Connections during China's Anti-Corruption Campaign: Evidence and Mechanism' (2019) 59 Accounting and Finance 3171 <https://onlinelibrary.wiley.com/doi/full/10.1111/acfi.12582> accessed 12 May 2021.

law and finance. According to the Wind database, by the end of 2020, out of a total of 14,060 independent directors, 6,122 held doctoral degrees, making up 43.54 percent of the total. Financial professionals accounted for about 10 percent, and legal professionals made up approximately 13 percent, with these three categories together representing nearly 70 percent of all independent directors.[875]

Moreover, while independent directors from universities or academia constitute the largest proportion of professional backgrounds among independent directors, in many cases, these academic independent directors serve as little more than "decorations." They are often invited primarily to enhance the company's reputation rather than to provide substantive governance oversight.[876]

4.5.4 Independent Directors' Nomination and Appointment

Under the Independent Director Measures, the nomination and appointment process for independent directors allows for candidates to be proposed not only by "the board of directors, board of supervisors, or shareholders solely or jointly holding over one percent of the outstanding shares of the company", but also by investor protection organizations. Ultimately, the selection of independent directors is decided by the shareholders' general meeting[877] However, this process reveals a fundamental weakness: in practice, independent directors are often nominated by controlling shareholders or boards under their influence and are then elected by these same dominant shareholders who control the voting in the general meeting.[878] Although by 2012, over 88 percent of listed companies set up the nomination committee, its functions were limited to procedural review of the qualification of independent directors candidates after the nomination of dominant shareholders, which lacks the capacity and the authority to screen independent directors candidates from the employment market.[879] Thus, independent directors elected through such an approach are not likely to oppose and adequately supervise the dominant shareholders who have nominated and elected them.[880]

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[875] Hua Sheng, Cai Qian and Dong Shen, 'Shanghai Stock Exchange Observer | Where Did We Go Wrong? —— Independent Directors and Corporate Governance (Part 2)' *shanghai Securities News* (2021) <https://news.cnstock.com/news,yw-202112-4796849.htm>.

[876] Tang Qingquan, Luo Danglun and Zhang Xueqin, 'Empirical Evidence of Relationship between Professional Backgrounds of Independent Directors and Corporate Performance (Duli Dongshi Zhiye Beijing Yu Gongsi Yeji Guanxi de Shizheng Yanjiu)' [2005] Contemporary Economic Management (dangdai jingji guanli) 97 <http://yuxiqbs.cqvip.com/Qikan/Article/Detail?id=15080779&from=Qikan_Article_Detail>.

[877] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.9.

[878] Clarke (n 194) 195.

[879] Allen and Li (n 63) 54.

[880] Xie Chaobin, 'Study on the System of Appointment and Removal of Independent Direction Ion Stock Corporation (Gufen Gongsi Duli Dongshi Renmian Zhidu Yanjiu)' (2004) 22 Hebei Law Science (Hebei faxue) 2, 2–4.

To counterbalance the influence of dominant shareholders and enhance the protection of minority shareholders' voting rights, the latest Independent Director Measures require listed companies to adopt cumulative voting when electing two or more independent directors.[881] This approach aims to reduce the sway of controlling shareholders over the appointment process and empower minority shareholders in the decision-making process.

4.5.5 Independent Directors' Remuneration

The Independent Director Measures issued by CSRC offer limited guidance on remuneration, merely stating that listed companies should provide independent directors with an appropriate allowance and prohibit them from receiving any additional, undisclosed benefits from the company, its major shareholders, or related parties.[882] The average remuneration for independent directors is notably lower than that of non-independent directors. As of the end of 2020, among the 4503 companies listed on the SHSE and SZSE, there were 14060 independent directors, with an average annual salary of RMB 84,155 yuan ($12,022). While this amount may be considered modest within the business sector, it is a decent part-time income for academics and professionals, especially given the minimal time commitment and the potential benefits of the associated social connections.[883] Additionally, since independent directors are expected to maintain their independence and minimise conflicts of interest with the companies they serve, their remuneration is fixed and not linked to the performance or stock price of the companies where they hold positions.

According to the Measures for Administration of Equity Incentives of Listed Companies and the Independent Director Measures, independent directors are excluded from performance-based incentives, and they risk losing their independent status if they own more than one percent of the company's outstanding shares.[884] Consequently, remuneration is predominantly provided in cash, without the inclusion of stock options, to preserve the impartiality and objectivity expected of independent directors.

4.5.6 Obligations

Independent directors are bound by duties of loyalty and diligence to the listed company and all its shareholders. They are required to faithfully execute their responsibilities in compliance with laws, administrative regulations, CSRC guidelines, stock exchange rules, and the company's articles of association. Their roles encompass decision-making, oversight, checks

[881] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.12.

[882] ibid Art.41.

[883] Sheng, Qian and Shen (n 246).

[884] Measures for Administration of Equity Incentives of Listed Companies 2018 Art.8; China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.6.

and balances, and providing expert consultation, all aimed at safeguarding the overall interests of the company and protecting the legitimate rights of medium and minority shareholders.[885]

As previously discussed, a significant corporate governance issue in Chinese listed companies is the exploitation of minority shareholders by dominant shareholders, who often abuse their control over the board.[886] Independent directors are thus expected to act as advocates for minority shareholders and work to prevent corporate misconduct. This expectation aligns with the requirement that independent directors must be free from ties to major shareholders. However, according to the voting system outlined in Company Law and other countries' legal traditions, the majority shareholders can out-vote the minority shareholder. Consequently, as long as large shareholders have the power to appoint directors, it remains challenging to ensure that directors representing minority shareholders can be elected without revising the fundamental principles of director selection.[887]

Second, tunnelling through RPTs is one common way of dominant shareholder exploitation. Independent directors are obliged to monitor RPTs where conflicts of interest may arise. The listed company shall disclose these issues promptly if it involves disclosure matters. However, some argue that independence should not be treated as a broad concept; instead, a transaction-based approach that closely examines the specific contexts of a director's independence may be more effective.[888]

Third, independent directors are obliged to provide enhanced oversight to address the perceived failure of the supervisory board. Although China's dual board model was inspired by German corporate governance practice, the structure between the two was significantly different. China's company law only stipulates the role of the supervisory board without providing functional powers such as the authority to appoint and dismiss members of the board of directors. As a result, the supervisory board played no supervisory role in Chinese corporate governance. The introduction of independent directors, alongside the retention of the supervisory board, suggests that independent directors are expected to complement the supervisory function and fulfill roles that the supervisory board has not effectively performed.[889]

Fourth, independent directors will serve as the company's advisors and consultants. In fact, before CSRC's mandatory requirement of establishing independent directors, their consultancy and expertise were highly valued by listed companies.[890] Independent directors from academia, law or accounting firms, and government departments can provide expert knowledge and

[885] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.3.

[886] Gongyun (n 178) 57.

[887] Clarke (n 194) 171.

[888] ibid 172.

[889] ibid 175.

[890] Zhou (n 19) 278.

strategic guidance and help build political connections.[891] In other words, independent directors usually have main jobs or multiple directorships except for the directorship in one company. There are concerns regarding whether independent directors have sufficient time and incentive to devote to consultant and advisory work.

4.5.7 Special Powers

Independent Director Measures mandate the ex-ante authorisation of independent directors on specific matters to enhance their monitoring role; the listing rules of stock exchanges then follow such ex-ante authorisation. Before these matters are presented to the board of directors for consideration, they must receive approval from over half of the independent directors on the board. The matters include: (1) related transactions that must be disclosed; (2) proposals for changes or exemptions of commitments by the listed company and related parties; (3) decisions and actions taken by the board of a company being acquired in response to the acquisition; and (4) other matters as stipulated by laws, administrative regulations, CSRC and company's articles of association.[892]

Given their unique role, independent directors are vested with certain special powers, including: (1) independently engaging intermediary institutions to audit, consult, or verify specific matters concerning listed companies; (2) proposing that the board of directors convene an interim shareholders' meeting; (3) proposing the convening of a board meeting; (4) legally soliciting shareholders' rights in a public manner; and (5) expressing independent opinions on matters that could potentially harm the interests of the listed company or minority shareholders.[893]

However, some aspects of these special powers remain ambiguous. For instance, independent directors do not appear to have the direct authority to convene shareholder or board meetings; they can only suggest that the board take such actions. To address this, the latest Independent Director Measures stipulate that listed companies should hold special meetings exclusively for independent directors. During these meetings, the special powers of independent directors and issues requiring pre-approval should be discussed and deliberated. Nonetheless, the exercise of these special powers cannot be undertaken by individual independent directors; for instance, any use of the special powers listed in Article 18, as well as ex-ante authorization, must have the agreement of at least half of the independent directors.

Additionally, the fifth clause of Article 18, which grants independent directors the power to express independent opinions on "matters that may harm the interests of the listed company or minority shareholders," lacks clear boundaries. This ambiguity can create confusion and

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[891] Jing Liao, Martin R Young and Qian Sun, 'Independent Directors' Characteristics and Performance: Evidence from China' [2009] Available at SSRN 1489088 11.

[892] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.23.

[893] ibid Art.18.

uncertainty for independent directors when it comes to exercising their judgment in expressing independent opinions on such matters.

4.5.8 Enforcement

The critical question is how the rules will be enforced to induce independent directors to perform their expected roles. Both governing authorities carry out the enforcement of independent director requirements: CSRC and the court. As the regulatory department governing the Chinese securities market, CSRC has the authority to supervise and regulate the actions of independent directors, including formulating administrative rules, market supervision and sanctions. When the listed company, its independent directors, or associated parties violate the provisions, the CSRC can employ various regulatory measures, such as issuing correction orders, conducting regulatory talks, sending warning letters, requiring public explanations, or demanding periodic reports. For violations that warrant administrative penalties under the law, the CSRC enforces sanctions in line with the applicable legal provisions.[894]

For instance, the Independent Director Measures, aligned with the Company Law, impose a duty of good faith and diligence on independent directors. Concurrently, the Securities Law mandates that disclosures made by directors must be truthful, accurate, complete, concise, clear, and easily understood, without any false or misleading information or significant omissions.[895] Independent directors are required to sign written confirmations regarding securities offering documents and periodic reports, ensuring that the issuer discloses information in a timely and fair manner.[896] Should independent directors fail in their information disclosure duties, or if the information provided is false, misleading, or materially incomplete, they may be ordered to rectify the issue, issued a warning, or subjected to fines.[897]

In practice, CSRC typically enforces penalties under the Securities Law rather than the Company Law. In the penalty decision, the CSRC emphasizes that directors are expected to fulfil their responsibilities with loyalty. However, penalties related to false disclosures are not typically linked to breaches of fiduciary duties. This is because the Company Law does not explicitly outline directors' obligations concerning information disclosure. As a result, CSRC's punishment against directors' false disclosure does not need to be based on the fiduciary duty basis but can be made according to the Securities Law directly.

Before imposing administrative penalties against directors, CSRC needs to determine who bears information disclosure obligations or who is the directly liable executive in charge.

[894] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223).

[895] Securities Law (2019) 2019 Art.78.

[896] ibid Art.82.

[897] ibid Art.197.

Directors' accountability depends on whether the board resolution they approved and signed would ultimately result in the corporate loss of benefits.

The liabilities of independent directors should be limited to matters in which they have been involved, are aware of, or have given their consent. According to the Independent Directors Measures, they are exempted from the liability if they can prove they have fulfilled their basic duties, but one of the following conditions is met: (1) the issue is out of the expertise despite seeking assistance before reviewing or signing information disclosure documents; (2) raising an objection and voting against or abstained on the illegal or non-compliant matters; (3) the company or the related parties deliberately concealed information and no indications show independent directors know that; (4) the listed company's refusal and obstruction of their duties.[898]

Independent directors who do not engage in corporate business operations bear different responsibilities when the loss of company benefits occurs because their independence determines their lack of information compared with the internal director. Thus, independent directors can argue against CSRC punishment because they do not have access to internal information regarding corporate business or they do not have a professional background. Directors' fiduciary duties are recognized by the CSRC in determining whether the directors are charged with the loss. If the CSRC recognizes that directors have performed their duty of loyalty and diligence, then the director will not be liable and will be free of sanctions.[899]

However, the failure to fulfil the fiduciary duties seems to be a catch-all provision that provides the administrative department with the discretion to make decisions. In the Kangmei Pharmaceutical Co. Ltd case, the independent directors of Kangmei signed and approved the annual report, which falsely increased revenues, interest revenues and operating avenues, falsely increased cash and cash equivalents, falsely increased fixed assets, construction in progress and investment properties. Kangmei's five independent directors pleaded that they had carefully reviewed the company's report as independent directors during the course of their duties and had independently formed and clearly expressed their opinions on the basis of their personal specialities. Although the independent directors of Kangmei objectively failed to identify the misrepresentation in the company's annual report, they argued that they had exercised due diligence, prudence, and reasonable care toward the interests of the investors. They also maintained that they had no prior or subsequent knowledge of the legal violations committed by Kangmei, nor did they gain any benefits from these infractions.

However, the CSRC rejected these arguments, reasoning that despite the independent directors not being directly involved in the fraudulent activities, the financial misconduct within the company persisted for an extended period, involved significant amounts, and was widespread. The CSRC stated that "if the independent directors had exercised their duty of

[898] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.46.

[899] Administrative Measures for Independent Directors of Listed Companies 2023 Art.46(5).

diligence, even in overseeing just part of the business, they could not have failed to detect the signs of fraud." Since the signature of independent directors confirmed the authenticity of the financial report, it is obvious that they "did not fulfil the duty of care, even if only part of the business in charge of, can't find the clues". Independent directors should bear part of the joint and several liability according to the extent of the negligence.

In addition to public enforcement by bodies like the CSRC, private litigation plays a crucial role in capital market oversight and the enforcement of the independent director system in China.[900] The private enforcement of the independent director system in China largely depends on shareholder litigation through the courts. However, empirical evidence suggests that Chinese courts typically only hear cases of fiduciary duty breaches related to closely held companies rather than publicly listed ones. [901] As a result, shareholders in listed companies often find themselves unable to leverage private litigation to safeguard their rights, leading to independent directors functioning much like non-independent directors in these contexts. Several factors contribute to this situation:

Vague legal provision: The legal framework for shareholder litigation is unclear, preventing shareholders from effectively filing lawsuits to protect their rights. Chinese legislation has historically followed the principle of "being vague rather than clear," a strategy rooted in Deng Xiaoping's approach to law during the early stages of economic reform.[902] This principle allows for flexibility in legal interpretation, enabling different actors to handle issues according to specific contexts. However, this also leaves significant discretion in legal rules, often hindering litigation.

Between 2000 and 2002, private securities litigation increased, driven by numerous corporate scandals. Individual investors who experienced substantial financial losses took legal action against listed companies. However, the 1993 Company Law imposed strict requirements for shareholder litigation, stipulating that a lawsuit could only be initiated if a resolution of the shareholders' general meeting or the board of directors had breached laws or regulations. This law primarily permitted injunctions but did not provide for compensation, making litigation a less attractive option for shareholders. [903] As a result, courts frequently dismissed private enforcement attempts due to the absence of explicit statutory directives.[904] In September 2001, In addition, the Supreme People's Court (SPC) issued a notice in September 2001 that further restricted such cases through a notification, stating that civil compensation claims related to

[900] Administrative Measures for Independent Directors of Listed Companies.

[901] Xu and others (n 117).

[902] This is from the instruction of Deng Xiaoping before The Third Plenary Session of the Eleventh Central Committee. He indicated that given the substantial workload for legislation and the shortage of manpower, legal provisions could initially be somewhat rough and then gradually refined.

[903] Company Law 1993 Art.111.

[904] Jiangyu Wang, 'Rule of Law and Rule of Officials: Shareholder Litigation and Anti-Dumping Practice in China' [2008] Rule of Law in China Series Policy Brief 3.

securities violations (insider trading, fraud, market manipulation, etc.) would not be accepted due to legislative and judicial constraints.

Although the SPC issued judicial interpretations to guide compensation cases for securities misrepresentation, these cases could only proceed if the misrepresentation had already been subject to an administrative penalty. Huang Hui collected cases eligible to sue (253 cases) and sued cases (65 cases) between 2002-2011. The result showed that only 25.7 percent of all the eligible criminal or administrative sanctions may lead to securities litigation.[905] Such procedural pre-condition was not removed until the new judicial interpretation issued by the SPC in 2022 that “courts shall not rule the unaccepted case solely on the ground that the misrepresentation has not been subject to an administrative penalty by the supervisory authority or an effective criminal judgment by the people's court”.[906] Despite this change, the effectiveness of these provisions remained limited, and it wasn’t until a 2022 revision that the SPC allowed courts to accept cases without requiring prior administrative penalties.

Shareholder Qualifications: The Company Law requires that shareholders own at least one percent of the company’s shares for a continuous period of 180 days before filing litigation.[907] In China’s retail investor-dominated stock market, where most investors own small quantities of shares for brief durations, these qualifications pose significant barriers to shareholder litigation. According to the investigation of investors in the Chinese stock market, the average investment cycle of more than 6 months accounts for only 16.60 percent. 27.91 percent of the investors hold their shares in less than a month, and 16.31 percent of investors hold their shares in 5 days. In addition, 64.83 percent of investors with less than 100,000 yuan in capital investment and 85.08 percent of investors with less than RMB 300,000-yuan capital investment.[908] The report highlights that most Chinese investors are small to medium-sized, with short-term investment horizons and limited capital. These characteristics make it challenging for them to meet the necessary qualifications for litigation, thus restricting their ability to defend their rights through legal action.

Prohibition of Class Actions: Historically, Chinese law has prohibited class actions, limiting the options available for minority shareholders to protect their rights. This prohibition stems from both economic and political considerations. [909] Permitting class actions could lead to a flood of shareholder lawsuits against SOEs, which play a crucial role in China’s economy. Politically, class actions are viewed as a potential threat to social stability, as they could organize large

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[905] Robin Hui Huang, ‘Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment’ (2013) 61 The American Journal of Comparative Law 757, 766.

[906] Provisions of the Supreme People’s Court on Trial of Civil Compensation Cases for Misrepresentation in the Securities Market 2022 Art.2.

[907] 2005 Company Law Art.152.

[908] Chinese Securities Investor Protection Fund Ltd., ‘Comprehensive Survey and Analysis Report on China’s Securities Investors 2009-2010’ 15.

[909] Walter Hutchens, ‘Private Securities Litigation in China: Material Disclosure about China’s Legal System’ (2003) 24 University of Pennsylvania Journal of International Law 599, 644–45.

groups of aggrieved shareholders, thereby creating anxiety among government authorities. [910] The revised 2019 Securities Law, however, legitimized class action litigation in the form of representative actions. It provides that "an investor protection institution may, as authorized by 50 or more investors, participate in actions as a representative, and according to the provision of the preceding paragraph, register right holders confirmed by the securities depository and clearing institution with the people's court, except for investors who have expressly indicated their reluctance to participate in the actions."[911]

The Kangmei case, ruled on 12th November 2021 by the Guangdong Intermediate People's Court, marked China's first special securities representative action.[912] The court ordered Kangmei's two primary controllers to pay a total of RMB 2.459 billion in compensation to 55,326 investors for their financial losses. In addition, four finance department executives who organized or were involved in the fraudulent activities were found jointly and severally liable. Eight other executives and employees, who were aware of but failed to disclose the financial fraud, were required to bear 20 percent of the total compensation liability. The accounting firm and the accountant involved were also held jointly and severally liable for their negligence. Furthermore, five independent directors who endorsed the annual reports without identifying the inaccuracies were deemed liable for either 5 percent or 10 percent of the total compensation, depending on their level of culpability.

In summary, both public and private approaches are crucial for enforcing the independent director system. However, public enforcement by the CSRC has been given much discretion in interpreting the legal rules. It can be argued that the legislation and institutions are intentionally designed to expand the discretion of administrative departments.[913] On the one hand, the broad discretion granted to the CSRC allows for greater adaptability in rapidly changing circumstances. On the other hand, the excessive discretion of CSRC may discourage investors' confidence in appealing for a judicial approach. Public law enforcement can impose penalties on corporate senior executives, potentially deterring misconduct. However, these penalties do not compensate shareholders, who are the victims of such misconduct. In contrast, aggrieved investors can seek compensation through private litigation. This gives shareholders more incentive to investigate directors' and senior executives' misconducts, such as misrepresentation and false disclosure, related party transactions, and market manipulation, and to scrutinize their compliance with their duties. Consequently, the director's behaviour would be subject to shareholder litigation, serving as a deterrent to the directors' disloyalty and negligence.

[910] Li Guoguang and Gu Wei, Zhengquan Shichang Xujia Chenshu Minshi Peichang Zhidu (The Civil Liability System For Securities Market Misrepresentations) (Falv Chubanshe 2003) 206.

[911] Securities Law (2019) Art.95.

[912] Special securities representative action (SSRA) is the representative action provided in 2009 Securities Law Art. 95.

[913] RP Peerenboom, China's Long March toward Rule of Law (Cambridge University Press 2002) 251.

4.6 Effectiveness of Independent Directors

Based on the principle of shareholder value maximization, the primary objective of the corporation is to improve the corporate performance for the benefit of shareholders.

The principle of shareholder value maximization suggests that the primary goal of a company is to enhance its performance for the benefit of its shareholders. The common approach to assessing the effectiveness of independent directors is to see whether they have improved corporate performance and the stock prices. Theoretically, an increased presence of independent directors should lead to more effective management oversight which can further prevent executives from avoiding responsibilities, misusing corporate resources, or unlawfully taking corporate assets. As a result, the corporation's income level would likely increase, leading to a rise in stock price. Consequently, agency problems caused by corporate insiders could be significantly mitigated, and the overall corporate value, which ultimately benefits shareholders as the residual claimants, could be greatly enhanced. Despite numerous empirical studies on the role of independent directors in China since their introduction, most have not provided compelling evidence that independent directors have significantly improved corporate performance.[914] This outcome mirrors findings from the U.S., where the roles and expectations of independent directors differ considerably between the two jurisdictions.

