
ARTICLE

A STATUTORY BUSINESS JUDGMENT RULE FOR CHINA'S COMPANY LAW: THEORETICAL AND COMPARATIVE CONSIDERATIONS

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Table of Contents

I.INTRODUCTION.....	3
II.ECONOMIC ASPECTS OF CENTRALIZED DECISION-MAKING	7
A. The Need for a Centralized Decision-Maker	8
B. Protecting the Centralized Decision-Maker's Discretionary Powers.....	11
III.DELAWARE'S BUSINESS JUDGMENT RULE	17
A. Corporate Framework.....	18
B. Elements of Delaware's Business Judgment Rule	18
1. No Fraudulent or Illegal Act.	19
2. No Conflict of Interest	19
3. Consideration of Reasonably Available Material Information.....	20
4. Good Faith Act	20
C. Function of Delaware's Business Judgment Rule.....	22
D. Justification	22
IV.CORPORATE LAW FRAMEWORK OF THE CHINESE JOINT STOCK LIMITED COMPANY	24
A. Organizational Structure	24
1. Shareholders' Assembly.	25
2. Board of Directors.	25
3. Board of Supervisors.....	26
4. The Allocation of the Decision-Making Power.	26

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B.	Directors' and Supervisors' Duties	29
1.	Duty of Loyalty	29
2.	Duty of Care	30
3.	Good Faith.....	31
V.	REVIEW OF BUSINESS DECISIONS.....	32
A.	Review Framework	32
B.	Application of the Business Judgment Rule by Chinese Courts..	35
1.	Literature Review	35
2.	Review of Court Cases.....	37
VI.	TRANSPLANTATION OF THE BUSINESS JUDGMENT RULE INTO CHINA'S	
	COMPANY LAW	39
A.	Need for Recognition of the Business Judgment Rule.....	39
B.	Examples of Legal Transplants.....	40
1.	Example of Business Judgment Rule in Switzerland.	40
2.	Example of Business Judgment Rule in Germany	45
C.	Feasibility of a Transplant into China's Company Law.....	48
1.	Doctrinal Aspect: Whether the Business Judgment Rule Is	
	Compatible with China's Civil Law System.....	49
2.	Legislative Aspect: Whether a Statutory Business Judgment	
	Rule Is Feasible	51
3.	Enforcement Aspect: Whether the Business Judgment Rule	
	Would Be Enforceable.....	54
4.	Sociological Aspect: Whether the Business Judgment Rule Is	
	Compatible with the Chinese Culture.....	54
D.	Proposal for a Codified Business Judgment Rule	56
VII.	CONCLUSION.....	58

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Kevin M. Hubacher

Abstract

The conversion of China's planned economy to a socialist market economy cleared the way for the emergence of enterprises in the sense of the Coasean theory of the firm. A centralized decision-maker coordinates the allocation of resources and the firm's activities. He is vested with authority and responsible to the firm's owners. The tension between authority and responsibility is balanced by the business judgment rule, a concept first established by U.S. Delaware courts. China has no statutory business judgment rule, and neither the English-speaking scholars nor the Chinese courts have yet established a uniform understanding of it. This paper proposes that China's Company Law for joint stock limited companies has all the prerequisites needed for an adoption of the business judgment rule: It not only separates ownership and management but also grants a certain amount of authority to the companies' directors and supervisors, who are required to perform their duties in due care, under good faith and in a loyal manner. This paper, after having assessed the feasibility of a legal transplant of the business judgment rule, thus argues that China's Company Law should recognize the value of authority granted to the board of directors and the board of supervisors and implement a due process based ex post review of business decisions.

I. INTRODUCTION

In December 1978, the Third Plenary Session of the 11th Central Committee of the Communist Party of China heralded a big change by deciding to open up the People's Republic of China ("China").¹ In 2018, China was the world's second largest economy measured by gross domestic product at current U.S. dollars.² On the way, China abandoned planned economy and turned towards market driven economy, labelled as "socialist economic system" or

¹ James V. Feinerman, *Economic and Legal Reform in China, 1978-91*, 40 PROBS. COMMUNISM 62, 63 (1991); Yue-man Yeung, *China's Openness and Reform at 30: Retrospect and Prospect*, 9 CHINA REV. (SPECIAL ISSUE) 157, 157-58 (2009); Lin Justin Yifu & Shen Zhongkai, *Reform and development strategy, in CHINA'S 40 YEARS OF REFORM AND DEVELOPMENT* 117, 117-20 (Ross Garnaut et al. eds., 2018).

² THE WORLD BANK GROUP, *GDP (current US\$) | Data* (2020), https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?end=2018&most_recent_value_desc=true&start=1960 (last visited Feb. 10, 2020).

“socialist market economy” (see art. 6, para. 1 and art. 15, para. 1 Constitution³).⁴ Hence, market mechanisms (the price mechanism in particular) became more and more important for the allocation and coordination of labor, capital and resources.⁵

The term “market” describes a concept where goods and services are exchanged on the basis of individual transactions or, put differently, on the basis of contractual relationships.⁶ As Ronald H. Coase elucidated in his distinguished article *The Nature of the Firm*, the application of the price mechanism entails costs. Firms are established because they can reduce production costs by integrating certain transactions.⁷ According to Stephen M. Bainbridge, the decisive element of the Coasean model of the firm is the centralized decision-making. The decision-maker is vested with authority, directs the utilization of inputs and thereby reduces the (coordination) costs inherent in team production.⁸ The reason why the coordination of team activities requires authority lies in the fact that team members do not have identical interests and/or identical information.⁹ Authority thus increases the efficiency of group coordination (*i.e.*, decision-making) and information processing.¹⁰ A centralized decision-maker with unlimited authority, however, is not responsible to anyone; there is no need for the centralized decision-maker to consider the interests of any other member.¹¹ This calls for corrective measures, *i.e.*, for a system which holds decision-makers responsible (or accountable) for their actions.¹² Authority and responsibility are thus antithetical; an increase in authority implies a decrease in responsibility.¹³ Maximum responsibility leads to a shift of the decision-making power from the

³ XIANFA (1988) (China) [hereinafter *Constitution*].

⁴ Wu Qianlan, *The Making of a Market Economy in China: Transformation of Government Regulation of Market Development*, 13 EUR. L. J. 750, 754 (2007); JÁNOS KORNAI, FROM SOCIALISM TO CAPITALISM 47–60 (2008); Ding Xiaoqing, *The Socialist Market Economy: China and the World*, 73 SCIENCE & SOCIETY 235, *passim* (Apr. 2009).

⁵ For an explanation of economic planning, see Wallace Peterson, *Planning and the Market Economy*, 3 J ECON ISSUES 126, 126–27 (1969).

⁶ Instead of many Hugh G. J. Aitken, *A Note on the Definition of a Free Market*, 16 THE CANADIAN JOURNAL OF ECONOMICS AND POLITICAL SCIENCE 236, 237 (1950).

⁷ R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390–94 (1937).

⁸ Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 556–57 (2002) [hereinafter *Director Primacy*].

⁹ KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974).

¹⁰ *Id.* at 69.

¹¹ Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 468 (1991); *cf.* ARROW, *supra* note 9, at 65.

¹² *Id.* at 73–76; Dooley, *supra* note 11, at 468.