Liu et al. offer some of the first comprehensive and credible evidence on the influence of board independence on corporate performance among Chinese listed companies.[915] Their study finds that independent directors can enhance a firm's overall operating performance, with this positive impact being more pronounced in SOEs.[916] Specifically, independent directors in SOEs help improve firm performance by curbing tunnelling activities, such as insider self-dealing through intercorporate loans, and by boosting investment efficiency.[917] These findings imply that while independent directors are effective in mitigating managerial misconduct, they may be less successful in controlling the expropriation by dominant shareholders.

Wu and Li also find that increasing board independence is associated with a decrease in RPTs, financial statement fraud, illegal insider trading, and asset misappropriation, as well as an improvement in firm performance (measured by stock market returns and ROA).[918] However, the effectiveness of board independence varies across firms. Companies with higher levels of stock return volatility tend to experience a diminished positive impact from independent

[914] The Editorial Staff, 'Chinese Independent Directors: Transitions and Reconstructions' [2011] China Chief Financial Officer 26.

[915] Yu Liu and others, 'Board Independence and Firm Performance in China' (2015) 30 Journal of corporate Finance 223.

[916] Eg: Yuan George Shan, 'Can Internal Governance Mechanisms Prevent Asset Appropriation? Examination of Type I Tunneling in C Hina' (2013) 21 Corporate Governance: An International Review 225.

[917] Eg: ibid.

[918] Xiaohui Wu and Hui Li, 'Board Independence and the Quality of Board Monitoring: Evidence from China' (2015) 11 International Journal of Managerial Finance 308, 313,321–25.

directors. Both Liu et al. and Wu & Li observed that the cost of obtaining information plays a crucial role in the ability of independent directors to monitor effectively.[919] Independent directors are more effective in companies' access to and monitoring of information about the firm's operation is easier and less costly.[920]

The role of independent directors within the board hierarchy has a positive association with firm value, especially when these directors hold higher positions.[921] Independent directors in more senior roles are often more willing to oppose management, particularly on issues concerning financial reporting.[922] This suggests that higher-ranking independent directors are more effective in their oversight roles. Furthermore, companies with higher-ranked independent directors show less earnings management, suggesting improved financial reporting quality.[923] However, Ma and Khanna observe that independent directors are more inclined to challenge management in firms with poor performance, possibly as a response to declining performance.[924]

Hu et al. examined the interplay between internal governance mechanisms and firm performance within China's unique corporate environment, characterized by concentrated ownership and significant state control.[925] Their findings indicate that ownership concentration has a notably adverse effect on firm performance, whereas the presence of outside and independent directors on the board does not yield a significant positive impact on firm performance, which contradicts conventional expectations.[926] This suggests that the mere presence of independent directors may not be sufficient to counterbalance the power of controlling shareholders, highlighting the necessity for a combination of other supervisory mechanisms.[927]

The subsequent study of Li et al. investigated the impact of board independence on firm performance during the 2005 split share reform. They find that board independence has a positive impact on firm performance, and this impact is more pronounced as ownership concentration decreases.[928] This suggests that independent directors become more effective

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919 Wu and Li (n 289); Liu and others (n 286).

920 Liu and others (n 286) 233.

921 Jigao Zhu and others, 'Board Hierarchy, Independent Directors, and Firm Value: Evidence from China' (2016) 41 Journal of Corporate Finance 262.

922 ibid 274.

923 ibid 275.

924 Juan Ma and Tarun Khanna, 'Independent Directors' Dissent on Boards: Evidence from Listed Companies in China' (2016) 37 Strategic Management Journal 1547.

925 Helen Wei Hu, On Kit Tam and Monica Guo-Sze Tan, 'Internal Governance Mechanisms and Firm Performance in China' (2010) 27 Asia Pacific Journal of Management 727.

926 ibid.

927 ibid 743.

928 Ke Li and others, 'Board Independence, Ownership Concentration and Corporate Performance-Chinese Evidence' (2015) 41 International Review of Financial Analysis 162 <http://dx.doi.org/10.1016/j.irfa.2015.05.024>.

in firms where ownership is less concentrated, as there is likely more room for them to exert influence and protect the interests of minority shareholders.

Further research by Li et al. focused on the influence of board independence on firm performance during the 2005 split share reform. Their study found that board independence positively affects firm performance, and this effect is more pronounced when ownership concentration decreases.[929] This finding implies that independent directors tend to be more effective in firms where ownership is less concentrated, as they have greater capacity to exert influence and safeguard the interests of minority shareholders.

The impact of board independence on firm performance differs depending on the type of ownership.[930] Wu and Li's findings suggest that state-owned enterprises (SOEs) are less prone to violations and achieve better auditing results, indicating that state ownership may enhance the role of independent directors in bolstering corporate governance.[931] In contrast, Li et al. report that board independence has a positive, statistically, and economically significant effect on the performance of privately controlled firms, while the effect is not significant for state-controlled companies.[932] This suggests that the advantages of having independent directors are more pronounced in private firms, where government influence is minimal, and market pressures drive efficiency.[933]

Kakabadse et al. highlight that the independent director system in Chinese SOEs is generally weak, which is attributed to several factors, such as concentrated ownership, distinct business culture, intervention by controlling shareholders, and limited awareness of the benefits that non-executive directors can provide.[934] The unique cultural and institutional context in China poses additional challenges to the effectiveness of independent directors. The focus on preserving personal relationships and the prevalence of insider-dominated boards create an environment where independent directors find it challenging to exert influence or question decisions made by executives and controlling shareholders.[935]

In summary, the empirical studies on the effectiveness of independent directors on the corporate performance of Chinese listed companies do not offer a definitive conclusion. Independent directors in Chinese SOEs generally remain weak due to cultural factors, concentrated ownership, and external interference. The effectiveness of independent directors

[929] ibid.

[930] ibid 170.

[931] Wu and Li (n 289).

[932] Li and others (n 299).

[933] ibid 165.

[934] Hu, Tam and Tan (n 296). This study shows no correlation between independent directors and firm performance.

[935] Nada K Kakabadse, Hong Yang and Richard Sanders, 'The Effectiveness of Non-executive Directors in Chinese State-owned Enterprises' (2010) 48 Management Decision 1063, 1071.

varies across firms, with factors such as ownership type and the ability to access information playing significant roles.

4.6.2 Evaluation of China's Independent Director System

Chapter 2 elaborate the criteria for successful legal transplant from different theoretical perspective, however no consensus has been reached. The transplantation of independent directors into Chinese corporate governance serves as a critical case study in the broader discourse on the success of legal transplants. The complex interplay of cultural, legal, and institutional factors in China provides a nuanced backdrop against which the effectiveness of this transplant can be evaluated. Based on the claim of legal transplants, below will assess the degree to which the role of independent directors has been successfully integrated into the Chinese context.

First of all, Teubner and Nelken argue that the success of legal transplants is rarely binary, often existing on a spectrum between success and failure due to contextual variations.[936] The case of independent directors in China exemplifies this ambiguity. While the institutional framework for independent directors exists and continues to evolve, their practical effectiveness remains contested. Chinese independent directors face significant challenges, such as pressures from controlling shareholders and limitations in their capacity to influence corporate decisions. These obstacles suggest that while the transplant has taken root in the formal legal structure, its operational success is partial and context-dependent, aligning with Teubner and Nelken's observation that legal transplants cannot be easily classified as entirely successful or unsuccessful.

A legal transplant to be genuinely successful, it is not sufficient for the recipient jurisdiction to merely adopt the form or label of the legal institution; the substantive role and functionality of the transplant must also be effectively integrated into the local context.[937] This distinction between form and substance is particularly pertinent in the case of independent directors in China, where the superficial adoption of Western governance models often belies the deeper issues of practical implementation and efficacy.

On the surface, China has implemented a legal framework that closely mirrors international standards, requiring independent directors on the boards of listed companies. This move aligns with global trends in corporate governance, where independent directors are seen as a critical

[936] Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergencies' (1998) 61 The Modern Law Review 11.

[937] Edward M Wise, 'The Transplant of Legal Patterns' (1990) 38 American Journal of Comparative Law Supplement 1, 9–10 <https://heinonline.org/HOL/Page?handle=hein.journals/amcomps38&id=13&div=&collection=> accessed 6 July 2021; Yves Dezalay and Bryant Garth, 'The Import and Export of Law and Legal Institutions: International Strategies in National Palace Wars' in Johannes Feest David Nelken (ed), *Adapting Legal Cultures*, vol 241 (Oxford, Hart Publishing 2001).

mechanism for enhancing board oversight, protecting minority shareholders, and ensuring that management acts in the best interests of the company.

According to the traditional Watsonian approach, the presence of independent directors in Chinese corporate law would signify a successful transplant.[938] However, this perspective falls short of capturing the practical realities, as noted by Daniel's critique of superficial adoption. In China, while the legal mandate for independent directors exists, the effectiveness of their implementation is inconsistent. Many independent directors serve more as figureheads than as active monitors of corporate governance, a situation that mirrors Daniel's observation of the superficial adherence to governance norms in other jurisdictions. This disconnection between formal adoption and genuine implementation complicates the assessment of success of the transplantation in China.

In practice, the substantive role of independent directors in China often diverges from these intended functions. While the label of "independent director" suggests a role that involves impartial oversight and checks on management, the reality is often compromised by factors such as the dominance of controlling shareholders, conflicts of interest, and the limitations imposed by local business practices and regulatory environments. For instance, in many Chinese companies, independent directors are appointed through processes that are heavily influenced by controlling shareholders, who can effectively determine the composition of the board. This creates a scenario where independent directors, despite their title, may lack true independence and be unable to effectively challenge decisions that favour dominant shareholders over minority interests.

Mattei posits that a legal transplant's success should be measured by its ability to produce similar social outcomes as in its origin country.[939] In jurisdictions like the US, independent directors are expected to enhance corporate governance by protecting minority shareholders and improving oversight. In China, however, these social outcomes are not consistently realized. Studies indicate that independent directors in Chinese listed companies have limited impact on curbing the excesses of controlling shareholders and improving corporate performance. This divergence in outcomes suggests that the transplant has not fully achieved the intended social functions, reflecting a mismatch between the role's potential and its realized impact.

The misalignment of label vs substance or the form vs function can lead to what Berkowitz et al. describe as 'transplant effects,' where the legal institution fails to achieve its intended outcomes because it has not been adequately adapted to the specific needs and conditions of the receiving society.[940] In China, the concept of independent directors has struggled to adapt fully to the local corporate environment, characterized by concentrated ownership and strong

[938] Alan Watson, *Legal Transplants: An Approach to Comparative Law*, vol 22 (2nd edn, 1974).

[939] Ugo Mattei, 'Efficiency in Legal Transplants: An Essay in Comparative Law and Economics' (1994) 14 International Review of Law and economics 3.

[940] Daniel Berkowitz, Katharina Pistor and Jean Francois Richard, 'The Transplant Effect' (2003) 51 American Journal of Comparative Law 163.

state influence. Although regulatory adjustments, such as stricter independence requirements, have been made, these measures have not entirely bridged the gap between the imported governance model and the local business culture. The result is a system that superficially resembles its Western counterpart but lacks the functional adaptation necessary for full effectiveness, illustrating a partial transplant success with significant room for further adaptation.

Larsson-Olaison’s staircase metaphor provides a more nuanced framework, recognizing that legal transplants may achieve varying degrees of success over time. The role of independent directors in China has achieved some level of institutionalization, representing a step up from mere formal adoption. However, it has not reached the higher levels of efficacy seen in jurisdictions where the role is more established and operationally effective. The staircase metaphor acknowledges that the transplant is not an outright failure but resides at an intermediate level of success, with potential for progression as further legal and institutional refinements are made.

In sum, the effectiveness of Chinese independent directors as a legal transplant can be assessed as a mixed and evolving success. While the formal structure and some degree of adaptation exist, substantial barriers—such as the influence of controlling shareholders, cultural factors, and limited practical independence—hinder full integration and effectiveness. By applying a multi-faceted evaluation framework, it becomes evident that the transplant has achieved partial success, occupying a lower step on Larsson-Olaison’s staircase, with potential for further progress contingent on continued reform and deeper adaptation to China’s unique corporate environment.

4.7 Barriers to Independent Directors in China

Given the lack of solid evidence provided to show the effectiveness of China’s independent directors, continuous legal and institutional improvement has been carried out to improve this institution. This section presents the main criticisms and barriers facing the independent director system within Chinese corporate governance.

4.7.1 Controlling Shareholder and Director’s Independence

The fundamental criticism of China’s independent director system is the difficulty in guaranteeing true “independence”. The previous Independent Director Guideline only provides the disqualification for independence; however, these negative standards have been criticised for not guaranteeing the independence of directors since they do not cover all situations of dependence. There are many ways to circumvent the regulation's requirement, for example, individuals who may not be independent but do not fall within the scope of the provided disqualification.

The latest Independent Director Measures impose stricter requirements on independence and qualifications compared with the Independent Director Guidelines. For the standard of independence, independent directors must be independent of the “actual controller” and must not have any “direct or indirect conflicts of interest” with the listed company, its major shareholders, or the actual controller.[941] The rules explicitly prohibit directors who also serve as senior executives from being members of the audit committee.[942] Furthermore, these measures mandate regular evaluations and self-assessments of a director’s independence, with findings disclosed in the company’s annual report.[943] The scope for disqualification is refined, adding several situations where the individual is prohibited from serving as an independent director: for individuals who are closely associated with the company’s controlling shareholders, and those with significant business dealings with the company, service providers, and those with recent conflicts affecting independence. Additionally, independent directors must have a good moral character and no significant record of dishonesty.

To increase the protection of investors, the Independent Director Measures introduces that investor protection institutions may publicly request shareholders to authorise them to nominate independent directors on their behalf;[944] the election of two or more independent directors requires the implementation of a cumulative voting system, with the voting results of minority shareholders to be counted separately and disclosed.[945]

Although current legal requirements have heightened the independence requirement and enhanced protections of minority shareholders, these changes fall short of resolving the fundamental issue based on the existence of controlling shareholders. Independent directors are still elected by the majority at the shareholders’ general meeting. The primary voting rule remains unchanged, favouring majority control at shareholders’ meetings.

Furthermore, independence in the abstract is insufficient to eliminate all potential influences, especially of the controlling shareholders, over the independent directors’ decision-making. Another critical flaw of China’s independent director system is its potential misuse to approve proposals of the controlling shareholders. Essentially, the approval of independent directors can be used to legitimise RPTs, protecting controlling shareholders from scrutiny and legal liability. Ma and Khanna show that, from August 2001 to June 2010, the annual rate of dissenting opinions was between 2.8 percent and 0.0 percent, accounting for a tiny

941 China Securities Regulatory Commission, ‘Administrative Measures for Independent Directors of Listed Companies’ (n 223) Art.6(2)-(5).

942 ibid Art.5.

943 ibid Art.8.

944 ibid Art.9.

945 ibid Art.12.

proportion.[946] The study suggests that independent directors in China act as rubber stamps and are misused as a tool to legitimise decisions made by controlling shareholders.[947]

4.7.2 State Control

Beyond the challenges posed by controlling shareholders, state control presents another significant barrier to the effectiveness of independent directors. The reform of SOEs and the strengthening of Party-building in recent years have indicated that the state has not refrained from loosening its control over SOEs but intensified it in various forms. While the Independent Director Measures broaden the scope of the directors' independence to include relationships with controlling shareholders, actual controllers of affiliated companies; they simultaneously exempt affiliated companies that are managed by the same state-owned assets management agency and those not formally recognised as affiliated with the listed company according to relevant regulations.[948] Besides, the Party building requires the referencing of the CCP constitution in the corporate charter, the ex-ante discussion of the Party committee before the board of directors, cross-appointment and the Party's supervision of corporate personnel. The state enhances its control through only the legal status as the shareholder, but also involves administrative and ideological control.[949] In this case, even though independent directors are pro forma independent, they struggle to be de facto independent from the state/government shareholder or the Party.

4.7.3 Access to Information and Expertise

A common concern of the independent director system is that independent directors lack the specific business expertise relevant to the corporation they serve and restricted information available to them. Corporate management typically controls the flow of information, sharing only what they choose to share, which often leaves the board unaware of corporate issues until it's too late. The combination of inside directors controlling the agenda, along with the limited time and expertise of independent directors, creates an environment that is highly unfavourable for open discussion and effective board decision-making.[950]

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[946] Ma and Khanna (n 295) 1552. Also see: Wei Jiang, Hualin Wan and Shan Zhao, 'Reputation Concerns of Independent Directors: Evidence from Individual Director Voting' (2016) 29 The Review of Financial Studies 655 <http://www.jstor.org/stable/43866022>.

[947] Sang Yop Kang, 'The Independent Director System in China: Weaknesses, Dilemmas, and Potential Silver Linings' (2016) 9 Tsinghua China L. Rev. 151, 175.

[948] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.6.

[949] Liang Zhang, Yeyao Ren and Jianzu Wu, 'Communist Ideological Imprinting and the Transformation of State-owned Enterprises' (2023) 34 British Journal of Management 1062.

[950] Betty M Ho, 'Restructuring the Boards of Directors of Public Companies in Hong Kong: Barking up the Wrong Tree' (1997) 1 Sing. J. Int'l & Comp. L. 507, 512.

In China, a large proportion of independent directors are academics, such as professors and scholars from universities. This presents two primary concerns. First, these academics are already occupied with full-time positions, leaving them with insufficient time to dedicate to their directorial duties. Previous independent director rules provided that an independent director can serve up to five domestic and overseas listed companies. The Independent Director Measures revised the provision to a maximum of three domestic listed companies,[951] aiming to ensure that independent directors have the necessary time and energy to fulfil their obligations effectively.

The second issue is they generally lack the practical business knowledge and experience. While these academics might be experts in their respective fields, many lack familiarity with the operational dynamics of listed companies and may not fully grasp the responsibilities of a directorship. Even if an independent director is highly successful in their own profession, it remains questionable whether they can effectively challenge management in a business context that is outside their expertise. When auditors who have full access to corporate records are struggling to detect fraud, it seems overly optimistic to expect independent directors to uncover dishonesty in the carefully curated documents presented to them during board meetings.[952]

4.7.4 Lack of Incentives

The more independent a director is, the fewer incentives he must prioritize maximizing shareholder interests; conversely, more incentives lead to less independence.[953] It is widely accepted that independent directors should not rely on the company for the majority of their income.[954]

According to the Company Law, the compensation for all directors is determined by the shareholders' general meeting.[955] In China, the remuneration for independent directors is not tied to their personal performance or the company's overall performance; they receive a fixed compensation that is low compared with Western standards.[956] The disparity in independent director allowances is significant. In 2020, the highest pre-tax allowance for independent directors in A-share companies was RMB 990,000($135,630) for Hancheng Li of Minsheng

[951] China Securities Regulatory Commission, 'Administrative Measures for Independent Directors of Listed Companies' (n 223) Art.8.

[952] Sibao Shen and Jing Jia, 'Will the Independent Director Institution Work in China' (2005) 27 Loy. LA Int'l & Comp. L. Rev. 223, 243.

[953] Ho (n 321) 520.

[954] Minkang Gu, 'Will an Independent Director Institution Perform Better than a Supervisor? Comments on the Newly Created Independent Director System in the People's Republic of China' (2003) 6 J. Chinese & Comp. L. 59.

[955] 2023 Company Law Art.112, 59 (1).

[956] Lay-Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy' (2007) 7 Journal of Corporate Law Studies 143, 158 <https://doi.org/10.1080/14735970.2007.11421512>.

Bank (stock code:600016).[957] However, 73.34 per cent of independent directors received an annual allowance of less than RMB 100,000 ($13,700), with 20.66 per cent earning under RMB 50,000 ($6,850) per year.[958] Candidates for independent director positions weigh both economic incentives and professional ethics when deciding whether to take on the role and how they will perform their duties. If the compensation is too low, it fails to provide sufficient economic motivation. Conversely, excessively high compensation can undermine their independence.

Compensation is closely linked to liability. Directors' liability could encourage independent directors to take their roles seriously, rather than merely serving as figureheads. However, if the liability is too burdensome, independent directors may become overly cautious in their decision-making, potentially rejecting all conflict-of-interest transactions to minimize risk exposure. This could deter qualified individuals from seeking independent director roles, making it harder to find suitable candidates. Consequently, companies may have to offer higher compensation to attract capable directors. For example, in the Kangmei securities fraud case, five independent directors were held jointly liable for the compensation ranging from 5 per cent to 10 percent, amounting to as much as 123 million RMB to 246 million RMB ($17.22 million to $34.44 million). This is in stark contrast to the relatively modest allowance they received during their tenure at Kangmei, with the highest being around RMB 100,000 ($14,000) and the lowest only RMB 71,000 ($9,940) per year. Following the judgement on 12th November 2021, there was a significant wave of resignations among independent directors in the A-share stock market. According to the Wind database, 65 listed companies experienced independent director resignations within 30 days, averaging two companies per day.

Without financial benefits, the primary motivation for independent directors to act is to build their reputation as diligent monitors. With a well-established reputation-based motivation framework, an independent director acts with genuine independence and objectivity on the board; their reputation is maintained or even enhanced, leading to increased market value and more opportunities.[959] As a result, independent directors are more likely to perform their duties impartially and professionally as expected.[960] However, this type of mechanism is entirely absent in China.