¹³ ARROW, *supra* note 9, at 77–78; Dooley, *supra* note 11, at 464; Bainbridge, *Director Primacy*, *supra* note 8, at 573.

centralized decision-maker to the ones to whom he¹⁴ is responsible.¹⁵ Maximum responsibility therefore deprives the firm of its original purpose, *i.e.*, the reduction of production costs through an efficient decision-making process.¹⁶ Consequently, the right balance between authority and responsibility has to be found.¹⁷

In many jurisdictions,¹⁸ a corporation's supreme authority is typically vested in the board of directors or an equivalent centralized corporate authority.¹⁹ It is the corporate law's task to provide a framework for an efficient decision-making system.²⁰ For this purpose, the U.S. corporate law developed the so-called business judgment rule which balances authority and responsibility.²¹ The business judgment rule is based on the economic theory of efficiency, as will be discussed later on,²² and has become a widely recognized legal institution implemented by numerous jurisdictions.²³

China's economic transformation cleared the way for the emergence of enterprises in the sense of the Coasean theory of the firm. In order to be competitive, especially in today's integrated world economy, Chinese firms need to incorporate a decision-making process whose efficiency at least matches its foreign counterparts. The question thus arises whether such a system is in process and how China's Company Law²⁴ balances authority and responsibility. This paper focuses on the *statutory* business judgment rule yet unknown to the Company Law.²⁵ Scholars suggest that the business judgment

¹⁴ For the sake of readability and simplicity, the masculine form was chosen in the text. Reference is nevertheless made to members of both genders.

¹⁵ ARROW, *supra* note 9, at 78; Bainbridge, *Director Primacy*, *supra* note 8, at 573; *see also* Huang Hui, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L. J. 227, 231 (2007).

¹⁶ *See* ARROW, *supra* note 9, at 78.

¹⁷ *Id.* at 79; Bainbridge, *Director Primacy*, *supra* note 8, at 573.

¹⁸ *See* chapters III (United States), VI.B.1 (Switzerland), VI.B.2 (Germany).

¹⁹ *Cf.* Dooley, *supra* note 11, at 467–68.

²⁰ Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 85 (2004) [hereinafter *Abstention*]; Dooley, *supra* note 11, at 463; Wayne O. Hanewicz, *Director Primacy, Omnicare, and the Function of Corporate Law*, 71 TENN. L. REV. 511, 511 (2003).

²¹ Bainbridge, *Director Primacy*, *supra* note 8, at 602–03.

²² *See* chapter II.

²³ Peter V. Kunz, *Business Judgment Rule (BJR): Fluch oder Segen?* [Business Judgment Rule (BJR): Curse or Blessing?], 3 SJZ 274, 274 (2014).

²⁴ Gongsì Fǎ (公司法) [Company Law] (promulgated by Standing Comm. Nat'l People's Cong., Oct. 26, 2018, effective Oct. 26, 2018), art. 2, CLI.1.324551(EN), translated by Chinalawinfo Co., Ltd., LTD., en.pkulaw.cn [hereinafter *Company Law*].

²⁵ GU MINKANG, UNDERSTANDING CHINESE COMPANY LAW 196–97 (2d ed. 2010); Sun Hui, *The Study on the Transplantation of Controlling Shareholders' Fiduciary Duty from U.S. to China*, 4 PEKING U. TRANSNAT'L L. REV. 72, 105 (2016); John D. Osgathorpe, *A Critical Survey of the People's Republic of China's New Company Law*, 6 IND. INT'L & COMP. L. REV. 493, 504 (1995); Wei Yuwa, *A Chinese Perspective on Corporate Governance*, 10 BOND L. REV. 363, 373 (1998) [hereinafter *Corporate Governance*].

rule is neither recognized by the Chinese courts,²⁶ nor is the Company Law ready for a legal transplant of the business judgment rule.²⁷

However, while the business judgment rule has not gone unnoticed among scholars of Chinese Company Law,²⁸ no in-depth review seems to have been conducted on the subject so far. It is therefore the purpose of this paper to establish a thorough understanding of the relevant aspects of the Company Law relating to the business judgment rule and to analyze what role the business judgment rule already plays in practice as far as joint stock limited companies (“Stock Companies”; art. 76 et seqq. Company Law) are concerned. In fact, this paper suggests that the business judgment rule fits well into the Chinese Company Law’s DNA and, contrary to the aforementioned scholarly opinions, has already received some judicial recognition.²⁹ Codifying the business judgment rule would not only help establish a uniform understanding of the rule but also enhance the statutory corporate governance framework of Stock Companies. The analysis focuses exclusively on the Stock Company with its typically broad owner base where the need for protecting the centralized decision-maker’s discretionary powers is especially high.³⁰ Due to the confines of this paper, the discourse concentrates uniquely on members of the Stock Company’s board of directors and board of supervisors without taking into account the role of officers or managers (cf. art. 113, para. 1 and art. 216, no. 1 Company Law).³¹

As the business judgment rule arbitrates the tensions between authority and responsibility, Part II discusses the economic aspects of centralized decision-making. It not only highlights the importance of protecting the centralized

²⁶ Weng Charlie Xiao-Chuan, *Assessing the Applicability of the Business Judgment Rule and the Defensive Business Judgment Rule in the Chinese Judiciary: A Perspective on Takeover Dispute Adjudication*, 34 *FORDHAM INT’L L. J.* 124, 141 (2010); Matthew P. Ponsford, *Corporate Governance and the Business Judgment Rule: Fiduciary Duties of Directors in Canada and the Peoples Republic of China*, 5 *J. CIVIL LEGAL SCI.* 1, 3 (2016); GU, *supra* note 25, at 196–97; cf. Luo Peixin, *A Brief Assessment of Corporate Governance in China*, 2 *US-CHINA L. REV.* 58, 61 (2005).

²⁷ GU, *supra* note 25, at 196–97.

²⁸ This paper only considers English written scholarly works regarding Chinese law and may, therefore, not fully reflect the scholarly opinions laid out in Chinese written works. English written works include: Weng, *supra* note 26; Ponsford, *supra* note 26; Zhu Yikun, *On directors’ accountability in China: Good faith path*, 4 *FRONTIERS L. CHINA* 401 (2009); Weng, *supra* note 26; GU, *supra* note 25, at 194–97; Hong Fidy Xiangxing, *Director Regulation in China: The Sinonization Process*, 19 *MICH. ST. U. COLL. L. J. INT’L L.* 501, 541–42 (2010); Xu Guangdong, et al., *Directors’ Duties in China*, 14 *EUR. BUS. ORG. L. REV.* 57, 66–73 (2013); Wei Yuwa, *Directors’ Duties Under Chinese Law: A Comparative Review*, 3 *UNELJ* 31, 49–54 (2006) [hereinafter *Directors’ Duties*]; Sun, *supra* note 25; Wang Jun, *On Cases against Corporate Managers for Breaching Their Duty of Loyalty and/or Duty of Diligence in China*, 10 *FRONTIERS L. CHINA* 77, 96–98 (2015); Luo, *supra* note 26, at 61–62.

²⁹ See chapter V.B.

³⁰ See chapter II.A; cf. regarding the Stock Company as a company with a broad owner base, see GU, *supra* note 25, at 27.

³¹ See in this regard for example: Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 *THE BUS. LAWYER* 439, *passim* (2005); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 *THE BUS. LAWYER* 865, *passim* (2005).

decision-maker's discretionary powers but also offers a unique explanation in this regard. Part III presents the "ideal model" of the business judgment rule developed by the case law of the U.S. state of Delaware. Part IV sheds light on the organizational structure of Stock Companies under the Company Law, the allocation of the decision-making power and the duties of the directors and supervisors. Part V introduces the legal framework for the review of business decisions and argues that the business judgment rule has already been recognized by Chinese courts. The question whether it is feasible to introduce a statutory business judgment rule into the Company Law is subject to the discourse under Part VI. The discussion looks at two foreign jurisdictions having transplanted the business judgment rule and analyzes four main aspects which might speak against the introduction of a statutory business judgment rule into the Company Law. Finally, Part VII concludes the analysis.

II. ECONOMIC ASPECTS OF CENTRALIZED DECISION-MAKING

The business judgment rule takes on a unique position in the concept of the firm. This position, somewhere³² between the antipodes of authority and responsibility, raises a number of fundamental questions, such as who owns the company in the first place, *i.e.*, who grants authority or, in other words, to whom the management owes responsibility,³³ and by whom and how the production factors (*e.g.*, employees, resources etc.) are to be allocated. These questions are not new and have attracted the attention of numerous scholars of various fields of research during the last couple of decades.³⁴ There are no conclusive answers to these questions.