Concluding Remarks

This chapter explores the evolution, structure, and effectiveness of China's corporate governance system, with particular emphasis on the introduction and development of

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[957] Jian Zeng, 'A-Share Independent Director Allowance Comparison: The Highest Is 990,000 Yuan per Year, and 100,000 Yuan or Less Is the Mainstream' *National Business Daily* (23 February 2022).

[958] Li Jia, 'The Remuneration of Independent Directors of Listed Home Appliance Companies Is Generally Not High, with More than 40% Earning Less than 50,000 Yuan per Year' *Securities Daily* (7 December 2021).

[959] Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 The Journal of Law & Economics 301, 315 <http://www.jstor.org/stable/725104> accessed 2 November 2017.

[960] Fama and Jensen (n 330).

independent directors as a legal transplant from Anglo-American jurisdictions. First, it traces the historical development of Chinese corporate governance from the early 20th century through successive stages of SOE reform, the transition to a market-oriented economy, and China's engagement with global regulatory standards. The establishment of independent directors, particularly since 2001, reflects China's formal commitment to aligning with international governance practices. However, a closer examination reveals that this transplant remains functionally weak and only partially effective within China's unique political-economic context.

The chapter shows that, although the legal framework for independent directors has been significantly revised—especially with the 2023 reforms—their practical independence and capacity for meaningful oversight remain severely constrained. The entrenched dominance of controlling shareholders, especially the state in SOEs, combined with institutional barriers such as weak enforcement, limited incentives, inadequate access to information, and low investor litigation capacity, undermines the intended functions of independent directors. Moreover, the persistent influence of the Party-state through both formal and informal mechanisms—such as Party committee involvement in decision-making and personnel management—blurs the separation of powers and reduces board autonomy.

Chapter 5 Political Economy and the Challenges of Transplanting the Independent Director System in China

Introduction

This chapter synthesizes insights from the preceding analyses: Chapter 1 laid the theoretical groundwork, outlining fundamental corporate governance principles, particularly emphasizing the critical role independent directors play in addressing agency conflicts and protecting minority shareholders. Chapter 2 introduced essential criteria from legal transplant theory—such as transferability, local adaptation, social demand, and the knowledge of the rule—providing a theoretical lens through which to understand China's experiences. Chapter 3 provided comparative institutional analyses from jurisdictions such as the U.S., Germany, Japan, and Singapore, identifying key institutional preconditions for effective independent director oversight. Chapter 4 then empirically examined China's own institutional and regulatory environment, illustrating clearly how specific constraints undermine independent director effectiveness in practice. Building directly on these preceding discussions, this chapter employs political economy analysis to address why the ineffective independent director system persists in China, demonstrating that its continued existence is a rational political strategy rather than regulatory oversight or misunderstanding

Building upon these comparative insights, this chapter focuses specifically on China’s unique political economy, examining why the transplanted independent director system has persisted despite its clear limitations. Chapter 4 examines the effectiveness of China’s independent directors and explores various factors accounting for it. Indeed, the overwhelming majority of current studies on China’s independent directors focus on these two issues with thousands of articles published as a result. While acknowledging the value of this body of work, it is notable that much of the research operates on a foundational assumption: the perceived ineffectiveness of independent directors in China primarily results from flaws in the institutional design of the system during its adaptation. For example, the process by which independent directors are selected often allows controlling shareholders, including state entities in the context of SOEs, to effectively dictate these appointments. The prevailing view is that, if such procedural and structural deficiencies were adequately addressed, independent directors could become a far more effective and valuable governance tool in the Chinese corporate environment.

Only a few researchers have attempted for further inquiry, posing the question of why these flawed rules were implemented in the first place. Professor Donald Clarke, in his frequently cited paper “The Independent Director in Chinese Corporate Governance,”[961] reviewed Chinese local governments’ initiatives involving independent directors in early 2000s and found it difficult to understand why a system seemingly designed to create opposition would be

[961] Donald C Clarke, ‘The Independent Director in Chinese Corporate Governance’ (2006) 31 Delaware Journal of Corporate Law 125.

welcome.[962] He suggested a possible explanation for this is ‘they [regional regulations] seem grounded more in a notion in the minds of the drafters that independent directors are a good thing and therefore should be recommended or required...the drafters simply have not thought much about the issue.’[963] Professor Xi Chao offered a comparable observation, contending that the adoption of the independent director system in China was somewhat of an “accidental” decision.[964] He suggested that this system was championed by certain influential figures within the CSRC who had been educated in the U.S. and had professional experience there, for example: the then Vice-Chairman Gao Xiqing and Vice-Chairwoman Laura Cha.[965] These individuals, according to Xi, were significantly influenced by globalization and the corporate law ideologies prevalent in the U.S., which shaped their advocacy for implementing this governance model in China.

As discussed in Chapter 2, the understanding and familiarity with the transplanted legal rule can significantly influence the success of legal transplantation. In the early 2000s, studies on Chinese corporate governance were just taking off, and there was a considerable amount of confusion and misunderstanding surrounding corporate governance theories and practices among Chinese scholars, practitioners, and policymakers.[966] For example, while the separation of ownership and control is typically viewed in the West as the fundamental cause of the agency problem, in China, it was often seen by many as a potential solution to the SOEs’ problems.[967] Thus, Clarke and Xi’s accusation that regulators’ lacking of understanding of independent directors is very likely to be true and at least partly account for the faulty designed regulations. However, the knowledge explanation becomes less persuasive as time gone by. In the past two decades, Chinese corporate governance in general, independent directors in particular, has attracted a great deal of interests both within and outside China. It has been thoroughly examined, tested and discussed in numerous studies, including the studies conducted by the CSRC and stock exchanges. The problem of independent directors has made widely known to the relevant parties, certainly to the regulator. Nevertheless, the regulator has made little use of the knowledge and shown no willingness to redress the fundamental issues.

The challenges surrounding independent directors have been well-publicized among all relevant stakeholders, including regulators. Despite this, regulators have largely ignored this knowledge and shown little intention to address the core issues. The latest ‘provision’ only addresses minor technical matters, such as the tenure of independent directors and the maximum number of boards they can serve on. The continued presence of ineffective rules and

[962] Given virtually all the regional regulations apply to enterprises in which the major shareholder is the local government

[963] Clarke, ‘The Independent Director in Chinese Corporate Governance’ (n 1) 180.

[964] Chao Xi, ‘In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China’ (2006) 22 Conn. J. Int’l L. 1, 37.

[965] ibid.

[966] See: Donald C Clarke, ‘Corporate Governance in China: An Overview’ (2003) 14 SSRN Electronic Journal 494 <https://papers.ssrn.com/abstract=424885> accessed 20 September 2021.

[967] ibid 498.

the regulators' reluctance to implement necessary reforms cannot simply be attributed to a lack of knowledge or misunderstanding; it is not merely a coincidental occurrence. This persistence demands an alternative explanation. As illustrated by the latest Independent Director Measures, it is only willing to touch the less important, technical issues, such as the independent directors' tenure, the maximum number of companies that independent directors can serve on. The persistence of the ineffectual rules and the regulators' reluctance to make the necessary changes cannot be explained by the lacking of knowledge or misunderstanding, it is also not 'accidental,' it calls for an alternative explanation.

This chapter will re-evaluate the transplant of independent directors by examining it through the lens of political economy. In doing so, the analysis draws on the insights of Kahn-Freund, whose argument is particularly helpful. As outlined in Chapter 2, Kahn-Freund argues that transferability is crucial to assessing the potential success of a legal transplant. The ease with which a rule can be transferred is largely determined by the extent to which it is interwoven with the power dynamics of its original legal environment.[968] It is often assumed that company law and commercial law are more readily transferable, as they are deeply intertwined with economic interests, making them less dependent on specific contextual factors.[969] Using Kahn-Freund's metaphorical framework, company and commercial law are situated closer to the 'mechanical' end of the spectrum. Company law includes many regulations that govern corporate matters such as company registration and the issuance of shares. These rules are largely unrelated to the allocation of political power, meaning that "there is less likelihood of them being rejected when adopted by a host jurisdiction with a completely different context from that of the originating jurisdiction."[970]

However, not all rules within company law are politically neutral, especially those concerning corporate governance in public companies. As noted by Mark Roe, corporate governance lies at the heart of the most important issue of society, "it affects the creation of wealth and its distribution into different pockets…it influences social mobility, stability, and fluidity. Corporate governance structures are fundamentally the result of political decisions."[971] Since corporate governance is deeply interwoven with the political context, the rules governing corporate governance thus cannot be easily transferred between countries with different political system.

As an essential part of corporate governance system, successful transplant of independent directors between different political system cannot be easy. It is even more difficult to transfer between the U.S. and China, given the former is a capitalist democracy while the latter is a socialist party-state. Kahn-Freund described the gulf between the communist and the non-communist world just like "the wall which separates East and West Berlin."[972] The

[968] Otto Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 The Modern Law Review 1, 13.

[969] Roger Cotterrell, 'Is There a Logic of Legal Transplants' (2001) 71 Adapting legal cultures 82.

[970] Ibid

[971] Mark J Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1996) 366.

[972] Kahn-Freund (n 8) 11.

transplantation of legal ideas and institutions from one political context to another is hindered by several key differences, including the varying roles of pressure groups, the structure of lawmaking processes, the distribution of decision-making authority, and the nature of the relationship between autonomous social entities and the state's formal machinery. These fundamental disparities create significant barriers to the successful transfer of legal concepts between distinct political systems.[973] The political distinction between the communist/socialist and non-communist worlds, which was of primary importance in Kahn-Freund's analysis at the time of his writing, has largely been overlooked in the literature since the collapse of the former socialist bloc. Meanwhile, China's reforms over the past four decades have significantly transformed its economy and, to some extent, its society. However, this transformation often obscures the reality that China's political system has undergone little substantive change. At its core, China remains a socialist state governed by the CCP. Revisiting Kahn-Freund's argument would be highly valuable in helping us better understand the complexities involved in transplanting the independent director system across such distinct political environments.

5.1 The Case of U.S.

The history of independent director system in the U.S. suggests that prior to 2002, neither federal nor state laws had attempted to specify the qualifications for or dictate the composition of board of directors in publicly traded companies. Legislative involvement emerged with the SOA of 2002, enacted in response to the high-profile collapses of companies like Enron and WorldCom, as well as a surge in significant financial restatements. Congress gave the SEC permission to forbid exchanges from listing securities of issuers without completely independent audit committees under the SOA of 2002,[974] and following this, the SEC established Rule 10A-3 in 2003.[975] Additionally, both the NYSE and NASDAQ amended their listing requirements to mandate that publicly listed companies maintain a board with a majority of independent directors.[976] Since 2004, NYSE and NASDAQ have also stipulated that compensation and nomination decisions must be made by independent directors or committees.[977]

Dodd-Frank Act of 2010, which was enacted as a legislative response to the 2008 financial crisis, initiated the further effort to strengthen the oversight role of independent directors, expanding the mandate by directing the SEC to prohibit exchanges from listing securities of companies without fully independent compensation committees.[978] By the time the SEC

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[973] ibid.

[974] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010).

[975] See 17 C.F.R. § 240.10A-3 (2013).

[976] For detailed listing rules of the NYSE and NASDAQ, please see Table 3-1

[977] See Order Approving NASD and NYSE Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154, 64,176–78 (Nov. 4, 2003).

[978] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010). Codified at 15 U.S.C. § 78j-3 (2012)

complied in June 2012,[979] the exchanges had been requiring compensation to be approved by independent decision-makers for the better part of a decade.[980]

While the regulatory mandates on director independence may appear restrictive, a closer examination reveals that they largely formalized practices already widely adopted by the time of their implementation. By 2001, nearly all public companies had fully independent audit committees and the vast majority had independent board majorities,[981] and nearly all had fully independent audit committees.[982] Regarding Dodd-Frank's mandate that businesses establish a completely independent compensation committee, this has been standard procedure since the middle of the 1990s.[983] Furthermore, by the early 2010s, a large number of businesses had voluntarily established so-called "super-majority boards" with just one surviving inside director who was not independent (typically the CEO), without being required to do so by law, regulations, or listing rules. By 2013, around 60 percent of public companies had these super-majority boards, and approximately 85 percent of all directors were independent.[984] Therefore, the prevalence of independent directors in the U.S. did not primarily arise as a response to regulatory requirements; rather, it was largely driven by business practices shaped by the influence of key interest groups, specifically institutional investors and corporate managers.

5.1.1 Managerial Endorsement

As early as 1978, managerial elites, though with a few rounds of back and forth, began expressing their support for board independence.[985] The Business Roundtable, a prominent organization representing the interests of corporate executives, declared its endorsement of “the tendency of U.S. corporations to move to a board structure based on a majority of outside

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[979] See 17 C.F.R. § 240.10C-1.

[980] The NYSE rules were first approved in 2002. NYSE, Inc., Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, August 1, 2002 (2002), http://www.nyse.com/pdfs/corp_gov_pro_b.pdf; Urska Velikonja, ‘The Political Economy of Board Independence’ (2013) 92 North Carolina Law Review 855 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2352109> accessed 16 August 2018.

[981] Lucian Arye Bebchuk, John C Coates IV and Guhan Subramanian, ‘The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy’ (2002) 54 Stanford Law Review, pp. 887-951, 2002, 887, 896 <https://papers.ssrn.com/abstract=304388> accessed 5 September 2020.

[982] The NYSE has required that the audit committee be fully independent since 1977, though the definition of independence was more relaxed at the time and did not include bankers, underwriters, or others with customary relationships with the firm. Jeffrey N Gordon, ‘The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices’ (2010) 59 Stanford Law Review 1479–80 <https://heinonline.org/HOL/Page?handle=hein.journals/stflr59&id=1477&div=46&collection=journals> accessed 9 April 2018.

[983] ibid 1480.

[984] Velikonja (n 20).

[985] ‘The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation—Statement of the Business Roundtable’ (1978) 33 The Business Lawyer 2083 <https://www.jstor.org/stable/40685901>.

directors."[986] As discussed in earlier chapter, the primary role of independent directors in U.S. public companies is to oversee management on behalf of dispersed shareholders. Hence, it raises the question: why corporate managers, whose authority independent directors are intended to restrain, come to endorse this measure—even in the absence of legal requirements—rather than oppose it? There are a few answers to this question.

5.1.1.1 Signalling

It is suggested that the independent directors can act as a bonding device. By adopting independent directors, management signals to potential investors that it is willing to be monitored effectively, which in turn, reduces the firm's cost of capital, makes the company more competitive with other firms and thus more likely to survive.[987]

One good reason of appointing independent directors is signaling function. For instance, the independent directors serve as a commitment mechanism role on behalf of management by providing the market with a signal, as well as the potential investors, that the management might accept active monitoring. This willingness to accept external monitoring is a signal that management is confident of their operations and also transparent and accountable. Firms voluntarily embrace a governance structure that includes independent directors; this shows a commitment to good corporate governance practices, improving their reputation and confidence among investors.

This signaling effect can have several positive impacts on public firms. It may reduce the firm's cost of capital because generally, investors are more willing to invest in firms perceived as bearing lower risks from the governance perspective. If investors happen to feel that management is under effective oversight, they are likely to perceive the company as less risky and, therefore, would require a lower return from equity. Besides, the presence of independent directors can attract more institutional investors who tend to invest in companies with good governance structures.

It also signals a commitment to good governance that can make the firm more competitive in its industry. Companies that possess strong, independent boards tend to be more capable of dealing with intricate business environments, managing risks, and making strategic decisions favoring long-term value. A company perceived as being markedly stable and reliable stands out from its competition and thereby possesses a competitive advantage. Lastly, this strategic initiative may lead to the long-term survival of the company in that a closely monitored

[986] Mariana Pargendler, 'The Corporate Governance Obsession' (2016) 42 Journal of Corporation Law 361, 376 <https://heinonline.org/HOL/Page?handle=hein.journals/jcorl42&id=377&div=16&collection=journals> accessed 18 February 2020.

[987] Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard university press 1996); Donald C Clarke, 'Three Concepts of the Independent Director' (2007) 32 Delaware Journal of Corporate Law 73, 106 <https://heinonline.org/HOL/Page?handle=hein.journals/decor32&id=79&div=8&collection=journals>.

management team is less likely to behave in a manner that could jeopardize the future of the firm.

What management is essentially doing by establishing independent directors is sending a very strong signal to the marketplace that it believes in oversight and accountability, which may ultimately convert into real financial and strategic advantages for the firm.

5.1.1.2 Shield from Liability

While the signaling benefits of independent directors can positively impact the company, a more compelling reason for management's endorsement lies in the legal protection they offer. Discussions surrounding independent boards often focus primarily on listed companies, particularly in the United States, where more than half of all publicly traded companies, including 64 percent of the Fortune 500, are incorporated in Delaware and thus governed by the Delaware General Corporation Law (DGCL). Although the DGCL does not mandate the inclusion of independent directors,[988] it incentivizes boards to enhance their independence by protecting decisions made by disinterested directors from judicial scrutiny.[989] When disinterested directors approve a self-dealing transaction, it shields the firm from subsequent legal challenges.[990]

Moreover, independent and disinterested directors play a crucial role in shareholder derivative litigation. Shareholders cannot initiate lawsuits against directors or officers for breaches of duty on behalf of the company without first requesting the board to pursue the lawsuit.[991] The case of Zapata v. Maldonado established that a subcommittee of the board has the authority to dismiss shareholder derivative litigation, even if the demand on the board as a whole was considered futile, as long as it can demonstrate independence, good faith, and reasonableness.[992] Delaware courts defer to the judgment of an outside director in 'freeze-outs', when a controlling shareholder of a public company buys out minority shareholders,[993] as long as the procedure they followed appears appropriate.[994]

Management's endorsement of a monitoring board and independent directors in the 1970s appeared to be a strategic concession aimed at preventing further extensive reforms, following

[988] See § 141(b)

[989] Norman Veasey, the former chief justice of the Delaware Supreme Court, recently warned: I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly presented complaint. See C Elson, 'What's Wrong with Executive Compensatoin' (2003) 81 Harvard Business Review 68, 68.

[990] See Delaware General Corporation Law s 144(a)(1).

[991] *McKee v Rogers, 156 A 191, 193 (Del Ch 1931)*.

[992] *Zapata Corp v Maldonado* 430 A.2d 779 (Del. 1981), 785–86.

[993] Guhan Subramanian, 'Fixing Freezeouts' (2005) 115 Yale Law Journal 2, 5.

[994] See *Weinberger v UOP, Inc - A 2d* (1983) 457 701, 709–711.

the collapse of Penn Central and questionable payments, such as national chartering.[995] Indeed, in response to the evolving political landscape of the Reagan era, which effectively eradicated the possibility of federal regulation, the Business Roundtable withdrew from its previous stances and vehemently opposed the American Law Institute's (ALI) proposal to support a majority of independent directors on corporate boards. Nevertheless, a decade later, the Business Roundtable once again embraced independent directors, this time actively promoting the benefits of a monitoring board.[996]

The corporate landscape in the United States was significantly transformed by a series of aggressive takeovers during the 1980s, commonly referred to as the 'Deal Decade.' During the period between 1982 and 1989, around 23 percent of the largest U.S. public corporations were targeted by hostile takeovers, while 57 percent received some form of takeover offer.[997] The courts in Delaware, where the majority of takeover-related court proceedings occurred, have adopted the practice of examining solely the decision-making process within the target company, without looking into the actual content of the transaction. Therefore, a well-structured board that adhered to the model and demonstrated a formally independence in its decision-making was permitted to decline a hostile offer that would benefit the shareholders of the target company without any concerns towards legal responsibility.[998] In such circumstances, managers sought the guidance of the monitoring board and independent directors as the most effective means of safeguarding against the hostile takeover movement,[999] notwithstanding the infringement on managerial independence.

5.1.2 Institutional Investors

The promotion of independent directors by management is more likely to be characterized by passivity, namely, unopposed endorsement. The primary driving force is institutional investors.[1000] For many years, institutional investors have held overwhelming ownership of the largest American public companies. As of the early 1990s, institutional investors owned 55 percent of the shares in the top one hundred publicly traded companies.[1001] In 2013,

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[995] Gordon (n 22) 1520.Gordon, the rise of independent director, at 1520

[996] ibid 1521.

[997] Mark L Mitchell and J Harold Mulherin, 'The Impact of Industry Shocks on Takeover and Restructuring Activity' [1996] Journal of Financial Economics 193, 199.

[998] See Jeffrey N Gordon, 'Corporations, Markets, and Courts' (1991) 91 Columbia Law Review 1931, 1931; Alan R Palmiter, 'Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence' (1988) 67 Texas Law Review 1351, 1351.

[999] Gordon (n 22) 1522.

[1000] Velikonja (n 20) 874.

[1001] See Carolyn K Brancato and Patrick A Gaughan, 'Nstitutional Investors Capital Markets: 1991 Update' [1991] Columbia Law School Institutional Investor Project. Table 10. Cited by Franklin R Edwards, *Financial Markets in Transition, Or, The Decline of Commercial Banking* (Columbia Business School, Columbia University 1993). (reporting that institutions held 54.8% of 100 largest U.S. companies) households, which include hedge funds, held 38 percent of corporate equities directly.[1002] Federal and state governments individually owned less than 0.6 percent, while institutional investors such as mutual funds, private and public pension funds, life insurance companies, and exchange-traded funds collectively owned around half of all outstanding corporate stock.[1003]

It might seem odd to ask why institutional investors continue to promote the development of independent directors, given the latter by design, is to serve their interests. However, when the emphasis on independent directors become excessive and the further increase in independence can no longer be justified, the question requires some serious consideration. This is precisely the situation unfolding in U.S. corporate governance.

By late 1980s, most public companies in the US have maintained a majority independent boards (i.e. more than half of the board members are independent),[1004] but the trend toward increased independence did not slow down; rather, it accelerated and gained momentum after 2000. As of 2013, 60 percent of the companies listed in the S&P 500 had boards that were super-majority independent, save for one inside director who was not independent, typically the CEO.[1005] The prevalence of super-majority independent board is hard to understand, especially given the lack of empirical evidence supporting their effectiveness; in fact, some studies suggest that such boards may actually perform worse.[1006] This raises the question: Why are institutional investors imposing a mechanism on themselves that may be potentially detrimental to their own interests?

Velikonja argued that director independence is 'a rational political strategy for institutional investors and managers to trade margin decreases in corporate performance for the reduced risk of costlier substantive regulation'.[1007] Shareholders and managers are undoubtedly two major interest groups in corporate governance, particularly in Delaware.[1008] Given Delaware's heavy reliance on franchise taxes, which constitute about 20 percent of the state's revenue,

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[1002] See Marcel Kahan and Edward Rock, 'Embattled CEOs' (2009) 88 Texas Law Review 997 <https://heinonline.org/HOL/Page?handle=hein.journals/tlr88&id=997&div=37&collection=journals> accessed 5 March 2020. (explaining that hedge funds do not have to disclose their positions and thus are counted in the residual category of "households").

[1003] Velikonja (n 20) 874.

[1004] Gordon (n 22) 1474.

[1005] Velikonja (n 20).

[1006] See: Sanjai Bhagat and Bernard Black, 'The Uncertain Relationship between Board Composition and Firm Performance' [1999] The Business Lawyer 921.

Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 BUS. LAW. 921, 924, 933 (1999)

[1007] Velikonja (n 20). See similar Pargendler (n 26).

[1008] The franchise tax doesn't just motivate Delaware in drawing the line between managers and shareholders, but also keeps out the other players since managers and shareholders, if united, can deny Delaware that franchise tax bonanza. No one in Delaware has that power.Mark J Roe, 'Delaware's Politics' (2004) 118 Harvard Law Review 2491, 2500.

DGCL primarily and directly responds to the interests of managers and investors.[1009] 'The general polity is not usually involved in Delaware, even though the corporation affects parties beyond managers and investors'.[1010] However, at federal level, Congress in particular, 'the range of interests with the clout to influence policy widens beyond just investors and managers'.[1011] When significant corporate misconduct or poor national economic performance triggers federal regulation, for instance, as seen in the 1930s when the Great Depression led to the Securities Act of 1933, or in 2008 when the financial crisis resulted in the passage of the Dodd-Frank Act of 2010, some of these wider interests would want to use corporate law to implement their public-regarding visions for the corporation. Their agenda would often be contrary to the interests of managers and shareholders.

Take Foreign Corrupt Practices Act (FCPA) of 1977 for instance, which was a response to the 'questionable payments' scandals in 1970s. Corporate entities had little incentive to curtail American corporate bribery of foreign government officials, as such practices often generated significant profits, but they were nonetheless compelled to comply with the Act, which was passed for ethical or foreign policy reasons. Apparently, corporate players had little reason to reduce American corporate bribery of foreign government officials which often generating enormous profitable business, but they had to comply with the Act that passed for moral or foreign policy reasons. In order to avert undesirable federal regulation like the FCPA, investors need a strategy that either diminishes the perceived necessity for reform or serves as a substitute for more burdensome federal laws.[1012] For this strategy to be effective, "it must appeal to Congress and interest groups that favor reform…at the same time, the regulation-avoidance strategy must also preserve the ability of corporate managers and investors to continue sharing the rents generated by the firm to the exclusion of others."

Independent boards as a regulation-avoidance strategy meets all these conditions. On one hand, independent directors appeal to Congress and various interest groups for several reasons: their perceived normative value, the ambiguity and adaptability of their role, the prevalence of independent bodies in institutional design, and the relative cost-effectiveness of

[1009] Ibid. Although the interests of managers might conflict with that of investors, with an increased use of stock-based pay, they are often aligned. This is so where they face a threat of federal regulation, which can be costly for both groups.

[1010] Roe (n 48) 2500.Roe further explained that "Delaware has built no regulatory agencies that regularize public oriented inputs. Its mode of regulation ex post fiduciary duties, not constant oversight reflects the desires of Delaware's key interest groups. The structure of Delaware corporate lawmaking doesn't bring in other groups. Bar advisory committees do propel the Delaware legislature, but the Delaware bar typically represents managers and investors (as well as themselves). Judges need a case or controversy in order to act, and it's the corporate players who have standing to sue, not the broader public". ibid 2501.

[1011] The players in Washington are not limited to the main corporate constituents, namely, employees, creditors, consumers, suppliers. They can include for instance, public-regarding policymakers who see themselves as custodians for the overall health of the American economy; the White House's Council of Economic Advisors influences the President, the GAO writes reports, and the SEC often proposes rules that managers and institutional investors dislike. See Roe (n 48) 2502.

[1012] Velikonja (n 20).

implementing independent governance structures.[1013] On the other hand, independent directors have a fiduciary obligation to shareholders. They are responsible to shareholders and are expected to prioritize the maximization of shareholder wealth rather than social welfare. Unlike an independent agency responsible for enacting new financial legislation, independent directors can be more readily aligned with shareholder interests.[1014]

5.1.3 Collective Action

At federal level, there are various interest groups that aim to exert influence over either legislation or regulatory policy, particularly in the aftermath of crises and scandals. Mancur Olson argues in his book "*The Logic of Collective Action"* that smaller, more well-structured groups are more likely to exert dominance over larger, but less cohesive, groups that have significantly larger membership base.[1015] Outside groups might outnumber institutional investors and managers, but they possess a wide range of agendas,[1016] lack organization, and hence their potential political influence is dispersed. Additionally, these groups often lose focus quickly, and once the immediate crisis diminishes or the memories of the scandal fade, the momentum for regulatory change tends to decline. Consequently, these outside interest groups frequently find themselves at a disadvantage when competing against the coordinated lobbying efforts of investors and managers.

Unlike individual investors in Berle-Means' era, contemporary institutional investors face much lower costs related to coordination and collective action. First, as a class, they are homogeneous with a unified focus on shareholder value. On the contrary, individual investors have lots of priorities and can appear to be variably engaged with their investments. Correspondingly, institutional investors such as mutual funds, pension funds, and insurance companies have a shared priority of increasing returns for their beneficiaries. It will create an alignment of interests that will enable them to act collectively with much more ease and effectiveness, since there would be fewer internal conflicts or divergent objectives to work out. This common focus makes the decision-making processes easier and their bargaining position much stronger, enabling them to negotiate with corporate management on a united platform or push for regulatory changes. This cohesion contrasts sharply with the diverse and often conflicting interests of individual investors in earlier times, where the wide variation in interest often conflicted, and the possibility of collective action was problematic due to the varies motivations.

Second, the industry is fairly concentrated, with decision-making power centralized among a small number of institutions and individuals. Use mutual funds as an example, in 2005, the five

[1013] ibid.

[1014] ibid.

[1015] Mancur Olson Jr, *The Logic of Collective Action: Public Goods and the Theory of Groups*, vol 124 (harvard university press 1971).

[1016] For instance, raising wages, improving environmental quality, flattening corporate hierarchies, increasing affirmative action.

largest U.S. mutual fund groups controlled approximately 37 percent of total assets in mutual funds; the ten largest held about 48 percent, and the top twenty-five managed nearly 71 percent.[1017] The centralization of decision-making powers in a few dominant institutions enables coordination in a much more coherent and effective manner.

Third, institutional investors have established and can coordinate through self-regulatory organizations (SROs) such as stock exchanges, the National Association of Securities Dealers (NASD), and trade associations like the Investment Company Institute (ICI)[1018] and the Council of Institutional Investors (CII).[1019] Organizations such as the California Public Employees' Retirement System (CalPERS)[1020] also play a role in reducing the costs of collective action. Managers are traditionally well organized and powerful, when they ally with institutional investors, the alliance is very hard to defeat.

Institutional investors and managers utilize a variety of tools to prevent regulatory interventions in response to crises. Lobbying is a commonly employed tactic, as is running public relations campaigns that frame failures as isolated incidents.[1021] A notable example of the public relations is in the wake of the 2002 accounting scandals, where then-President George W. Bush attributed the issues to "a few bad apples," emphasizing that the problem was rooted in individual misconduct rather than systemic flaws.[1022]

In summary, the U.S. independent director system evolved primarily by market forces rather than direct regulatory requirements. Corporate managers initially endorsed independent directors on a voluntary basis, primarily motivated by strategic incentives such as market signalling and legal protection. Independent directors served as credible signals to investors, which indicated management's willingness to be subject to external monitoring and accountability, thereby lowering the firm's cost of capital and enhancing market competitiveness. Furthermore, independent directors gave management useful legal shields against shareholder suits and liability for breach of fiduciary duty, particularly in states like Delaware, where board monitoring by independent directors protected corporate choices from judicial review.

Institutional investors also played the same crucial role in advancing board independence through coordinated collective actions. They effectively promoted and solidified higher standards of corporate governance, especially the appointment of independent directors, as a

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[1017] Ronald J Gilson and Jeffrey N Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) 113 Colum. L. Rev. 863, 886.

[1018] A trade group representing mutual funds, closed-end investment companies, and exchange-traded funds that together manage more than $16 trillion and serve more than ninety million investors.

[1019] A non-profit association of 125 pension funds—including United Auto Workers and the California State Teachers' Retirement System ("CalSTRS")109 —employee benefit funds, foundations, and endowments, representing more than $3 trillion in assets.

[1020] The nation's largest pension fund.

[1021] Velikonja (n 20) 899.

[1022] ibid.

strategic measure to fend off and shield against more interfering and burdensome federal regulations in the aftermaths of financial crises or corporate scandals. By the proactive embracement of independent directors, institutional investors actually shaped a governance environment that safeguarded their interests and minimized the need for governmental interventions, thereby maintaining a market-oriented, investor-friendly governance structure.

Collective action among institutional investors was facilitated by a cohesive group identity and a shared objective to maximize shareholder value. The concentrated ownership and decision-making power of large institutional investors simplified coordination efforts and strengthened their bargaining power vis-à-vis corporate management. This alignment allowed for a highly effective mechanism to negotiate and implement governance standards beneficial to investors, further institutionalizing independent directors within the corporate governance fabric of the United States.

Understanding the U.S. scenario is crucial for contextualizing and illuminating the peculiarities of China’s approach to independent directors. Unlike the market-based, investor-driven adoption in the U.S., China’s system was entirely introduced and enforced by regulatory mandates through the CSRC. This critical distinction highlights China's lack of similar autonomous market forces and institutional investor activism, which fundamentally weakens the effectiveness of independent directors as a corporate governance mechanism. Moreover, China's distinct political and administrative environment, characterized by pervasive governmental influence and stringent political oversight of both listed enterprises and regulatory authorities, inherently limits the autonomy and authority of independent directors. Hence, examining the U.S. experience provides valuable insights into why China's regulatory-centric independent director system has struggled to replicate the governance outcomes achieved in more market-oriented jurisdictions, and why it remains ineffective yet persistent in China's unique political-economic context.

5.3 The China Case

In the U.S., the emergence of independent directors has been primarily driven by market forces, with Congress and the SEC playing only a limited role in this development. In sharp contrast, as discussed in Chapter 4, China’s independent director system is entirely a regulatory creature. It was established and enforced by the CSRC through its Independent Director Guideline and later endorsed with minimal changes in the Company Law of 2006. At the time of its introduction, even its proponents appeared to have an incomplete understanding of the system, and it was largely unfamiliar to most market participants.

The CSRC’s dominant role and the absence of market involvement in the development of independent directors, however, by no means suggest that the system’s implementation was an ‘accidental’ decision driven by several leaders’ preference or lacking understanding. As will be elaborated in the following sections, in the face of corporate scandals and public pressure, independent directors represented the most viable governance tool available to the CSRC within the constraints of that period. To fully grasp why the CSRC turned to independent directors, it is essential to first understand the CSRC's status, powers, and limitations, which necessitates an exploration of the broader Chinese political system.

5.2.1 China's Political System

The United States operates as a capitalist democracy with a presidential system, whereas China lies on the opposite end of the political spectrum as a socialist party-state.[1023] Over the past four decades, there have been efforts to transform and restructure China's political system to better align with the new social and economic conditions brought about by its reforms. However, these changes have not altered the fundamental nature of the system. At its core, China remains a Leninist state governed by the CCP, much like its former socialist counterparts prior to their collapse.

5.2.1.1 The Structure of the Party-state

Leninism is characterized by a hierarchical system that operates from the highest levels of governance down to the most local levels. The organizational and decision-making frameworks of the CCP were in place even before the establishment of the PRC. After the CCP's victory in the Chinese Civil War and the founding of the PRC in 1949, the new state adopted a structure modeled on the Soviet Union during the late Stalinist era.[1024] This approach positioned the state apparatus as subordinate to the ruling Party, firmly entrenching the CCP's authority within the PRC's political and administrative framework.[1025]

The Leninist model is deeply embedded in the Chinese political system, creating a structured hierarchy that extends throughout society.[1026] In line with typical Leninist principles, the CCP is the dominant force in China's political landscape, wielding control over all state functions and significant segments of the economy. By the end of 2016, the CCP boasted a membership of 86.5 million individuals, including around 9 million members (10.4%) working as government employees and 7.5 million (8.7%) serving as Party cadres.[1027] This extensive membership

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[1023] It must note that, in the Leninist model, the 'Party' is an entity of much more comprehensive than political parties in democratic systems. On the other hand, the 'government' cannot be seen as a decision-making body, but only as a bureaucratic creation which administers China on behalf of the CCP

[1024] For historical background, see: Yves Hervouet, 'The Cambridge History of China. Volume 12: Republican China 1912-1949, Part 1'; Jonathan Fenby, *The Penguin History of Modern China: The Fall and Rise of a Great Power, 1850-2009* (Penguin UK 2008).

[1025] Interestingly, the CCP does not formally have any legal personality, as it refuses to register as a social organization. Jakub Jakóbowski and Michał Bogusz, *The Chinese Communist Party and Its State. Xi Jinping's Conservative Turn* (OSW Report 2020) 14.

[1026] The CCP was established in 1921.Until the PRC's break with Moscow in 1960, the Soviet Union provided it with material, personnel and political assistance.

[1027] See Statista, 'Chinese Communist Party - Statistics & Facts' <https://www.statista.com/topics/1247/chinese-communist-party/#topicOverview>.

highlights the CCP’s pervasive influence, reflecting its comprehensive control over the state as well as its broad reach into the societal and economic domains of China.

5.2.1.2 The CCP’s Organizational Structure at the Central Level

The organizational structure of the CCP is highly centralized and hierarchical. At the apex is the Standing Committee of the Politburo (PSC), composed of seven members who wield near-absolute authority over both the Party and the state. This powerful body is headed by the Party General Secretary, who, according to the CCP’s constitution, holds “supreme power and authority over the Party, the government, and the state.” Directly below the Standing Committee is the Politburo, consisting of approximately twenty-five members who represent the key factions and groups within the CCP, encompassing critical roles across both state and Party levels.

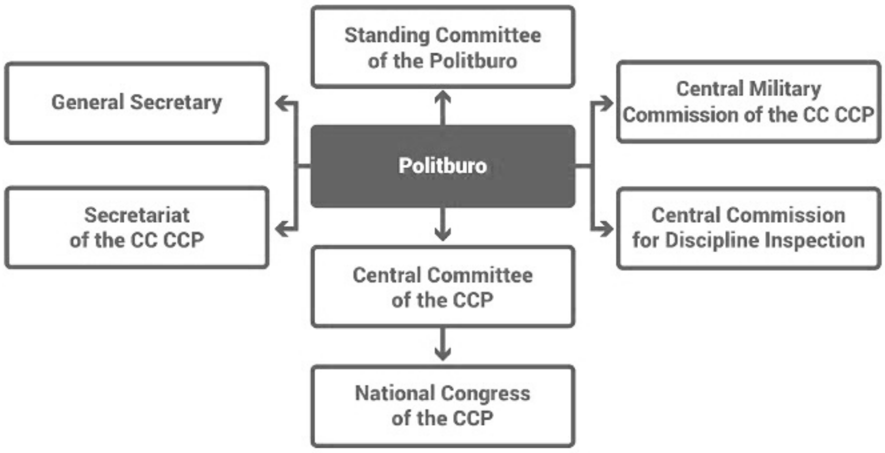
The top leaders of the Party are ostensibly elected by the Central Committee,[1028] which comprises around 370 members, including 205 full members with voting rights and 171 alternate, non-voting members. This Committee includes high-ranking cadres from provincial levels, the military, the bureaucracy, and central state-owned enterprises. The Central Committee itself is elected by the National Party Congress, which convenes every five years with around 2,000 delegates. Despite the ostensibly representative structure of the CCP, the composition of each organizational level is effectively determined by higher levels in the hierarchy, resulting in a top-down flow of power. Consequently, the Politburo and its Standing Committee select their successors through a process of co-optation rather than through open elections.[1029]

The Central Committee oversees several key Party organs that play critical roles in controlling both state functions and the internal mechanisms of the CCP. These include the Central Military Commission, which oversees the armed forces; the Secretariat; the Central Commission for Discipline Inspection, responsible for enforcing Party discipline and combating corruption; the Organizational Department, which manages personnel appointments and promotions within the Party; and the Publicity Department of the Central Committee of the CCP, often referred to as the “propaganda department,” which controls media and ideological messaging. These bodies collectively ensure the CCP’s pervasive influence over both the state apparatus and society.

Figure 5-1 CCP’s Organizational Structure at the Central Level

[1028] In realty, the elections are settled in advance through complicated discussion, negotiations between people representing party factions. Jakóbowski and Bogusz (n 65) 14.

[1029] Neil Collins and Andrew Cottey, ‘Understanding Chinese Politics: An Introduction to Government in the People’s Republic of China’, *Understanding Chinese politics* (Manchester University Press 2018).



5.2.2 State Structures of the PRC

5.2.1.1. National People's Congress

According to the 1982 Constitution, the state structures of the People's Republic of China (PRC) are based on a system of People's Congresses, which are formally chosen through a multi-tiered electoral process at all administrative levels, culminating in the National People's Congress (NPC).[1030] The NPC, often referred to as China's parliament, is officially the highest state authority. Under the Constitution, the NPC is vested with the power to legislate, amend the constitution, and appoint officials to key state positions, including the president and vice-president, the State Council and its premier and vice-premiers, the Supreme People's Court, the Supreme People's Procuratorate, and the Central Military Commission.[1031]

However, this formal structure is simply a facade. In practice, the NPC, like other People's Congresses at subordinate administrative levels, operates under the direct control of the CCP

[1030] The full English-language text of the 1982 state constitution and its subsequent amendments can be accessed on the website of: 'People's Daily Online' <http://en.people.cn/>..

[1031] The National People's Congress (NPC) convenes in full session once a year, typically in March, for a period of 10 to 14 days. During this annual meeting, delegates vote on new legislative proposals that may alter citizens' rights and obligations or adjust the relationships between state bodies. However, the bulk of legislative activity occurs outside this limited session, primarily through the deliberations of the NPC's Standing Committee (SC), which holds the same legislative powers as the full Congress, including lawmaking functions. Despite these powers, neither the NPC nor its Standing Committee holds exclusive authority over legislative initiatives. In recent years, much of the PRC's legislation has been drafted by the State Council. While delegates to the NPC can petition State Council bodies—which are required to respond—they lack the authority to amend the proposals presented to them. Consequently, in the legislative process, the NPC's role is largely confirmatory rather than creative or innovative, serving more to endorse pre-existing proposals rather than to generate new legislation.

and is effectively subordinate to the National Congress of the CCP.[1032] Consequently, the NPC's primary function is to endorse the decisions of the Party and formally integrate them into the legal framework of the PRC, leading to its characterization as a 'rubber stamp' legislature. By maintaining control over the NPC, the CCP exerts comprehensive control over all state institutions in the PRC.

5.2.1.2 The State Council

The CCP delegates the implementation of its policies and the routine governance of the country to state institutions, primarily the State Council, also referred to as the Central People's Government. The State Council comprises 20 sector-specific ministries and 13 ministerial-level agencies, including the central bank. Its principal decision-making body is the Standing Committee of the State Council, which is chaired by the Premier of the PRC, who also serves as a member of the PSC.

Below the national level, this administrative structure is replicated across various layers of 'people's governments.' To ensure the Party's dominance, top state officials at each administrative level often simultaneously hold senior positions within the Party. This dual role of state and Party positions ensures that CCP oversight is maintained throughout the entire state apparatus, thereby consolidating the Party's control over the administration and governance of the country.

5.2.1.3 People's Political Consultative Conferences (PPCCs)

China's formal political framework also comprises two additional categories of institutions. The first category is the People's Political Consultative Conferences (PPCCs), with the highest level being the Chinese People's Political Consultative Conference (CPPCC) National Committee. These consultative bodies are intended to provide a forum where the Party and State "consult" on policy matters. The second category includes China's eight minor political parties, often referred to as the "democratic parties."[1033] These parties, all established before the CCP came to power, pledge loyalty to the CCP and operate under its leadership. Although these entities possess minimal power in substance, their existence enables the CCP to characterize China's

[1032] The Party nominates all candidates for positions as delegates, Provincial-level People's Congresses and the People's Liberation Army elect deputies from among the nominees. Campaigning is forbidden. Jiang Jinsong, *The National People's Congress of China* (Foreign Languages Press Beijing 2003) 86–104.