This chapter introduces the economic aspects of centralized decision-making within the corporate context. These aspects build the basis for understanding the reasons for having a business judgment rule and how the rule

³² The question where exactly the business judgment rule intervenes is the *core* question of the discourse about managerial decision-making power (see ARROW, *supra* note 9, at 79; Bainbridge, *Director Primacy*, *supra* note 8, at 573).

³³ See in this regard chapter IV.

³⁴ The confines of this paper do not allow summarizing everything which has been written elsewhere. The interested readers might refer to the following scholarly works: Bainbridge, *Director Primacy*, *supra* note 8; ADOLF A. BERLE JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403 (2001) [hereinafter *Accountability*]; Margaret M. Blair & Lynn A. Stout, *Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) [hereinafter *Team Production*]; James H. Davis, et al., *Toward a Stewardship Theory of Management*, 22 AMR 20 (1997); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 JOURNAL OF POLITICAL ECONOMY 288 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 THE JOURNAL OF LAW AND ECONOMICS 301 (1983); Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, 4 JOURNAL OF LAW, ECONOMICS, & ORGANIZATION 119 (1988); Harry G. Hutchinson, *Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm*, 36 LOY. U. CHI. L.J., 1111 (2004); Michael Jensen & William H. Meckling, *Theory of the firm: Managerial behavior, agency costs and ownership structure*, 3 J. FIN. ECON. 305 (1976).

works from an economic perspective.³⁵ The discourse focuses on two hypotheses: First, every firm³⁶ needs a centralized decision-maker.³⁷ Second, the discretionary power of the centralized decision-maker needs to be protected. Both hypotheses refer to the same issue, *i.e.*, the allocation of decision-making power within a system of production. The first hypothesis rules out full decentralization where no centralized decision-maker exists at all.³⁸ The second hypothesis does not rule out that the centralized decision-maker is subject to checks and balances, but assumes that his power of discretion is to be protected.

A. *The Need for a Centralized Decision-Maker*

Each conclusion of a contract comes at a cost.³⁹ As the Coasean theory of the firm shows, the construct of the firm reduces the number of contracts needed through cooperation. The firm's owners⁴⁰ do not each need to negotiate and conclude a contract with every production factor (*e.g.*, employees, suppliers). Contracting parties may prefer single long-term contracts because of lower negotiation costs or the parties' risk behavior.⁴¹ Due to future uncertainty, long-term contracts only set forth the contractual limits of the parties' powers.⁴² "Within these limits, [the owner (or principal)] can therefore direct the [...] factors of production."⁴³ Long-term contracts require more coordination in terms of resource allocation. Hence, it is preferable to delegate the command of the resources to an authority (the agent).⁴⁴ The essential point of Coase's theory thus is that there is a *need* for a centralized decision-maker who is empowered to direct the resources and, consequently, to amend the contracts entered into

³⁵ For the legal mechanics of the business judgment rule *see* chapter III.A.

³⁶ In this chapter, the general term "firm" is used instead of the term "corporation", since the latter refers to a legal concept rather than to the economic tenet of the firm as an organizational structure.

³⁷ *Cf.* Dooley, *supra* note 11, at 466, asking who shall be the decision-maker; Stephen M. Bainbridge, *Why a Board—Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, *passim* (2002) [hereinafter *Board*].

³⁸ *Cf.* Ján Zábajník, *Centralized and Decentralized Decision Making in Organizations*, 20 J. LABOR ECON. 1, 5 (2002).

³⁹ Coase, *supra* note 7, at 390–91; *see* Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, 4 JOURNAL OF LAW, ECONOMICS, & ORGANIZATION 119, 121–23 (1988); *see* Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE LAW & POLICY REVIEW 265, 289–91 (1998).