[1033] The eight minor parties are the Revolutionary Committee of the Chinese Kuomintang (RCCK), China Democratic League (CDL), China National Democratic Construction Association (CNDCA), China Association for Promoting Democracy (CAPD), Chinese Peasants and Workers Democratic Party (CPWDP), China Zhi Gong Dang (CZGD), Jiu San Society, and Taiwan Democratic Self-Government League (TSL).

political system as one of “multi-party cooperation and political consultation led by the Communist Party of China.”[1034]

5.2.1.4 The *Nomenklatura* System

The preceding discussion highlights a core aspect of the Chinese political system, wherein the CCP makes all significant political decisions, while the execution and routine management of these decisions are delegated to state institutions. A key mechanism through which the Party maintains control over state entities is the *nomenklatura* system.[1035]

Nomenklatura is a term originating from the Soviet Union, and the CCP adopted a very similar system inspired by the Soviet Union. Chinese *nomenklatura* refers to the job title list known as zhiwu mingcheng biao. Occasional, the phrase yaozhi xulie (order of key posts) is employed to describe the same phenomena.[1036] Party leadership list refers to a compilation of top officials who are directly appointed by the Party, as well as those officials for whom recommendations for appointment, release, or transfer may be made by other entities, but who need the Party's approval.[1037] Accordingly, the *nomenklatura* list comprises two distinct components: one is exclusively managed by the Organization Department (OD) of the Party, while the other is overseen by other state and Party entities. Although the Party primarily concentrates on the former list, it does possess the ability to exercise veto power over the latter list. Furthermore, the *nomenklatura* system also comprises compilations of individuals who are suggested for future appointment. This intricate system enables the Party to exercise control over the process of selecting and appointing leaders to key positions in Chinese society, such as executive agencies, the military, the police, the judiciary, SOEs, cultural institutions, media, academies, universities, institutes, and schools.[1038]

China's *nomenklatura* operates within a complex hierarchy of authority. Centrally, the Organizational Department of the Central Committee oversees a roster of high-ranking positions in government and Party organs at both the central and provincial levels, as well as the leaders of the most esteemed higher education institutions and the 53 largest state-owned

[1034] State Council Information Office of the People’s Republic of China, ‘China’s Political Party System, White Paper’ (*Xinhua*, 2007); Susan V Lawrence and Michael F Martin, ‘Understanding China’s Political System’ (Congressional Research Service Washington, DC 2013) 4.

[1035] The Chinese concept for nomenklatura is zhiwu mingcheng biao (job title list). However, on occasion, the expression yaozhi xulie (order of key posts) is used to express the same phenomenon.

[1036] On the nomenklatura system in China, see, for example, John P Burns, *The Chinese Communist Party’s Nomenklatura System* (Routledge 2019); John P Burns, ‘Strengthening Central CCP Control of Leadership Selection: The 1990 Nomenklatura’ (1994) 138 The China Quarterly 458, 458–91 <https://www.cambridge.org/core/journals/china-quarterly/article/abs/strengthening-central-ccp-control-of-leadership-selection-the-1990-nomenklatura/597D16560CAACB73EB019899B859D62B>.

[1037] Kjeld Erik Brødsgaard, ‘Cadre and Personnel Management in the CPC’ (2012) 10 China: An International Journal 69, 75.

[1038] ibid 76.

enterprises. At higher levels, the management of cadres is overseen by CCP committees at the provincial level for prefectures and the prefectural level for counties.[1039]

A further notion of *bianzhi* is closely linked to *nomenklatura*. *Bianzhi* is the officially designated number of staff members in a unit, office, or organization, together with the corresponding financial allocations for salary and allowances of these personnel.[1040] The term is commonly rendered as "establishment". There exist three primary types of *bianzhi*: administrative *bianzhi* (xingzheng *bianzhi*), business *bianzhi* (qiye *bianzhi*), and *bianzhi* specifically implemented in public service units (shiye danwei *bianzhi*). The administrative *bianzhi* plays a vital role in shaping the structure of the governance system. The document specifies the quantity of organs (jigou *bianzhi*) and the proportion of personnel (renyuan *bianzhi*) assigned to these organs. The Central Commission for Institutional *Bianzhi* (Zhongyang jigou *bianzhi* weiyuanhui) oversees the *bianzhi* system and operates under the direct administrative authority of the Party's Central Committee.[1041] Through the regulation and management of the *bianzhi* and *nomenklatura*, the Party exerts authority over the political, economic, social, and cultural infrastructure of modern China.

5.2.1.5 The Political Institutions and Regulatory Practices

The institutional framework of China, consisting of the CCP, the NPC, the State Council, the PPCC, and the nomenklatura system, profoundly shapes the country's regulatory practices, particularly concerning corporate governance and financial regulation.

The CCP’s dominant position as the ultimate decision-making body in China creates a hierarchical political environment where regulatory institutions such as the CSRC must navigate complex layers of political oversight and influence. The CCP's pervasive role fundamentally limits regulatory autonomy, compelling regulatory bodies to align their actions with party interests and broader political strategies rather than purely market-oriented or independent governance principles. Consequently, this dominance can lead to regulatory decisions driven more by political considerations and stability concerns than by the objective merits of regulatory effectiveness or economic efficiency.

The NPC, despite its constitutional mandate as the highest state authority responsible for legislation, operates under significant CCP control. Its limited legislative autonomy means that regulatory frameworks and governance laws predominantly reflect party preferences and objectives, restricting the potential for meaningful, independent legislative initiatives aimed at improving corporate transparency and accountability. The result is often a compromised

[1039] One-level-down management principle

[1040] Brødsgaard (n 77) 76.

[1041] Brødsgaard further explains the difference between *bianzhi* and *nomenklatura* is that a *bianzhi* list specifies and ranks the various organs and positions in an administrative setup, including detailing the administrative functions of these organs, whereas the *nomenklatur*a list specifies which leadership positions in the *bianzhi* configuration the Party controls. ibid.

legislative process, where regulations such as those pertaining to independent directors become vehicles for symbolic compliance rather than substantive reform.

The State Council, as the executive arm responsible for policy implementation, reflects the centralized and hierarchical governance model. Regulatory practices administered under the State Council are often subject to top-down decision-making processes that prioritize political stability and administrative uniformity over regulatory flexibility and innovation. This hierarchical structure frequently leads to standardized, politically safe approaches that discourage regulators from exercising significant discretion or undertaking robust enforcement actions against politically influential entities such as state-owned enterprises (SOEs).

The PPCC, serving as a consultative body, further illustrates the symbolic rather than substantive nature of regulatory consultation in China’s political system. Although formally structured to provide a forum for consultation, the PPCC has minimal practical influence over regulatory policy-making, often functioning as a legitimizing institution rather than a platform for meaningful debate and critical oversight. Its consultative role, therefore, provides limited opportunities for challenging or improving regulatory frameworks, further consolidating regulatory practices within a politically prescribed boundary.

The nomenklatura system, underpinning China's hierarchical power structure and personnel management within the CCP, significantly influences regulatory practices by controlling key appointments within regulatory bodies and SOEs. This system ensures that regulatory leaders and senior officials remain politically aligned with CCP objectives, severely limiting their ability to independently enforce regulations, particularly against politically powerful entities. The resultant environment significantly undermines regulatory impartiality and the consistent application of laws, fostering a culture of selective enforcement and regulatory passivity.

Collectively, these institutional characteristics significantly constrain regulatory effectiveness and autonomy within China’s corporate governance landscape. The regulatory environment that emerges from these institutions often prioritizes political stability and control over robust corporate governance, leading to persistent gaps between formal regulatory frameworks and their practical enforcement. Understanding these institutional influences is critical for comprehensively evaluating the limitations and persistent ineffectiveness of governance reforms, such as the independent director system, within China's distinctive political-economic context.

5.2.3 The Chinese Securities Regulatory Commission (the CSRC)

5.2.3.1 The Political Status of the CSRC

As Chapter 2 emphasized, effective enforcement adaptation and robust judicial support are crucial for the functional transplantation of legal mechanisms such as independent directors. Chapter 4 specifically documented the profound institutional constraints within China’s regulatory environment—weak judicial enforcement, political subordination of regulators, and entrenched bureaucratic interests—that directly violate these theoretical prerequisites. This context explains the constrained capacity of the CSRC to substantively enforce independent director governance, perpetuating their symbolic rather than substantive role.

CSRC was established in October 1992, shortly after the creation of China's two primary stock exchanges. However, it was not formally recognized as the principal regulator of China's securities markets until the enactment of the Securities Law in 1998. Currently headquartered in Beijing, the CSRC comprises 18 departments and operates 36 regional offices across China, including prominent locations in Shanghai and Shenzhen dedicated to securities regulation oversight.

The Securities Law empowers the CSRC to oversee issuers, securities markets, and market intermediaries, and allows it to delegate certain regulatory responsibilities to stock exchanges.[1042] Until recently, the CSRC held the authority to approve public stock issuances. Additionally, the CSRC plays a crucial role in recommending legal amendments, developing regulations for the securities markets, and investigating and penalizing violations of securities and futures laws and regulations.

As a ministry-level institution directly under the State Council, the CSRC is often seen as the Chinese counterpart to the U.S. SEC, given that both are governmental agencies. Comparative studies between these two regulatory bodies have consistently highlighted a significant disparity in their enforcement activities. For example, from 2002 to 2004, the SEC initiated an average of 639 enforcement actions annually,[1043] whereas the CSRC was markedly less active, averaging only 33.6 actions per year during the same period.[1044] Some scholars suggest that different analytical perspectives, such as evaluating enforcement actions relative to market capitalization, could reduce the apparent gap between the two agencies.[1045] This thesis believes this is a mis-interpretation of the data, apparently, it ignored the basic facts that the overall quality of the Chinese listed companies is considerably lower than their U.S. counterparts, that is to say, there are numerous wrongdoing remain uncovered. The current literature normally attributed this gap to the differences in regulatory inputs, such as budgets, staff. In this thesis, we argue that there is a more fundamental difference between the CSRC and SEC, which is their relationship with the regulated companies resulting from their respective political status.

Figure 5-2: Administrative Fines and Disgorgements from Securities Regulators from 2008 to 2013 by the CSRC[1046]

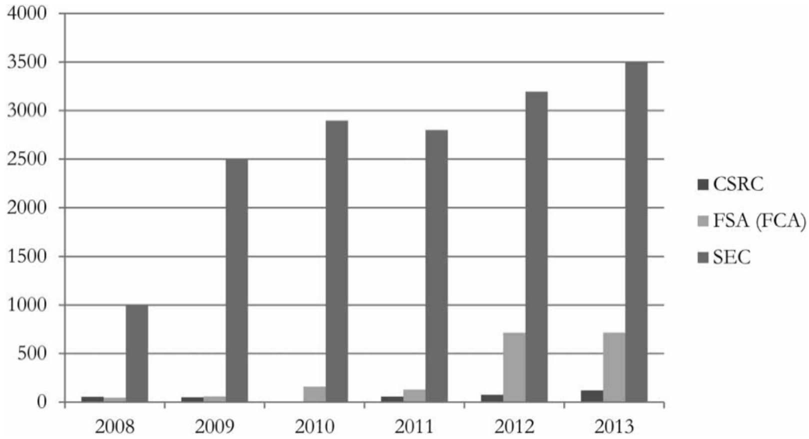
[1042] Securities Law 1999 Art.10; Securities Law 2005 Art.10.

[1043] Howell E Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' (2007) 24 Yale Journal on Regulation 253, 280.

[1044] Benjamin L Liebman and Curtis J Milhaupt, 'Reputational Sanctions in China's Securities Market' (2008) 108 Columbia Law Review 929, 942.

[1045] Tianshu Zhou, 'Is The CSRC Protecting A "Level Playing Field" In China's Capital Markets: Public Enforcement, Fragmented Authoritarianism And Corporatism' (2015) 15 Journal of Corporate Law Studies 377.

[1046] ibid 383.



The SEC was created by the US Congress under Securities Act 1933 following the collapse of the markets in the Great Depression. Direct political interference in the work of the SEC is rare. While the president appoints the five commissioners, only three of the give commissioners may belong the same political party and congressional confirmation tends to prevent overtly political appointees from being nominated. Once appointed, commissioners are insulated from administrative interference in their day-to-day work, they serve for fixed five years and cannot be removed without due cause.[1047] The SEC is traditionally known for its stringent enforcement, although after financial crisis, it was criticised for being slow, inept and captive to industry. The SEC has taken a number of actions to rebuild its reputation since 2018. For instance, in 2008, the SEC brought 671 enforcement actions-the second highest number of enforcement actions in history. 1,355 investigations bad been closed, 260 per cent more than in 2007.[1048] Since 2009 the SEC has opened 10 per cent more cases than the same period last year. And it issued 224 formal orders of investigation, compared with 93 over the same period last year, and filed 147 per cent more temporary restraining orders.[1049] Of course, it is not to say that there is no regulatory failure, it does, evidenced by the Enron scandal and the financial crisis. But we argue the regulatory failure in the US is not due to political constraints that imposed by the regulated companies.

The U.S. SEC was established by Congress under the Securities Act of 1933 in response to the market collapse during the Great Depression. Direct political interference in the SEC's operations is uncommon. Although the president appoints the SEC's five commissioners, there is a requirement that no more than three commissioners belong to the same political party, and congressional oversight during the confirmation process helps to mitigate the appointment of excessively partisan individuals. Once in office, commissioners serve fixed five-year terms, are shielded from daily administrative interference, and can only be removed for justifiable reasons.[1050] Historically, the SEC is recognized for its rigorous enforcement practices; however,

[1047] Roberta S Karmel, 'Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America'.

[1048] Securities Exchange Commision, 'SEC 2008 Performance and Accountability Report' (2008).

[1049] Joanna Chung and Brooke Masters, 'Enforcement Push Gives SEC Image Boost",' *Financial Times* (7 August 2009).

[1050] Karmel (n 87).

following the financial crisis, it faced criticism for being sluggish, incompetent, and overly influenced by industry interests. Since 2018, the SEC has implemented various measures to restore its credibility. For example, in 2008, the SEC executed 671 enforcement actions, marking the second-highest number in its history, and concluded 1,355 investigations, representing a 260 percent increase from 2007.[1051] Since 2009, the SEC has initiated 10 percent more cases compared to the same timeframe the previous year and issued 224 formal investigation orders, up from 93 in the prior year, alongside a 147 percent increase in temporary restraining orders.[1052] Of course, it is not to say that there is no regulatory failure, it does, evidenced by the Enron scandal and the financial crisis. But we argue the regulatory failure in the US is not due to political constraints that imposed by the regulated companies.

Conversely, the relationship between the CSRC and listed companies is notably distinct. The CSRC was established as a "public institution" (shiye danwei) directly under the State Council,[1053] a designation that includes various entities like hospitals, schools, universities, and institutions involved in healthcare, sports, social welfare, culture, and research. Among similar organizations under the State Council are prominent institutions such as Xinhua News Agency, the Chinese Academy of Sciences, the Chinese Academy of Engineering, and China Media Group. Although the title of "public institution" (shiye danwei) is prestigious, within the Chinese context, it equates to a non-governmental organization (NGO), which places it lower in the state hierarchy, despite being led by a minister.

The CSRC's classification as a "public institution" (shiye danwei) raises concerns about its authoritative capacity. Some scholars argue that the CSRC is not a fully empowered administrative department under the State Council as prescribed by the Constitution, which would normally authorize an agency to formulate regulations within its domain. Instead, the CSRC operates with delegated authority, meaning it can enforce rules but not create them independently. Moreover, it is argued that the CSRC lacks the mandate to establish regulations that impose punitive measures such as bans.[1054]

Another factor limiting the CSRC's regulatory effectiveness is its organizational rank. As a public institution (shiye danwei), the majority of its personnel do not hold administrative "bianzhi" status, excluding them from being classified as civil servants. Nevertheless, the senior leadership of the CSRC has consistently been composed of members of the CCP and covered under the nomenklatura system. According to Burns, the nomenklatura system in China functions within a complex hierarchy of authority. Organizational ranks in China are structured beneath the central government in Beijing, which includes 22 provinces, five autonomous regions, and three centrally governed cities (Beijing, Shanghai, and Tianjin) that hold equivalent

[1051] Commision (n 88).

[1052] Chung and Masters (n 89).

[1053] The CSRC defines itself as a "ministerial-level public institution directly under the State Council". See the CSRC's Introduction on its official website <http://www.csrc.gov.cn/pub/csrc_en/about/intro/200811/t20081130_67718.html>

[1054] Donald C Clarke, 'Law without Order in Chinese Corporate Governance Institutions' (2010) 30 Nw. J. Int'l L. & Bus. 131, 173.

ranks. Below these are 175 prefectures or prefecture-level entities, followed by over 2,000 county or county-level units. A corresponding hierarchy of party committees mirrors this administrative structure, descending from the Central Committee in Beijing. In this hierarchy, ministers and deputy ministers of central ministries are on par with provincial governors and deputy governors. Heads of general bureaus (zongju) at the central level align with leaders of provincial commissions, while bureau heads (ju and si) of central ministries and commissions are equivalent to provincial bureau heads (ting and ju) and prefectural leaders.[1055]

Table 5-1 Ranking system of central and local government bureau under the State Council[1056]

Central Government	Example	Local Government	Example
Comprehensive ministry (*wei*),	The National Development and Economic Reform Commission	Super-province, Province (*sheng*)	Shanghai, Guangdong Province
Ministry (*zhengbu*),	Ministry of Finance	Centrally administered cities (*zhixiashi)*	Shanghai, Beijing
		Autonomous regions (*zizhiqu*)	Tibet, Xijiang
Vice-ministry (*fu bu*)		Provincial capitals(*fusheng*),	Guangzhou
		Plan-autonomous cities (*jihua danlie shi*)	Shenzhen

[1055] John P Burns, 'China's Nomenklatura System' (1987) 36 Probs. Communism 36, 36.

[1056] Stephen Green, *The Development of China's Stockmarket, 1984-2002: Equity Politics and Market Institutions* (Routledge 2004) 46.

General Bureau (*zongju*)	Provincial commission(*weiyuanhui*)
Bureau (j*u or si*)	Bureau (ting or ju)
Division(*chu*)	Division (*chu*)
Section (*ke*)	Section (*ke*)

Understanding the bureaucratic ranking system is crucial because it largely dictates the formal interactions between entities within these structures. Rankings are rigorously observed to determine the relative significance of individuals, governmental bodies, public institutions, state-owned enterprises, and geographic units. For instance, a bureau cannot issue directives to another bureau of equal or higher rank, even when the subject matter clearly falls within its policy scope. Furthermore, leaders from one bureau cannot engage in negotiations on equal footing with leaders from a higher-ranking bureau. Additionally, a clear distinction exists between the xitong (systematic) and difang (local) structures. Ministries, unless granted explicit authorization by the State Council, are prohibited from issuing binding documents, such as orders (mingling), decisions (jueding), or directives (zhishi), to provincial governments. In the absence of such authority, they must resort to issuing non-binding communications, such as notifications or guidelines (tongzhi).[1057]

5.2.3.2 Power Dynamics: CSRC vs SOEs

The bureaucratic ranking system within China's political structure has profound implications for the CSRC authority, particularly in relation to its capacity to regulate SOEs. The CSRC, classified as a public institution under the State Council, occupies a relatively modest position within the Chinese political hierarchy. While officially designated as a ministerial-level agency, its practical regulatory authority remains significantly constrained due to the deeply entrenched political power of the SOEs it seeks to oversee.

The constraints facing the CSRC become particularly clear when compared with regulatory structures analyzed in Chapter 3. For example, in Germany and Japan, Chapter 3 noted

[1057] ibid 45.

substantial difficulties in implementing independent oversight due to powerful controlling shareholders and limited judicial enforcement mechanisms. China's challenges are similar yet even more pronounced due to additional political complexities, including high-ranking SOE executives and bureaucratic hierarchies, further weakening CSRC's authority to enforce meaningful corporate governance oversight

As discussed in earlier chapter, many listed companies in China are owned by the central or local governments. SOEs are inherently embedded in the Chinese political system. Their leading managers are state officials with administrative ranks. The CCP's COD directly controls personnel of the central SOEs that are ranked at either the ministerial or vice-ministerial level (the general manager and the chairman), currently 51 out of 96 central SASAC enterprises. These 51 corporations represent China's prominent enterprises in sectors deemed strategically significant, such as oil and gas, nuclear power, chemicals, and others, often referred to as national champions. Their senior executives hold ministerial-level standing and are equivalent in rank to State Council ministers and provincial governors.

Since 2002, they have been included as a separate group in the Central Committee, sitting alongside representatives from central government and Party institutions, the provinces, the military, and the academic world. The total number of elected members was 18, consisting of two full members and 16 alternate members. Two full members of the committee were Li Yizhong, who serves as the Chairman and President of Sinopec, and Zhang Qingwei, who holds the position of President of China Aerospace, Science and Technology Commission.

In contrast, the CSRC is a ministry-level public institution, the ranking system suggests that its authority over regulating SOEs with the same ranking would be severely compromised, if ever possible. Its weak public institution (shiye danwei) position only makes the job even more difficult. How can even an NGO-like governmental entity exercise authority over enterprises whose senior management has been appointed by COD? These chairman/CEOs do not report to a government ministry, they report directly to a solid-line into the Party system.

Moreover, many SOE leaders are politically influential, with strong connections and significant standing within the political hierarchy. Some have even ascended to the upper echelons of the Chinese political system. Senior executives of many centrally-administered SOEs possess administrative ranks equivalent to or higher than the leadership of the CSRC. These executives are often appointed directly through the Communist Party's nomenklatura system and enjoy substantial political influence. For instance, Wang Qishan served as the head of the Construction Bank of China (1994-1997), Vice-Governor of Guangdong (1998-2000), Party Secretary in Hainan, and Mayor of Beijing (2003-2007) before advancing to Vice-Premier and ultimately becoming a member of the Politburo Standing Committee (2013-2018). In contrast, the head of the CSRC is typically a financial expert with relatively limited influence in the broader political structure, with the highest possible position being the governor of the Central Bank. The alignment of SOE leadership with the Party's central hierarchy grants them political leverage that substantially exceeds the regulatory authority of the CSRC, which lacks comparable political clout.

The CSRC struggles in regulating SOEs can also be exemplified by the experiences of the SASAC, which, like the CSRC, is also a ministry-level public institution. Despite being tasked by the State Council to act as the representative owner of central SOEs, the SASAC has faced considerable challenges, primarily due to the reality that it is not the actual owner of these enterprises. The complexities of the SASAC's role are evident in its ongoing difficulties with SOEs that have persistently resisted paying substantial dividends. After years of negotiations, a temporary agreement was reached in 2007, but even then, dividend payments were limited to 5 to 10 percent of post-tax profits, which were exclusively reinvested back into the SOEs, effectively sidestepping the intended financial obligations.

Moreover, Zhu's empirical study also confirms that the CSRC is either incapable or unwilling, or both, to initiate measures against the misconduct committed by the centrally-owned SOEs. According to his report, between 2008 and 2013, the CSRC took more enforcement measures and imposed more substantial fines on privately-owned listed companies compared to listed SOEs during the misrepresentation cases. Instead, the CSRC typically employs the ex-ante cooperative strategy to oversee Chinese government-owned companies. During 2009, the CSRC revealed that it developed a distinctive regulatory framework for companies listed on the Chinese stock exchange. The aim was to enhance the regulation of significant controllers, so improving the effectiveness of regulation on listed government-owned companies. The regulatory approach at hand is focused on collaboration between centrally owned listed companies or their parent companies and the CSRC, rather than enforcement. It may be dissected into two significant methodologies. The first method is on-site visits and investigations. By November 2009, the CSRC had conducted on-site visits and investigations on 62 central-government-controlled corporate groups and financial enterprises, accounting for 42% of the companies in this specific category. The second method integrates administrative licensing with regulation: by collecting and utilizing information from corporate issues of Centrally-owned listed companies with the CSRC's administrative approval, the CSRC thoroughly analyzed fundamental aspects such as corporate governance structure, industry competition, and related party transactions. By the end of 2009, this specific regulatory approach had identified 90 non-compliances in the activities of controlling shareholders and significant controllers. Nevertheless, the CSRC refrained from imposing any fines or other forms of penalties. Contrarily, it offered 78 recommendations to address these issues.

Consequently, the CSRC faces inherent difficulties in enforcing regulations effectively against SOEs. Regulatory decisions and enforcement actions targeting SOEs are influenced not merely by economic or legal considerations but significantly by political hierarchies and power relationships. When SOE leaders occupy political positions equal or superior to those held by the regulators themselves, the CSRC's authority is substantially diminished, often rendering it practically unable to impose meaningful sanctions or disciplinary actions. This power dynamic creates an environment of regulatory asymmetry, where private enterprises are subject to more rigorous and frequent enforcement actions compared to their SOE counterparts. The result is a regulatory environment that systematically advantages politically connected SOEs, perpetuating weak corporate governance practices and limiting the efficacy of reforms such as the independent director system. Therefore, the bureaucratic ranking system profoundly constrains the CSRC’s autonomy and effectiveness, illustrating how China's unique political and administrative structure significantly shapes and limits regulatory practices.

5.2.3.3 Public Pressure

Looking back at the late 1990s, the CSRC was facing enormous pressure from investors and the general public. A series of accounting fraud cases, including those involving Yin Guangxia, Lan Tian, Ke Long, and Liang Mianzhen, shook the Chinese stock markets. Among these notorious cases, the financial statement fraud committed by Yin Guangxia was seen as China’s Enron, leading to an unprecedented crisis in investor confidence. Wu Jinliang, a well-known economist, remarked that China’s stock market was worse than a casino.

In response to this pressure, the CSRC needed to act to restore public confidence. The introduction of independent directors at that time became the most viable option. By granting shareholders the power to appoint independent directors and setting a minimum threshold of one-third of the board, the CSRC aimed to make a gesture that would be acceptable to powerful SOEs while demonstrating to investors that action was being taken. For the same reasons, despite being aware of the system’s ineffectiveness, the CSRC has largely left the system unchanged.

This “one-third” requirement enabled the CSRC to create the appearance of reform while avoiding direct confrontation with entrenched interests. The reform allowed regulators to claim they were taking actions on investor concerns, but it was designed to remain the control rights of SOEs and their superior supervision departments. Directors were still nominated and effectively appointed by controlling shareholders, often with close political or personal ties, which diluted their independence from the outset. As a result, the institutional design remained superficially impressive but substantively weak.

This strategic response to public pressure is part of pattern that how CSRC regulates: reforms are often launched in response to the anger of the public or agency’s reputation crisis, but the reforms cannot go as far as they could because they need to preserve political and bureaucratic stability. In this case, the CSRC prioritized preserving harmony among powerful constituencies—SOEs, local governments, and central Party departments—over empowering genuinely independent board members capable of challenging insider control.

While the CSRC has reviewed the independent director system on a regular basis and published evaluation reports and proposed technical adjustments (such as limiting the number of boards one can serve on), it has consistently avoided addressing the fundamental institutional deficiencies: the lack of a credible nomination process, absence of enforcement mechanisms, and the broader cultural and political constraints on director autonomy. This lack of action is not just the oversight but is better understood as a rational regulatory strategy within the existing political economy. Showing the signal of governance modernization without undermining Party-state authority or SOE dominance allows the CSRC to balance conflicting pressures from domestic investors, political actors, and international observers.

However, this balance is not stable. Investor expectations for real accountability may grow as China's capital markets become more advanced. Repeated cycles of market scandals followed by symbolic reforms run the risk of trapping the CSRC in a situation where people start to doubt its ability to function as a reliable regulator. If trust in regulatory enforcement keeps going down, fewer investors may participate or they may start to act speculatively, which would hurt long-term capital formation and market stability.

In this light, the transplantation of the independent director system in response to public pressure shows not only the limits of formalistic reform under political constraints, but also the long-term risks of leaving the rules substantively unchanged. Without structural reform that addresses the underlying power asymmetries in board governance, the CSRC's credibility as a market regulator remains vulnerable to decline—particularly during times of financial instability or public dissatisfaction.

5.2.4 Lack of Institutional Support

While the CSRC played a central role in introducing the independent director system, this institutional dominance should not be misconstrued as evidence of an arbitrary or accidental policy choice driven solely by individual preferences or conceptual misunderstandings. Rather, the adoption of the independent director regime was shaped by significant macro-political and reputational pressures. It functioned primarily as a symbolic accommodation, allowing regulators to restore investor confidence in the wake of high-profile corporate scandals and to signal convergence with international governance norms—without undermining the institutional foundations of state ownership and Party control.

Given the political and regulatory constraints of the early 2000s, independent directors represented the most politically viable and publicly acceptable governance mechanism available to the CSRC. To fully understand the persistent ineffectiveness of the system in China, however, it is necessary to move beyond a narrow focus on the CSRC's role and consider the broader institutional environment in which the system was embedded. The introduction of independent directors was not the result of a misguided or ill-informed decision, but rather a calculated regulatory response within a context that lacked the foundational conditions necessary for effective board oversight. The following sections examine these structural limitations in detail, highlighting how the absence of strong judicial enforcement, underdeveloped market mechanisms, weak investor protection, and the overarching influence of the Party-state apparatus collectively impeded the ability of independent directors to function as effective agents of corporate governance.

5.2.4.1 Weak Judicial enforcement and Accountability

Judicial institutions serve as an essential support, providing independent directors and minority investors with credible enforcement tools to hold management and controlling shareholders accountable for misconduct, breaches of fiduciary duty, or violation of disclosure obligations. However, in the context of China's corporate governance, the judicial infrastructure suffers from systemic weaknesses that severely undermine independent directors' ability to fulfill their oversight responsibilities.

At the core of judicial effectiveness in corporate governance cases is judicial independence—the capacity of courts to adjudicate disputes without undue political or economic interference. Chinese courts remain structurally and institutionally subject to influence from local governments and political entities, particularly when powerful SOEs or politically influential business actors are involved.[1058] Due to their high rank and political importance, SOE leaders frequently have significant informal leverage over local judicial systems. Judges who adjudicate sensitive corporate disputes involving politically connected companies may face substantial career risks, political pressure, or direct interference, resulting in compromised neutrality and inconsistent enforcement of corporate governance rules.

Even when judicial authorities are willing to act, the procedural framework for enforcing accountability through shareholder litigation in China is highly restrictive.[1059] The existing legal remedies are limited, and procedural requirements often create significant barriers for minority shareholders attempting to sue directors or controlling shareholders for wrongdoing.

For instance, class-action litigation—widely used in jurisdictions like the U.S. to enforce corporate governance—is either unavailable or severely constrained in China. Shareholders must typically undertake individual suits, bearing the full burden of proof, cost, and procedural complexities, significantly discouraging litigation. Such barriers mean that minority investors seldom initiate lawsuits, effectively allowing misconduct or negligence by directors to remain largely unpunished.

Fiduciary duties—especially duties of care and loyalty—represent foundational obligations for directors globally. However, Chinese corporate law and judicial practice have struggled to enforce these duties effectively.[1060] The interpretation and application of fiduciary duties remain

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[1058] Donald C Clarke, 'Empirical Research into the Chinese Judicial System' (2003) 164 Beyond common knowledge: Empirical approaches to the rule of law; Stanley B Lubman, *Bird in a Cage : Legal Reform in China after Mao* (Stanford University Press 1999) <https://books.google.co.uk/books?hl=en&lr=&id=0k9SChVyrJwC&oi=fnd&pg=PR11&dq=+Bird+in+a+Cage:+Legal+Reform+in+China+after+Mao&ots=z5QQOgZ2IG&sig=7_4AXPTWvJXyJ6fcGGAPMbMFRqk#v=onepage&q=Bird in a Cage%3A Legal Reform in China after Mao&f=false> accessed 13 April 2019.

[1059] Hui Huang, 'The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform' (2007) 4 Berkeley Business Law Journal <https://heinonline.org/HOL/Page?handle=hein.journals/berkbusj4&id=233&div=12&collection=journals> accessed 17 February 2021; Jingchen Zhao and Chuyi Wei, 'Shareholder Remedies in China—Developments towards a More Effective, More Accessible and Fairer Derivative Action Mechanism' (2021) 16 Capital Markets Law Journal 445 <https://academic.oup.com/cmlj/article/16/4/445/6368673> accessed 17 February 2021.

[1060] Guangdong Xu and others, 'Directors' Duties in China' (2013) 14 European Business Organization Law Review (EBOR) 57 <https://www.cambridge.org/core/journals/european-business-organization-law-review-ebor/article/abs/directors-duties-in-china/D3E8C099128F0FB0A668AEFB2A72F0C3> accessed 12 March 2021.

inconsistent and vague, and courts frequently show hesitation in holding directors personally liable, especially independent directors who often argue they were kept unaware of managerial misconduct. Furthermore, the evidentiary standards required by courts in proving breaches of fiduciary duties can be exceedingly high, creating further obstacles to accountability.

In robust governance structure, courts and regulatory bodies cooperate closely to ensure effective enforcement. In China, however, there is limited practical coordination between the CSRC and the judiciary.[1061] Regulatory investigations and administrative enforcement actions by the CSRC rarely translate into judicial actions, diminishing their deterrent effect. Consequently, directors have little reason to fear judicial sanctions, even if regulatory violations have been identified by the CSRC.

In many cases, political stability, local economic development, and social harmony are prioritized by local and national authorities over rigorous enforcement of corporate governance rules.[1062] Judicial decisions thus often reflect broader political or economic considerations rather than strictly legal reasoning. High-profile cases involving politically significant companies or senior executives may be resolved through administrative or informal political channels, bypassing judicial accountability altogether. This political calculus significantly limits the scope and effectiveness of judicial enforcement as a genuine tool for corporate accountability.

Consequently, the judicial system's inherent weakness not only compromises independent directors' ability to enforce accountability on corporate boards but also significantly diminishes their incentive to actively perform oversight functions. Without the realistic possibility of judicial consequences, independent directors often adopt passive roles, fulfilling only minimal compliance obligations rather than serving as genuine guardians of shareholder interests or corporate governance integrity. In summary, weak judicial enforcement and accountability mechanisms constitute a fundamental institutional flaw in China's corporate governance structure. This flaw directly undermines the potential effectiveness of independent directors, perpetuating a governance regime characterized more by symbolic compliance than substantive oversight.

5.2.4.2 Lack of Market-Based Enforcement Mechanisms

Effective corporate governance, particularly the functioning of independent directors, relies heavily on the presence of active, informed, and empowered investors who can exert consistent pressure on boards and management to uphold principles of transparency, accountability, and fiduciary responsibility. In mature market economies like the U.S., investor activism and strong minority shareholder protections serve as critical market-based enforcement mechanisms that complement judicial and regulatory oversight. Minority shareholders and activist investors often play a decisive role in shaping board behavior, promoting corporate accountability, and

[1061] ibid; Chien-Chung Lin, 'The Chinese Independent Director Mechanism under Changing Macro Political-Economic Settings: A Review of Its First Decade and Two Possible Models for the Future' (2011) 1 Am. U. Bus. L. Rev. 263.

[1062] RP Peerenboom, *China's Long March toward Rule of Law* (Cambridge University Press 2002).

ensuring that directors fulfil their oversight duties. However, China's corporate governance landscape is markedly deficient in both respects. Investor activism remains weak, with institutional investors typically passive and retail investors primarily engaged in short-term speculative trading. At the same time, minority shareholders face substantial legal, procedural, and informational barriers that inhibit their ability to challenge managerial misconduct or influence board decisions. These structural constraints not only undermine external checks on controlling shareholders and management but also deprive independent directors of the market-driven incentives and accountability mechanisms that are essential to their effectiveness. As a result, independent directors in China operate in an environment largely devoid of meaningful investor oversight, reducing their role to one of formal compliance rather than substantive governance.

Investor Activism

Chinese listed companies typically exhibit a highly concentrated ownership structure, and the stock markets remain overwhelmingly dominated by retail investors.[1063] Firstly, these controlling shareholders, often powerful SOEs or large private conglomerates, whose substantial equity stakes grant them decisive influence over corporate decisions, board appointments, and strategic directions. Such concentration of ownership creates severe power asymmetries, placing minority shareholders at a pronounced disadvantage. Controlling shareholders effectively determine the composition of the board, including the appointment of independent directors, who are consequently incentivized to align closely with controlling shareholders' interests rather than vigorously advocating for minority rights. This structural imbalance greatly weakens minority shareholders' potential influence, undermining the efficacy of independent directors as impartial corporate monitors.

Secondly, the predominant retail investors primarily seek short-term gains through speculative trading, focusing on rapid price fluctuations rather than sustained corporate value.[1064] Given their short investment horizons and limited incentives to deeply engage with corporate governance practices, retail investors generally demonstrate minimal interest in financial transparency, fiduciary oversight, or the independence of corporate boards. Their speculative behavior—often driven by transient market rumors and short-term profit motivations—precludes the development of stable, long-term investor pressure that would hold directors accountable for corporate governance outcomes. Consequently, the essential governance pressures from the investor base, which in mature markets significantly motivate directors to maintain rigorous oversight, remain notably absent in China.

[1063] Lin Tan, Xiaoyan Zhang and Xinran Zhang, 'Retail and Institutional Investor Trading Behaviors: Evidence from China' (2023) 16 Annual Review of Financial Economics 460; Clarke, 'Corporate Governance in China: An Overview' (n 6).

[1064] Franklin Allen, Jun Qian and Meijun Qian, 'Law, Finance, and Economic Growth in China' (2005) 77 Journal of financial economics 57.

In developed markets, institutional investors, including pension funds, mutual funds, and asset management firms, play a pivotal role as powerful enforcers of corporate governance, leveraging substantial resources and market influence to advocate for greater board accountability and transparency. In China, however, institutional investors typically exhibit significant passivity regarding corporate governance issues. Frequently affiliated with state entities or influenced by regulatory and political considerations, Chinese institutional investors face substantial political and economic constraints, rendering them reluctant to engage in proactive governance activism or challenge politically connected firms.[1065] Such institutions rarely initiate shareholder proposals, conduct proxy battles, or publicly pressure management to improve governance practices. This institutional passivity further deprives independent directors of external pressures and accountability mechanisms, effectively reducing their incentives and obligations to actively monitor managerial conduct or represent broader shareholder interests.

Given the dominance of speculative retail investors and the cautious passivity of institutional investors, effective shareholder activism—encompassing organized campaigns, public advocacy, proxy voting initiatives, and direct engagement with corporate boards—is severely lacking in China. Retail investors lack the resources, organization, and expertise necessary for sustained activism, while institutional investors remain constrained by regulatory, political, and commercial factors. Without sustained and explicit pressure from activist shareholders demanding greater accountability, transparency, or fiduciary diligence, independent directors have little market-driven incentive or obligation to rigorously scrutinize management or to actively challenge controlling shareholders' decisions. In this environment, independent directors are deprived of critical external motivations to fulfill their intended oversight role effectively, reducing their position to one of passive compliance rather than active corporate stewardship.

Minority Shareholder Protection

Minority shareholders in China face considerable procedural, regulatory, and informational barriers that severely limit their ability to influence corporate governance effectively. Shareholder meetings are often structured to favour controlling shareholders, offering minimal meaningful opportunities for minority voices to influence decision-making.

Proxy voting system is allowed under Chinese law,[1066] however it is underdeveloped, opaque, or practically inaccessible to small investors.[1067] The proxy voting system enables a shareholder who is dissatisfied with the company's management or operational performance, they may attempt to influence corporate control through the proxy voting mechanism. Prior to the general shareholders' meeting, such a shareholder may solicit proxy authorizations from

[1065] Dan W Puchniak, 'The False Hope of Stewardship in the Context of Controlling Shareholders: Making Sense out of the Global Transplant of a Legal Misfit' (2024) 72 The American Journal of Comparative Law 109; Lin (n 101).

[1066] 2023 Company Law Art.118.

[1067] OECD, Corporate Governance in China (OECD Publishing 2017).58-60 other shareholders by means of newspapers, the internet, or other media platforms. By accumulating a sufficient number of proxy votes, the shareholder can obtain significant influence during the meeting, potentially enabling them to oversee, or even control, the company.

However, the introduction of the proxy voting system is premised on an implicit assumption—namely, a dispersed ownership structure. In jurisdictions where the proxy voting system functions effectively, capital markets are highly developed, and share ownership is widely distributed. Under such conditions, it is meaningful for minority shareholders to form coalitions to challenge incumbent control, thereby exerting substantive influence over corporate affairs.

In contrast, the ownership structure of Chinese listed companies is far more concentrated. The largest shareholder often holds a dominant equity stake, leaving minority shareholders with limited capacity to alter control through the proxy voting process. As a result, minority shareholders exhibit little enthusiasm for this mechanism. Instead, it has increasingly been appropriated by controlling shareholders. In the Chinese context, proxy voting has been transformed into a strategic tool among major shareholders engaged in alliances and rivalries, deviating significantly from its intended purpose.

For example, some controlling shareholders have acquired company control via proxy voting only to engage in reverse takeovers or asset injections aimed at personal gain, often at the expense of minority shareholders. This practice constitutes a fundamental departure from the original rationale of the proxy voting system, which was designed to enhance shareholder democracy and protect minority interests. In sum, while the proxy voting mechanism is legally recognized in China, it has failed to serve its protective function for minority shareholders in practice. Instead, it has been co-opted as a means for dominant shareholders to consolidate or contest corporate control.[1068]

Furthermore, effective minority shareholder activism requires robust legal protections and accessible judicial remedies. In China, however, minority shareholder protections remain weak and inconsistently enforced. Procedural requirements for shareholder lawsuits against controlling shareholders or board members are cumbersome and costly, while remedies available through the courts are often limited and ineffective.[1069] Minority shareholders thus rarely resort to judicial action, weakening the deterrent effect of potential litigation. Independent directors, consequently, operate with minimal risk of judicial accountability for failures of fiduciary oversight. The absence of effective legal protection perpetuates a cycle of non-engagement and passivity among minority shareholders, further eroding any incentives for independent directors to challenge controlling shareholders or management actively.

[1068] Lin (n 101) 310–13.

[1069] Shaowei Lin, 'Derivative Actions in China: Case Analysis' (2014) 44 Hong Kong Law Journal <https://heinonline.org/HOL/Page?handle=hein.journals/honkon44&id=623&div=37&collection=journals> accessed 17 February 2021.

Minority shareholders require clear, accurate, and timely information to engage effectively in governance oversight. Yet, weak disclosure standards, limited transparency, and inadequate financial reporting practices common in Chinese companies create severe information asymmetries. This informational disadvantage severely constrains minority investors' ability to detect and respond to governance problems promptly.[1070] Independent directors, who depend on market signals and shareholder vigilance to inform their oversight functions, find their roles compromised by limited and biased information flows. Without independent and critical shareholder analysis holding boards accountable, directors face significantly reduced incentives to perform proactive and independent oversight.