⁴⁰ In the context of a corporation, the owners are the shareholders as holders of the residual claims.

⁴¹ Coase, *supra* note 7, at 391.

⁴² Coase, *supra* note 7, at 391.

⁴³ Coase, *supra* note 7, at 391; *see* in general with regard to information uncertainty Didier Dubois & Henri Prade, *Formal Representations of Uncertainty*, in DECISION-MAKING PROCESS 85, *passim* (Denis Bouyssou et al. eds., 1st ed., 2009).

⁴⁴ Coase, *supra* note 7, at 392; *cf.* Dooley, *supra* note 11, at 463–65; *see* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 THE AMERICAN ECON. REV. 777, 788 (1972); Blair & Stout, *Team Production*, *supra* note 34, at 263–64; Paul L. Davis, *The Board of Directors: Composition, Structure, Duties and Powers*, at 4–5 (2000), <https://www.oecd.org/daf/ca/corporategovernanceprinciples/1857291.pdf> (last visited Feb. 28, 2020); *see* further Patrick G. M. Bolton & Mathias Dewatripont, *Authority in Organizations: A Survey*, at 4 (2012), <https://pdfs.semanticscholar.org/e4d9/f21eff43a6d53bd60ffa1575baee25ab61f8.pdf> (last visited Feb. 28, 2020).

by the firm if required.⁴⁵ The decisive element leading to production costs reduction is that the owners are not involved in the negotiation, conclusion and maintenance of contracts (*i.e.*, monitoring and renegotiation as well as direction of resources).

In a fully decentralized scenario, *i.e.*, where a company (understood as a structure pooling two or more owners) is established but no centralized decision-maker exists, the owners would still be involved in the process of conclusion, negotiation and maintenance of contracts. There is no agent. In this scenario, the benefit of the concept of the firm to reduce production costs by appointing a centralized authority, who directs the resources, is non-existent.⁴⁶ In addition, the coordination between the owners would be very difficult (if not impossible) and thus costly because each owner possesses different information and has different interests.⁴⁷ Moreover, some owners would not involve themselves in the process of negotiation and maintenance of contracts due to the collective action problem. Instead, they would try to maximize their profit by having other owners bearing the negotiation and maintenance costs; they shirk responsibility.⁴⁸ The centralized decision-maker acts as a coordinator, makes sure that the common interest is pursued and alleviates the collective action problem as the owners bear the costs of the centralized decision-maker according to the percentage of their investment.⁴⁹

The diagram below epitomizes the described situation. On the left side, we can see a perfect market driven by the price mechanism (M_F). There is no need to establish a firm, as the owners (O_{1-5}) possess full information and no uncertainty exists.⁵⁰ Each owner individually enters into contracts with the production factors (P_{1-4}). In the middle, the market (M_F) consists of a firm with a centralized authority (A). The owners are not directly involved in the process of negotiation, conclusion and maintenance of contracts with the production factors. Finally, the right side shows a market (M_C) with a company without a centralized authority (-A). In an ideal world – without any collective action

⁴⁵ Bainbridge, *Director Primacy*, *supra* note 8, at 556–57.

⁴⁶ Cf. Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 353 (1991); cf. Bolton & Dewatripont, *supra* note 44, at 4.

⁴⁷ Dooley, *supra* note 11, at 466–67; ARROW, *supra* note 9, at 60–70; cf. Bainbridge, *Board*, *supra* note 37, at 5; see *e.g.*, with regard to the importance of information Alchian & Demsetz, *supra* note 44, at 793; this proposition does not neglect that common interests exist among the owners. Without these common interests, there would not be any incentive to incorporate a firm (see MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 5–8 (21st ed. 2003)). The statement assumes, however, that if the owners were directly involved in the processes of (re)negotiating the contract, they would pursue additional non-common (personal) interests.