5.3 Assessment of China's legal transplant of Independent Director System

5.3.1 Transferability of the Independent Director System in China

As Kahn-Freund argues, the successful transplantation of a legal rule depends significantly on whether it is "organic" (embedded deeply within social, political, or cultural contexts) or "mechanical" (relatively neutral and adaptable to different settings).[1071] While company law rules, including corporate governance structures, are often perceived as mechanical and hence easily transferable, the political dimension of independent directors complicates this assumption significantly. Indeed, independent directors embody more "organic" characteristics, as their effective functioning is heavily reliant on institutional and political contexts. The board independence in the U.S. emerged largely as a politically expedient mechanism, aiming to respond to legitimacy crises without challenging deeper structural power relations within corporations. Such political embeddedness substantially reduces its actual transferability, particularly into a politically distinct context like China.

The key challenge to the transferability of independent directors to China lies in the fundamentally different power structures between the originating system and the recipient system. In the U.S., independent directors evolved within a democratic political context characterized by dispersed corporate ownership, strong capital markets, and effective legal institutions—courts, regulatory bodies, shareholder activism—which together provided a supporting environment necessary for meaningful director independence.

China, by contrast, presents a starkly different institutional and political landscape. Its corporate governance system remains heavily dominated by the state, particularly through SOEs. Political considerations and Party directives heavily influence corporate decisions, appointment of senior management, and board-level oversight. The presence of a powerful state actor, the CCP and its nomenklatura system—means that director appointments and oversight roles are

[1070] Katharina Pistor and Chenggang Xu, 'Governing Stock Markets in Transition Economies: Lessons from China' (2005) 7 American Law and Economics Review 184, 195.

[1071] Kahn-Freund (n 8) 6–7.

not simply corporate governance decisions but are intricately tied to political control and patronage

This embeddedness of corporate governance rules in China's unique political context makes the independent director system inherently less transferable, even though it might superficially appear neutral or mechanical. According to Kahn-Freund's framework, rules that significantly implicate local political power structures are typically difficult to transplant. While corporate governance rules—such as independent directors—are often presumed to be culturally neutral, this neutrality diminishes when governance rules intersect with political power, control rights, and state management of enterprises.

However, China lacks comparable institutional foundations, significantly limiting the effectiveness of the transplanted rule. Specifically, empirical studies have consistently demonstrated that independent directors in China, despite their formal presence on boards, rarely exert meaningful oversight. Extensive empirical analysis of listed Chinese companies found minimal evidence that independent directors successfully mitigate controlling shareholder expropriation or significantly enhance corporate transparency. Their limited autonomy, influenced by controlling shareholders—frequently state entities—renders their supposed oversight ineffective.

The role of the CSRC also complicates the transferability of independent directors. In the U.S. context, regulatory agencies such as the SEC function with considerable political independence, backed by robust judicial enforcement, shareholder litigation, and a relatively active market for corporate control. These institutional supports are crucial for enabling independent directors to fulfil their oversight functions effectively.

In contrast, the CSRC operates within a more constrained regulatory environment, with its independence circumscribed by broader political imperatives—especially the Party's emphasis on economic stability, social order, and state-sector dominance. Its regulatory actions often prioritize maintaining stability and safeguarding Party interests rather than vigorously enforcing corporate governance rules. Consequently, even though independent director requirements exist formally, the CSRC's limited political and operational autonomy restricts its willingness and ability to enforce these rules vigorously, weakening the prospects of meaningful oversight.

Due to these structural mismatches, the independent director system, although formally adopted by China, has functioned mainly as a symbolic governance tool. Independent directors frequently lack genuine autonomy, or the institutional backing required to challenge managerial or political dominance. Instead, directors often remain beholden to the controlling shareholders who appointed them—typically SOEs or government entities—thus severely limiting their oversight role.

This gap between formal adoption and substantive function is precisely the outcome predicted by Kahn-Freund's theory for low-transferability rules. In China, independent directors represent a case where superficial transplantation fails to replicate the institutional and political contexts necessary for the imported rule to function as originally intended.

5.3.2 Local adaption

The transplant adaption involves the transplant adaption and enforcement adaption, which refers to the legislative action and application of the rule respectively. However, both the legislative choice and the subsequent implementation by domestic institutions reflect structural tensions and contextual misalignments that have hindered its effectiveness.

The legal transplant theory indicates the transplant adaption includes the careful selection and modification of a foreign legal rule to ensure relevance to the recipient country's legal, economic, and institutional context. However, the transplantation of the independent director system into China did not follow this ideal path.

5.3.2.1 Transplant Adaption

The transplant of the independent director system was carried out in 2001 not through national legislation passed by the NPC, but by the issuance of the administrative policy document from the CSRC. This top-down reform lacks the deliberate process of legislative debate, which the help broader institutional discussions and stakeholder engagement. In other word, the transplantation of independent directors is not the product of a domestic reform movement, nor did it arise from sustained demands by civil society, investors, or legal scholars. Instead, its adoption was a strategic arrangement to restore investor confidence following several damaging financial scandals and to project convergence with global corporate governance standards.

However, this transplantation undergoes merely deep contextualization-what Örücü describes as "transposition" that considers local needs and institutional realities. Independent director system was largely drawn from U.S. corporate governance practice, particularly as it developed post-Enron, where independent directors serve as a safeguard against managerial abuse and protect minority shareholders. However, this model was adopted without robust comparative analysis or serious examination of whether the institutional foundations that make the model work in the U.S.—such as dispersed ownership, shareholder litigation, market-based accountability, and judicial independence—were present in China. While these institutional supports make independent directors not merely a regulatory command, but in response to deep market pressure and reputational incentives.

China’s case shows it lacks the institutional support, as a result, the independent director rule was not meaningfully “transposed” and tailored to the recipient’s structural and cultural characteristics. Instead, it was mechanically imposed in a manner that preserved political co troll and avoided any fundamental changes of current power hierarchy, especially within SOEs.

5.3.2.2 Enforcement Adaptation

If the first stage of transplant adaptation was compromised by formal design, the second stage—enforcement adaptation—has fared no better. Örücü refers to this phase as "tuning": the process by which local legal actors—judges, regulators, corporate officials—gradually reinterpret, enforce, and internalize the transplanted rule through ongoing practice. Ideally, this phase allows for correction of initial misfits and enables gradual alignment of the transplanted rule with the local institutional environment.

However, the "tuning" process has stunted. This is not merely a matter of capacity, but of structural constraints embedded in China's political and regulatory environment: the dominance of state interests in listed firms, weak legal accountability, and the absence of a supporting market infrastructure. Independent directors are often appointed not for their objectivity or expertise, but for their personal ties to controlling shareholders or political background. Many are current or former government officials, academics, or lawyers who sit on multiple boards simultaneously and devote minimal time or effort to oversight. The "one-third rule," which mandates a minimum proportion of independent directors on the board, is routinely satisfied in form but rarely in substance. They often serve as formal bodies that ratify decisions already made by executive management or the Party committee embedded within the company. Independent directors have little access to information, few channels for dissent. In the absence of legal or market-based accountability, there is minimal incentive for independent directors to challenge management or represent minority shareholders.

Even the CSRC has demonstrated limited capacity or willingness to enforce independent director duties rigorously. Regulatory action against directors is rare, especially in politically sensitive cases involving SOEs. Judicial institutions, likewise, have played a minimal role in defining or enforcing the fiduciary duties of directors.

The case of the independent director system in China demonstrates the limitations of local adaptation when both stages—transplant and enforcement—are undermined by institutional constraints, political priorities, and a lack of genuine contextualization. The Chinese experience thus affirms Örücü's insight that local adaptation of transplant rules is a deeply political and institutional process, where the effectiveness of legal transplants depends not on formal adoption, but on meaningful integration into the legal, economic, and political fabric of the recipient society.

5.3.3 Social demand

The internalization of a transplanted legal rule within a recipient legal system is closely tied to the degree of social demand that underpins it. As Berkowitz, Pistor, and Richard argue, legal institutions are only effective if there exists a societal demand for the rule, which ensures that the law is actively utilized rather than becoming a symbolic or unused provision.[1072] The

[1072] Daniel Berkowitz, Katharina Pistor and Jean Francois Richard, 'Economic Development, Legality, and the Transplant Effect' [2003] European Economic Review 174.

independent director system in China, while formally adopted, has struggled to become a functional part of the country's corporate governance infrastructure.

At the time of its transplantation in 2001, the independent director mechanism was not introduced in response to strong endogenous demand from within Chinese society. Rather, its adoption was promoted by external and institutional pressures: the CSRC was facing intense public criticism in the wake of major financial scandals (e.g., the Yin Guangxia fraud), and there was growing international emphasis on aligning Chinese corporate governance with global standards. Independent directors were introduced primarily as a regulatory response to restore public confidence and project credibility to international investors. However, this demand was not grounded in a widespread societal understanding of or advocacy for board independence. Investors, particularly the dominant retail investor base, lacked awareness of corporate governance mechanisms, while institutional investors were either politically cautious or structurally passive. Thus, although the reform addressed a general desire for improved market integrity, there was no specific, grassroots-level demand for the independent director model as the solution to governance problems.

Unlike some legal transplants that fail due to the existence of local substitutes, China's corporate governance landscape did not offer an equivalent mechanism to fulfill the oversight function intended for independent directors. In this sense, there was a structural gap that the independent director rule was designed to fill. However, the effectiveness of the rule was still undermined by the low level of familiarity with the concept among key stakeholders—including corporate executives, legal professionals, and investors.

This lack of familiarity meant that the rule was not actively used or demanded in practice. Independent directors often remained passive, their roles poorly defined and their appointment processes captured by controlling shareholders. Few companies or investors sought to use independent directors as a channel for accountability or governance improvement. As Berkowitz et al. suggest, unfamiliarity with a legal rule weakens the demand for its enforcement.[1073] This phenomenon is clearly evident in China's case, where the independent director mechanism, though legally mandated, has been applied unevenly and often ineffectively.

5.3.4 Misunderstanding and misapplication

Berkowitz et al. argue that the effectiveness of a borrowed legal rule depends heavily on how well its concepts, functions, and underlying values are understood by the legal community and, to a lesser extent, the general public.[1074] The transplantation of independent director system occurred with minimal investment in domestic legal education, professional training, or comparative contextualization. This lack of foundational understanding contributed to

[1073] ibid.

[1074] ibid 167.

widespread misinterpretations and strategic misapplications of the rule by both policymakers and legal practitioners.

At the time of transplantation, Chinese policy makers and corporate actors has misunderstood and strategically misused the rule. A recurring misconception among Chinese regulators and company boards has been to equate independence with political neutrality or professional prestige, rather than oversight function. Consequently, this has led to the appointment of retired government officials, professors, and financial experts whose reputational capital or institutional status conferred legitimacy, but who lacked the structural and functional independence necessary to challenge management decisions. This approach reflects a bureaucratic logic that prioritises credentials above accountability. The presence of high-status individuals on boards was seen as sufficient to reassure investors, even though such appointments often reinforced deference to controlling shareholders and discouraged critical scrutiny.

Another pervasive misunderstanding involves the conflation of the oversight role of independent directors with that of technical or strategic advisors. Although the Company Law references both supervisory and consultative functions, in practice, independent directors in many firms are expected primarily to offer advice rather than to engage in rigorous oversight—particularly regarding related-party transactions or managerial misconduct. This misconception is reinforced by cultural and relational norms. Notably, the social norm of reciprocity has been identified as a significant factor undermining board independence in China.[1075] Independent directors frequently feel indebted to senior management for their appointment, and in return, they reciprocate by endorsing management proposals without substantive evaluation. As empirical studies have shown, this dynamic leads to patterns of passive compliance, rather than active fiduciary engagement.[1076]

As a result, even well-qualified independent directors often do not perceive themselves as fiduciary monitors with duties to minority shareholders. Instead, they act as consultants or intermediaries, helping facilitate consensus among insiders rather than safeguarding outsiders' interests.

Such conceptual misalignment arises from deeper structural and epistemic deficiencies. As Kahn-Freund argued, without a deep understanding of the socio-political context from which a legal rule originates, the transplant risks being superficial and ineffective. In China, few legal professionals, corporate managers, or policymakers at the time had a comprehensive understanding of the functional logic behind the independent director role as it evolved in common law systems. The mechanisms that made independent directors effective in the U.S.—such as dispersed shareholding, active institutional investors, fiduciary culture, and judicial

[1075] Juan Ma and Tarun Khanna, 'Independent Directors' Dissent on Boards: Evidence from Listed Companies in China' (2016) 37 Strategic Management Journal 1547; Yanlin Li and others, 'Courtesy Calls for Reciprocity: Appointment of Uncertificated Independent Directors in China' (2021) 29 Corporate Governance: An International Review 352.

[1076] Ma and Khanna (n 115).

enforcement of director duties—were either weak or entirely absent in China. As a result, the rule was largely adopted in form but not in substance.

Following the adoption of the rule, the lack of structured legal education and professional training significantly impeded its internalization. In the U.S., the evolution of the independent director role has been supported by an ecosystem of legal interpretation, continuing education, and regulatory refinement. Corporate lawyers, judges, and regulators receive ongoing training through institutions such as the American Bar Association, the SEC, and state judicial colleges. In particular, Delaware courts have played a leading role in shaping the interpretation of independent directors' duties through a large body of case law, including decisions on director liability, shareholder litigation, and the business judgment rule.

In contrast, Chinese law schools in the early 2000s had limited coverage of modern corporate governance, let alone the specific functions of independent directors. Most legal curricula were rooted in doctrinal civil law frameworks and offered little exposure to comparative corporate law or governance theory. Judges, lawyers, and regulators—the key implementers of the rule—lacked the conceptual tools to give substantive meaning to board independence. This problem was compounded by institutional constraints: courts were hesitant to interfere in internal corporate affairs, and regulators (especially the CSRC) often prioritized administrative compliance over functional effectiveness. Without continuous professional development and judicial or administrative guidance on interpreting the duties of independent directors, the system remained formalistic.

5.4 Persistence of Ineffective Mechanism: A Rational Political Strategy

Chapter 1 outlined the central theoretical rationale for independent directors as a mechanism designed explicitly to mitigate agency conflicts and safeguard minority investor interests. Meanwhile, Chapter 2 provided a comprehensive theoretical framework outlining how institutional preconditions influence legal transplantation success, and the comparative analysis in Chapter 3 clearly demonstrated how these theoretical insights translate into effective governance across various jurisdictions. However, the stark institutional contrast outlined in Chapter 4 clearly demonstrates that China systematically lacks these critical institutional preconditions. The persistence of independent directors, therefore, must be understood as intentionally symbolic—a strategic political decision rather than a regulatory misunderstanding or oversight—aimed at preserving existing political-economic balances, as analysed extensively throughout this chapter.

As discussed in previous sections, the independent director mechanism was introduced in response to severe public pressure and significant reputational crises following major corporate scandals in the late 1990s. Its adoption was not driven by genuine market demand or robust institutional support, but rather by the strategic necessity to restore public confidence and to signal regulatory responsiveness and convergence with international governance standards. Over time, despite clear evidence of ineffectiveness and extensive scholarly critique, the revision has restricted to symbolic and technical adjustments rather than substantive reform.

This strategy reflects not a failure of comprehension but rather a calculated choice and political compromise aimed at preserving political stability and accommodating powerful vested interests within the existing governance framework.

The persistence of an ineffective independent director system in China reflects not merely institutional inertia but a carefully balanced political equilibrium. This equilibrium primarily serves three influential stakeholder groups whose interests strongly align with preserving the current symbolic governance framework: SOEs, regulatory authorities (i.e. CSRC), and local government authorities, on the other hand, the cost was bore by the minority shareholders and the Chinese capital market.

5.4.1 Beneficiaries of the Status Quo

The intended role of independent directors is impartial monitors, who is essential in restraining powerful controlling shareholders. The comparative analysis clearly demonstrates successful models (e.g., Singapore's GLCs), illustrating effective regulatory and political insulation required for genuine oversight. By stark contrast, the empirical reality documented in Chapter 4 shows that independent directors in China function mainly to legitimize managerial decisions and reinforce existing political and economic interests—directly benefiting powerful stakeholders such as state-owned enterprises, local governments, and regulatory authorities, rather than promoting genuine accountability. Moreover, the ongoing reforms consistently serve to strengthen the advantaged position of these actors.

5.4.1.1 SOEs and Their Leadership

SOEs remain the most influential beneficiaries of the current arrangement. As extensively discussed earlier in 5.2.2, SOEs hold substantial political and economic power within China's institutional framework.[1077] Their leadership consists of politically influential individuals appointed directly by Party organs such as the COD, holding ranks equivalent or superior to the CSRC. Because SOE executives often enjoy ministerial or vice-ministerial status, the bureaucratic hierarchy significantly constrains the CSRC's regulatory oversight capacity.

The analysis in Chapter 3, particularly from jurisdictions such as Singapore, underscores how effectively independent directors can function in state-dominated or politically sensitive contexts when properly insulted from political interference and supported by strong regulatory and judicial framework. However, as discussed in Chapter 4 and 5, these conditions are distinctly absent in China and the institutional environment starkly contrasts with these conditions. Independent directors in China's SOEs, for instance, largely function to legitimize managerial decisions and political interests, explicitly aligning with the preferences of politically powerful stakeholders rather than effectively monitoring them

[1077] See 5.3.2

Independent directors in China rarely pose substantive oversight threats due to their dependency on controlling shareholders for nomination and continued board tenure.[1078] Independent directors appointed to SOEs often have close ties—professional, personal, or political—with the controlling shareholders or executives who nominate them.[1079] This structural dependency ensures that independent directors pose little threat to existing managerial authority, maintaining executives' autonomy in crucial decisions like asset allocation, investment strategies, and related-party transactions.

Moreover, as the previous sections highlight, powerful SOEs operate strategically important sectors (energy, finance, telecommunications, and infrastructure), placing their governance beyond mere corporate considerations and integrating it within broader political and economic stability objectives.[1080] The nominal independence of directors provides SOE leadership with a valuable political and reputational buffer, enabling them to signal compliance with governance norms domestically and internationally, without risking substantive checks on their managerial autonomy. This arrangement consolidates managerial power, entrenches political patronage networks, and protects incumbent interests against both market discipline and regulatory oversight.

5.4.1.2 Regulatory Authorities: CSRC

For regulatory authorities such as the CSRC maintaining a system of symbolic rather than substantive governance serves significant political and bureaucratic advantages. Section 5.2.3 emphasizes that CSRC's constrained regulatory capacity largely stems from its bureaucratic position as a ministry-level public institution subordinate to the State Council, limiting its authority over politically powerful SOEs. Given these constraints, regulators prefer incremental, technical reforms over meaningful structural changes, as minimal intervention allows them to manage political risks effectively. Independent directors, introduced initially to respond to public pressure after accounting scandals, offer regulators an efficient and politically low-risk solution: they can be responsive to public pressures arising from corporate scandals and financial misconduct without provoking confrontation or conflict with politically entrenched SOE interests.

For the CSRC, symbolic governance aligns closely with bureaucratic incentives of minimizing political conflicts and maximizing institutional stability. Given the complex political dynamics highlighted earlier—such as the hierarchical ranking system and the politically charged appointment of SOE executives—the CSRC strategically maintains a minimalist regulatory approach. Its primary objectives include demonstrating compliance with international corporate governance standards, managing public perceptions, and maintaining a stable relationship with powerful economic and political stakeholders. Thus, ineffective independent directors allow the

[1078] See 4.5.4

[1079] Ibid

[1080] See 4.2

CSRC to signal regulatory reform while preserving critical relationships and bureaucratic harmony within China's political-economic ecosystem.

5.4.1.3 Local Governments and Regional Political Interests

Local governments constitute a crucial group benefiting significantly from maintaining the status quo. They are deeply interconnected with SOEs, relying heavily on these entities for employment, tax revenue, and financing major infrastructure projects within regional jurisdictions.[1081] This mutual economic dependency encourages local governments to maintain the autonomy of these enterprises, thereby reinforcing the preference for symbolic governance reforms rather than substantial board-level oversight mechanisms.

Local authorities are also deeply intertwined with SOE management through intricate political and economic relationships, including their role in local GDP performance assessments and cadre promotion.[1082] Introducing genuinely independent directors with strong oversight powers could disrupt established local power networks, potentially undermining local governments' ability to influence corporate decisions such as project approvals, financial resource allocation, and management appointments, which aligned with their regional economic priorities and political objectives. By supporting a governance mechanism that only nominally constrains managerial discretion, local governments retain significant economic control and political influence over corporate governance outcomes, thereby safeguarding regional political and economic stability.

5.4.2 Losers from the Status Quo

5.4.2.1 Minority Shareholders

Minority investors constitute the most direct and immediate victims of the persistently ineffective independent director system. The independent director mechanism was initially designed to protect minority shareholder interests, mitigate the risks associated with controlling shareholders' abusive behaviors, and promote transparency and fairness in corporate decision-making.[1083] From the comparative analysis of Chapter 3, the effective protection of minority investors through independent directors requires substantial legal authority, robust enforcement, and genuine director autonomy. However, due to structural and institutional factors—including the concentration of corporate ownership, politically influenced appointments, and the absence of meaningful judicial remedies—independent directors in China rarely serve these protective functions in practice.

[1081] Chenggang Xu, 'The Fundamental Institutions of China's Reforms and Development' (2011) 49 Journal of economic literature 1076.

[1082] See 5.3.1.4

[1083] See 4.4.2

Minority investors face severe informational asymmetries due to insufficient corporate transparency standards and inadequate disclosure practices. As discussed previously, without genuine oversight from independent directors, these investors remain vulnerable to systematic abuses such as asset tunneling, unfair related-party transactions, and misrepresentations of financial conditions.[1084] Moreover, procedural barriers, high litigation costs, and political sensitivities associated with contesting powerful state-affiliated interests significantly hinder minority shareholder's ability to assert their rights or pursue legal remedies.[1085] As a result, minority shareholders experience ongoing economic exploitation and the lack of power, significantly restricting their capacity to influence corporate governance outcomes and safeguard their economic interests.

5.4.2.2 Public Trust

The broader implications of maintaining symbolic and ineffective governance measures extend significantly beyond individual minority shareholders. Public confidence in corporate governance mechanisms and regulatory institutions is critically undermined by persistent governance failures and recurring corporate scandals. Ineffective independent director system reinforces widespread skepticism regarding market transparency, fairness and regulatory capability.

This leads to negative impact on market integrity and stability, fostering the culture of speculative short-term investment behaviour. The weak corporate accountability discourages long-term investment and the rational capital allocation, undermining the efficiency and credibility of the broader Chinese capital market. In this environment, the repeated governance failure result in further diminished investment incentives. Thus, public trust and overall market stability suffer significantly as collateral damage from maintaining ineffective governance mechanisms.

5.4.2.3 Market-oriented Reform and Broader Economic Development

The persistent ineffectiveness of the independent director system undermines the potential for market-oriented reform and has negative impact for the broader economic development. First, the institutional settings prevent the internalization and effective implementation of governance practices transplanted from mature market economies. The continued application of independent directors represents a missed opportunity for genuine structural reforms that could strengthen accountability mechanisms, improve corporate transparency, and enhance corporate governance efficiency. Such governance reform cultivates a regulatory environment resisting innovation and institutional evolution. Instead of fostering genuine corporate governance improvements, such as robust judicial enforcement mechanisms, stronger fiduciary standards, or empowered investor activism. The current system reinforces existing power structures, limits corporate innovation, and hinders institutional evolution necessary for ongoing

[1084] ibid

[1085] See 4.7

market development and competitiveness. As a result, China continues to adhere to governance practices that emphasise political stability and managerial control, often at the expense of long-term economic efficiency, market competitiveness, and institutional adaptability.

More broadly, the public and broader economic development are adversely affected by the persistence of ineffective corporate governance. When corporate governance consistently fails to prevent managerial abuses and inefficient decision-making, broader economic productivity and resource allocation suffer. The inability of corporate governance systems to ensure accountability, transparency, and market discipline negatively impacts overall economic growth, ultimately imposing costs upon society at large.

5.5 Rethinking Legal Transplant Theory

Legal transplant theory evaluates the success by whether a transplanted rule functions in its new context. The Chinese case, however, shows that ineffective transplants may continue not because of the failure to reform or the misunderstanding, but because their strategic function serves political goals. The independent director system is still in place in China not because its ineffectiveness, but because its ineffectiveness is politically useful. It allows regulators to signal the determination to reform and the compliance with international norms without threatening Party-state control.

The analysis in this chapter shows that transplants can be used to satisfy investors' demands, protect the company's reputation, or ease public criticism after financial scandals. The CSRC in China used the independent director system reform to deal with market problems without confronting SOEs or change the real balance of power. This highlights the critical change in legal transplant theory, that transplants may be designed to fail in function but succeed in purpose, particularly when the purpose is to confer legitimacy or satisfy external expectations.

Based on Kahn-Freund's concept of transferability, the analysis shows that legal transplants can be successful only when they are politically embedded and compatible with institutions. The independent director system are not neutral technical devices; they are deeply political. They work in the U.S. partly because they evolved in a system with dispersed shareholding, institutional investor activism, judicial enforcement, and a regulatory body insulated from political interference. In China's Party-state structure, which is based on SOE dominance, political appointments, and weak enforcement mechanisms, these conditions are absent, making the transplant structurally impossible.

China's case reveals that transplanted rules may be deliberately separated from their original functions. This goes beyond Örücü's concept of "tuning." In China, adaption is not about modify the rule to fit local context, it about keeping the rules form while changing its meaning. This separation is a rational political choice, it preserves appearances, avoids conflict with powerful interests, and maintains bureaucratic and political stability.

Earlier explanations for ineffectiveness of legal transplants focus on local demands, ot misunderstanding by policy makers, however, the analysis shows that such explanations are no longer sufficient in long-standing transplant cases like China's. Independent director system has been studied, criticised, evaluated, but no real changes have been made, which indicates that political incentives and institutional interests are more important than knowledge gaps or cultural mismatch in explaining transplant effects.

Concluding Remarks

This chapter has critically analyzed the transplantation of the independent director system into China's corporate governance framework through the lens of political economy, drawing heavily upon the theoretical insights of Kahn-Freund. The persistence of ineffective independent directors is a rational political strategy that is deeply embedded within China's political and economic institutions, contrary to simplistic explanations that attribute the system's ineffectiveness to misunderstandings or accidental adoption.

The analysis began by contrasting the U.S. experience, where independent directors evolved primarily due to market-driven factors and strategic compromises among powerful stakeholders—such as corporate managers and institutional investors—with China's state-driven, regulatory-centric approach. In contrast to the U.S., where independent directors developed naturally and offered significant oversight due to strong institutional supports like dispersed ownership structures, active institutional investors, judicial accountability, and market pressures, China's strategy was deficient in these essential institutional foundations.

The chapter identified several systemic barriers constraining the effectiveness of independent directors in China. Foremost among these is the Party-state apparatus's political dominance through powerful SOEs, which exert substantial political and economic influence, often ranking equally or higher than the main regulatory authority, the CSRC. The hierarchical and political constraints inherent in China's governance structure significantly limit regulatory enforcement capabilities, reducing independent directors to symbolic roles with minimal substantive oversight. Meanwhile, the lack of institutional support, characterised by inadequate judicial enforcement, ineffective market-based accountability mechanisms, and insufficient protection for minority investors, intensifies the ineffectiveness of independent directors.

The persistence of this ineffective governance mechanism reflects a carefully balanced political equilibrium serving powerful stakeholders: SOE executives benefit by maintaining managerial autonomy and political influence; the CSRC achieves bureaucratic stability and symbolic compliance without confronting powerful interests; and local governments preserve economic control and regional political stability by avoiding disruptions to established power networks. Conversely, minority shareholders suffer persistent exploitation, while public trust in corporate governance and regulatory integrity is significantly undermined, harming long-term market development.

Chapter 6 Conclusion

6.1 Addressing the Research Question

This thesis set out to explore a fundamental question: Why was the independent director system transplanted into China, and why does it persist despite its evident ineffectiveness? To find the answer to this central research question, it looked at different theoretical view, different corporate governance frameworks, and China's institutional realities. The thesis argues that the transplantation and persistence of the independent director system in China should not be understood as a failed or accidental reform, but as a rational political strategy that meets both internal and external needs while keeping political and economic elites in power in a state-capitalist system.

Rather than assuming that ineffectiveness signals regulatory failure or institutional misunderstanding, this thesis has shown that the independent director system in Chins works as a symbolic governance tool. It responds to reputational pressures, gives the impression of reform and convergence and allows for selective adaption without troubling established power structures. So, the sustained ineffective institution, therefore, shows not an inability to reform, but a political calculus within an authoritarian capitalist system.

To answer the research question, the thesis set out several objectives, each of which helped to figure out why China's persistence of independent directors despite constrained outcome. First, the thesis reviewed major theories in corporate governance, institutional transplantation and legal reform. Agency theory is the mainstream to explain the conflict of interests in corporate governance. However, it does not fully explain things because it assumes that independent directors work the same way in all situations and does not take into account how institutions are built into society. The study drew upon the different theoretical perspectives and legal transplant scholarship to better understand how reforms work in certain legal and political settings. This theoretical foundation makes it clear why formal convergence in governance structures doesn't always mean functional equivalence.

Second, the thesis looked at how the independent director model spread around the world by comparing jurisdictions like the UK, Germany, Japan and Singapore. Even through independent directors are widely borrowed, their roles, powers, and effectiveness depend a lot on the institutional logics of each legal system. The results of the comparison showed that transplants are often shaped by domestic needs rather than by copying legal models from other countries.

Third, it looked closely at Chinese system's internal structural constraints, including the Party-state control, weak legal enforcement, and the dominance of controlling shareholders, especially in state-owned enterprises. These limits the autonomy of independent directors and explain why formal. Institutional reforms fail to generate substantive outcomes.

Forth, by comparing the Chinese case with the U.S, which is the main source of the independent director system. It demonstrated how differences in ownership structure, enforcement and market discipline profoundly shape institutional outcomes. While independent directors in the US are empowered to act independently, directors in China operate within a context that systematically limits their autonomy.

Fifth, the thesis looked at the repeated changes to China's independent director system's rules and policies, and asking why reforms have failed to produce meaningful change. These revisions are mostly performative, designed to meet international standards and avoid criticism instead of actually empowering directors in practice. Such argument was reinforced by assessing the gap. Between policy intension and practical outcomes. Even though regulators talk a lot about making boards more independent, the institutional environment is still not receptive to meaningful change, highlighting the limits of such rule-based reform in the absence of deeper institutional transformation.

Looking at the roles of key actors, including the controlling shareholders, regulators, and the broader Party-state apparatus, the thesis seeks to understand their influence in shaping and maintaining a symbolic board independence. The thesis showed that these actors benefit from such appearance of reform while keeping effective control, making substantive director independence politically and economically undesirable.

Taken together, the findings of this thesis challenge the notion that China's independent director system is merely a failed transplant or poorly implemented reform. Instead, it offers a new perspective to look at legal changes in China, especially those borrowed from liberal market economy, which needs to view through the lens of political system adaptability and symbolic convergence. The independent director system persists not despite its ineffectiveness, but because its function of ineffectiveness: it satisfies external and internal stakeholders without threatening the core interests of state and Party control.

6.2 Some Theoretical Implications for Legal Transplant Theory and Comparative Corporate Governance Studies

6.2.1 Theoretical Implications for Legal Transplant Theory

Legal transplant theory has long tried to figure out whether and how legal rules and institutions can be successfully transferred across borders. Early scholarship, particularly the work of Alan Watson, emphasized the ease of legal borrowing with little regard for social political, or economic structures that were in place. Later scholars, especially Otto Kahn-Freund, Gunther Teubner, and Pierre Legrand, challenged this view by pointing out that law is deeply rooted in culture and transplanted rules can be misunderstood, adapted, or rejected in the host context because of the contextual incompatibility.

This thesis contributes to this evolving theory by offering an alternative explanation for the not well-fitted transplants. Using the example of China's independent director system, it demonstrates that poorly adapted transplants can not only survive but also continue to exist. The system continues not because it resolves Chinese corporate governance problems, but it is a politically low-cost, high symbolic mechanism. It creates the appearance of conforming to global corporate governance standards, particularly those of the United States, without threatening the real power structures that define corporate and political control in China. Its inefficiency is a political asset that offering flexibility to regulators while maintaining state dominance.

Unlike the conventional view that legal transplants fail because they are not fit within local institutions, this thesis further shows that transplants can succeed on symbolic grounds even when they functionally fail. The independent director system in China is a prime example of what might be called the formal transplant that is imported to serve as a visible marker of modernization, market reform, and global convergence, while also being adopted to serve local political purpose.

The analysis in this study leads to specific contributions to legal transplant theory, building on the example of China’s independent director system. These insights emphasize the strategic, symbolic and complex nature of transplantation in a top-down legal system, moving beyond conventional assessments of success or failure.

Legal transplant theory often assumes that convergence, either functionally, normatively, or economically is the goal. However, this thesis challenges the assumption that successful transplants need to copy their initial functions. In the Party-state country like China, the divergence between legal form and practical function is not a sign of failure but a feature of strategic governance. The independent director system is not intended to improve board oversight or shareholder protection in any meaningful way but taking actions to respond to the public while preserving internal political control.

Additionally, China’s case illustrates a broader pattern where transplanted legal rules are formally adopted and publicly emphasized but selectively applied or reinterpreted to serve domestic political goals. Instead of replacing existing governance practices, the independent director requirement has been added on top of them, producing the appearance of reform while preserving the underlying power structures. This analysis builds on and extends Teubner’s concept of "legal irritants"—foreign legal norms that provoke local adaptation or resistance—by suggesting that such tensions may be deliberately managed or neutralized. In this view, the selective implementation of transplants is not simply the result of cultural misfit, but a strategic choice to absorb external pressures without disrupting core institutional interests.

These insights enrich the legal transplant theory that moves beyond the culturalist or functionalist binaries. Instead, it advances a political economy approach to legal transplantation that emphasizes who benefits. From a transplant, how it is instrumentalized, and why ineffectiveness can be accepted. Or even preferred. The Chinese independent director system, in this view, is not a failed transplant but a strategic legal fiction: it borrows the legal institutions from other corporate governance model, but redefines its practice to suit its Party-state order.

For a broader implication, scholars should not presume that legal borrowings imply the functional convergence. Instead, it is necessary to consider the symbolic, reputational, and legitimating role of law. The argument that transplants succeed only when they effectively function needs to be reconsidered. In reality, legal rules can be used to serve political goals, hide a lack of real change, or create the appearance of aligning with international standards—even if they don't work in practice.

6.2.2 Theoretical Implications for Comparative Corporate Governance Studies

This thesis has substantive implications to the comparative study by challenging the common view that focusses on formal institutional structures instead of how their actual political and functional operation within the context. Much of the current literature in this field compares corporate governance systems based on formal structures—such as how many independent directors are required on a board, or whether certain legal duties are imposed. These comparisons often assume the formal or functional convergence to its origin.

However, this thesis shows that even similar rules can work very differently in practice, depending on the political and institutional environment in which they are involved. China's transplants try to copy those in the US and other development markets. For example, public-listed companies are requirement to have one third of independent directors in the board, but in reality, those independent directors often lack the independence, authority, and incentives to perform this role effectively. The controlling shareholder, often state-owned or Party-connected, has leading nomination rights. Independent directors feel pressured to follow the decisions of the majority or stay silent to preserve their directorship.

This suggests that just looking at the formal adoption is not enough. Instead, scholars need to look at how the rule is put into action, who is in control, and what role it actually plays in the broader governance system. This approach helps to explain why a rule, for example the independent director system, may contribute to stronger accountability in one country, but not in another.

Legal institutions do not operate in a vacuum, so formal comparisons are not enough. What they mean and how they work depend on the local context, such as political control, ownership structure, regulatory enforcement and informal cultural norms. In China, these factors have created a situation where the independent director system is still in place, not because it works as it should, but because it has other benefits. It signals to the international investors that China is aligned with global standards. It enables regulators to reference formal reforms when dealing with corporate scandals. And it helps to maintain the appearance of modern corporate governance, without challenging existing power structures. It shows that corporate governance institutions can be used for political purposes, going beyond the functions of supervision and shareholder protection. As a result, it should be cautious to assume the actual effect in different countries.

In sum, this thesis shows that comparative corporate governance must look at how institutions actually work in different legal systems, not just at rules themselves. China's case demonstrates that legal institutions can be adopted for political reasons, and that rules can survive because they serve for strategic purpose. This goes against the idea that reforms always aim to improve governance and supports a more realistic view of how corporate governance works in different political economies.

6.3 Practical implications to Corporate Governance

This thesis offers several important practical implications for policymakers, international development agencies involved in corporate governance reforms, particularly in developing countries and transitional economies. By examining the transplantation and persistence of independent director system in China, the research provides valuable lessons on how legal and institutional reforms are adopted, shaped, or undermined in different political and social settings.

6.3.1 Recognizing and Addressing Political Constraints of Governance Reform

One of the key lessons from this thesis is that governance reforms in China do not operate in a neutral or purely technical environment. When trying to improve board independence or strengthen regulatory oversight, it's important to think about the bigger picture, like the power of controlling shareholders, the Party-state's hold on power, and the limited freedom of regulatory bodies.

Reform efforts that focus solely on revising technical rules—such as increasing the number of independent directors, enhancing disclosure, or modifying nomination procedures — are unlikely to succeed unless the political structures that constrain director autonomy are also addressed. In other words, without changing the rules of director appointment, director's accountability and the exercise of regulatory authority, legal revisions are likely to produce limited or symbolic outcomes.

Therefore, reformers should take a more realistic and strategic approach that recognises that opposition to real board independence is not just due to poor implementation or lack of awareness, but also to deeply ingrained political and economic incentives. Building real independence on corporate boards in China will require more than rule changes—it will require institutional reforms that reduce the influence of dominant shareholders and enhance the credibility and capacity of enforcement mechanisms.

6.3.2 Adapting Legal Transplants to Local Contexts

This thesis highlights the risks of promoting standard, Western-style corporate governance reforms, e.g. independent director system discussed in this thesis, without taking into account the unique political, legal, and institutional realities in each country. International organizations or foreign investors often promotes legal reforms in many developing and transitional economies. These reforms often aim to copy successful models from more developed countries like the U.S. and U.K, where independent directors play an essential role in corporate governance.

However, the Chinese case shows that putting in place formal legal structures without making them fit with the local social and political environment can lead to a symbolic and ineffective legal reform. The independent director system has established, and the revision has persisted not because it fulfils its governance objectives, but because it plays an important political role, signalling compliance with international norms while preserving State dominance. These insights inform policymakers to stop using the checklist-style legal borrowing, and to pay closer attention to how laws operate within specific domestic context.

The thesis suggests that the "one-size-fits-all" approach to legal transplants may not be workable. Adopting foreign models without deep contextual adaption may lead to hollow institutions that only exist in name, particularly in state-led economies, where legal enforcement might be weak, ownership structure might be concentrated, or regulatory institutions politically constrained. This suggests that legal transplants should not simply be seen as the technical tool, but need to be carefully integrated with local norms, enforcement capabilities, and political realities. Policymakers and advisers should do country-specific research to understand local dynamics before recommending or implementing legal reforms.

6.4 Limitations of This Research

While this thesis provides a detailed and critical analysis of the independent director system in China and contributes to broader debates on legal transplantation and corporate governance, several limitations should be acknowledged.

First, this study focuses primarily on listed firms and the formal regulatory framework established by the CSRC. While this scope allowed for a detailed analysis of how independent director rules are constructed, revised, and publicly presented, it excludes other types of corporate entities such as unlisted private firms, non-public state-owned enterprises (SOEs), and foreign-invested enterprises, many of which play a significant role in China's broader economic landscape. In addition, the study relied on doctrinal and institutional analysis, rather than gathering empirical data on director behavior through fieldwork, interviews, or large-scale surveys.

Because listed companies—especially those traded on domestic or international stock exchanges—are subject to more formal governance regulation and external scrutiny, they are also more likely to demonstrate symbolic compliance with global governance norms. As a result, the study's focus on these firms may overrepresent the performative aspects of the independent director system and underrepresent how informal power dynamics operate in firms with different ownership structures, sectoral characteristics, or regulatory obligations.

The lack of direct empirical data on how independent directors behave in practice also limits the study's ability to capture internal motivations, pressures, and discretion exercised by individual directors. The thesis gives a strong institutional and political reason for why the system doesn't work as a whole, but it can't fully explain why behaviour varies between firms, industries, or regions, or tell the difference between directors who follow the rules and those who don't.

To address these limitations, I think future research should include more types of businesses, especially unlisted SOEs, family-owned businesses, to see if and how governance practices change depending on the type of ownership or sector. Moreover, future research can conduct empirical fieldwork such as semi-structured interviews with independent directors, regulators, and corporate insiders, or develop surveys to measure director perceptions, independence, and influence across different governance environments.

The second limitation is the lack of availability and reliability of primary data. Due to institutional opacity, political sensitivity, and limited access to internal governance processes in Chinese firms, this study necessarily relies on secondary literature, publicly available regulatory documents, official guidelines, and media reports. These sources give us a lot of information about how the independent director system evolved and be framed, but they do not tell behind-the-scenes dynamics such as how they work with Party organs, controlling shareholder and management teams.

Because of the reliance on secondary sources, it cannot fully understand the full picture of independent directors and the unwritten practices that may govern their behavior. Documents alone cannot answer important questions like whether directors feel pressure to conform, how they see their responsibilities, or they see their role supervisor or symbolic organ. Moreover, it is also hard to observe the window-dressing compliance or off-the-record influence without inside access. As a result, the thesis observes the macro-level analysis pf the political economy but pay less attention to the micro-level understanding of how actors engage with independent director system in practice.

To strengthen the empirical basis of the research, it can conduct interviews with current or former independent directors, board secretaries, Party representatives, and compliance officers to gain insight into internal board dynamics and institutional constraints.

6.5 Recommendation for Further Research

This thesis begins with the central puzzle: why was the independent director system transplant into China and Why does it persist despite its evident ineffectiveness? Through the interdisciplinary analysis grounded in legal transplant theory, comparative corporate governance, the study argues that the persistence of independent director system cannot be adequately explained by the functional or technical reasons. Instead, the existence of the system reflects its value as a symbolic instrument of governance, a performative legal transplant that enables the Chinese state and regulators to give the impression that they are in line with the global corporate norms and taking actions to strengthen corporate supervision, while maintain the existent power structure.

The Chinese case shows that legal transplants can be selectively adopted and built into the existing political and bureaucratic structures. This does not generate institutional transformation, but to serve alternative goals, such as regulatory signalling, reputational enhancement, or keeping reform pressure under control. The independent director system, although ineffective in enforcing real board independence, fulfils important political and institutional functions. The formal retention, periodic revision, and public endorsement shows the intention of the regulatory authority to be in line with successful governance standards, even though its practical limitations help to keep the power of the Party-state actors and controlling shareholders.

The findings carry broader implications for how we look at legal transplantation, legal reform and corporate governance in an authoritarian regime. They stress the ned to go beyond the surface assessment of legal convergence and instead ask what transplanted institutions actually work in practice, who they benefit, and why they exist despite the ineffectiveness.

The survival of China’s transplant of independent director system illustrates the Pary-state regimes can absorb, reshape global governance norms in ways that maintain political dominance while appearing to reform. Recognizing this pattern calls for a more critical and context sensitive approach to the study of legal reform, not just in China, but also in any legal system where political logic shape the law.