⁴⁸ Cf. *id.* at 7; cf. with regard to the collective action problem also Fama, *supra* note 34, at 293; in the context of team production (as which the situation among the owners can be interpreted), this phenomenon is called “shirking” (Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 745 (1998) [hereinafter *Business Organizations*]; Alchian & Demsetz, *supra* note 44, at 780–81); cf. also Fama, *supra* note 34, at 293.

⁴⁹ The board of directors can, however, not fully resolve the collective action problem. Some owners only very passively (if at all) exercise their control rights (also called rational apathy) (see instead of many Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICHIGAN L. REV. 520, 521–29 (1990)).

⁵⁰ Cf. Coase, *supra* note 7, at 386–94.

problems – all owners would be heavily involved in the negotiation, conclusion and maintenance of the contracts with the production factors.

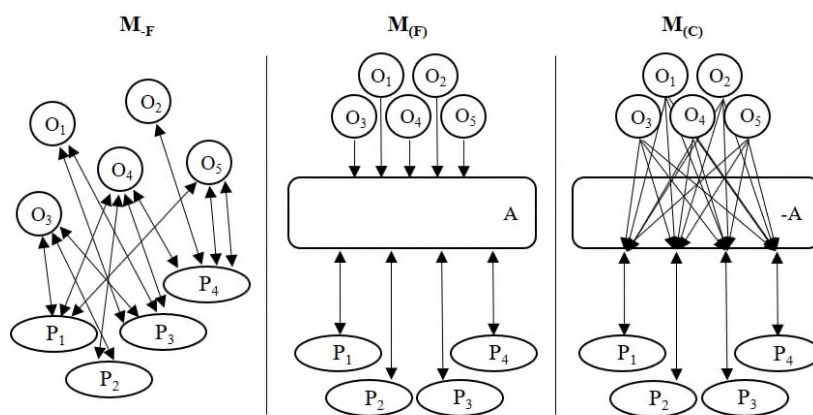


FIGURE 1. MARKET SCENARIOS WITHOUT AND WITH A FIRM AND WITH A COMPANY WITHOUT A CENTRALIZED AUTHORITY

The diagram above demonstrates impressively that a firm without a centralized decision-maker is not beneficial to the owners. However, the theory of the firm has not been left uncriticized, namely because it ignores how the interests and objectives of the different market participants are brought into a balance.⁵¹ This shortcoming becomes apparent when looking at the diagram above, which admittedly oversimplifies the relationships within and outside the firm. The existence of external suppliers, creditors or customers is suppressed.⁵² The contrarian understanding of the firm initially introduced by Michael C. Jensen and William H. Meckling emphasizes that the firm is nothing more than a “[...] legal fiction which serves as a nexus for contracting relationships [...]”.⁵³ Jensen and Meckling’s contrarian model seems to suggest that the necessity of a centralized decision-maker stems from the fact that the initial owner-managers seek risk diversification. Hence, they sell part of their shares in the firm in order to diversify their risks – due to uncertainty⁵⁴ – and reach an optimal portfolio selection.⁵⁵ Due to his somewhat restricted time budget, the

⁵¹ Jensen & Meckling, *supra* note 34, at 306–07, with further references.

⁵² Cf. Jensen & Meckling, *supra* note 34, at 310.

⁵³ Jensen & Meckling, *supra* note 34, at 311 (italics in the original omitted); see also Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 JOURNAL OF POLITICAL ECONOMY, 288, 290 (1980); contra Orts, *supra* note 39, at 274.

⁵⁴ Instead of many Harry M. Markowitz, *Foundations of Portfolio Theory*, 46 THE JOURNAL OF FINANCE 469, 469–70 (1991) [hereinafter *Foundations*].

⁵⁵ Jensen & Meckling, *supra* note 34, at 348–49; see with regard to the portfolio theory Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77, *passim* (1952) [hereinafter *Portfolio Selection*]; Markowitz,

owner-manager is not able to get involved in his other investments the same way as he is in his “initial” firm. Moreover, the costs of such multiple involvements would eventually exceed the portfolio diversification benefits. It is less costly to delegate certain powers to an authority within the firm. Not all owners are able (or willing) to reach an optimal portfolio diversification. Hence, small non-complex organizations exist where the decision-makers are also the owners.⁵⁶ However, “[w]hen there are many residual claimants [owners], it is costly for all of them to be involved in decision control and it is efficient for them to delegate decision control.”⁵⁷ In addition, the separation between owners and a centralized decision-making authority is preferred because the decision-making authority has better quantitative and qualitative (*i.e.*, more specific) information and can therefore make more efficient decisions leading to a production costs reduction.⁵⁸

The discussion above shows that market uncertainty, differences in the level of available information (*i.e.*, the importance of specialized knowledge), the interests pursued, as well as risk diversification make it necessary to have a centralized decision-maker in cases where a firm becomes complex due to a broad owner base.

B. *Protecting the Centralized Decision-Maker's Discretionary Powers*

Having affirmed the need for a centralized decision-maker, questions arise whether the centralized decision-maker has to be vested with authority and, if so, whether his discretionary powers are to be protected. The terms “authority” and “discretion” are used interchangeably herein.

For the purpose of this discussion, authority shall mean what Kenneth J. Arrow understood as “giving and taking of orders”.⁵⁹ Responsibility means that the giving and taking of orders is subject to a system of checks and balances, suggesting that the orders can be reviewed and repealed.⁶⁰ Responsibility limits the “power of free decision”,⁶¹ *i.e.*, the power of discretion. A decision-maker does not have discretion if he can merely choose between right and wrong. Discretion in the present context shall be understood along the lines of H. L. A. Hart's thoughts. A decision-maker thus enjoys discretion if there is:⁶²

Foundations, *supra* note 54, *passim*; *cf.* also Fama & Jensen, *supra* note 34, at 306; *see* further Fama, *supra* note 53, at 291, with further references; seemingly *contra* Alchian & Demsetz, *supra* note 44, at 785.

⁵⁶ Fama & Jensen, *supra* note 34, at 305–07; *see* also Orts, *supra* note 39, at 272.

⁵⁷ Fama & Jensen, *supra* note 34, at 309.

⁵⁸ Fama & Jensen, *supra* note 34, at 322; Alchian & Demsetz, *supra* note 44, at 793; *cf.* also Fama, *supra* note 53, at 294; *cf.* Tony Evans & Peter Hupe, *Conceptualizing Discretion*, in *DISCRETION AND THE QUEST FOR CONTROLLED FREEDOM* 1, 9 (Tony Evans & Peter Hupe eds., 1st ed., 2020).

⁵⁹ ARROW, *supra* note 9, at 63.

⁶⁰ *Cf. id.* at 65.

⁶¹ MERRIAM-WEBSTER DICTIONARY, *Definition of Discretion*, <https://www.merriam-webster.com/dictionary/discretion> (last visited Feb. 27, 2020); *see also* Evans & Hupe, *supra* note 58, at 7.

⁶² H. L. A. Hart, *Discretion*, 127 HARV. L. REV. 652, 659–60 (2013); *see also* Keith Carrington, *Is There a Need for Control?*, 29 PUBLIC ADMINISTRATION QUARTERLY 140, 142–43 (2005) (with further references);

- 1) no right or wrong answer to the question which is to be decided;
- 2) no exactly defined purpose (*i.e.*, the purpose is fairly vague);
- 3) uncertainty as to the environment under which the decision will be implemented; and
- 4) no rule or principle as to which values must prevail.

In other words, discretion exists if there is a *process of consideration requiring the decision maker's judgment*. Decisions based on such a process are in the following called "business decisions". The diagram below epitomizes the relationship between the antipodes of authority and responsibility. The decision-maker can only move along the "decision line".

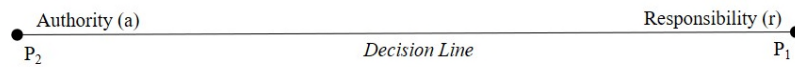


FIGURE 2. DECISION-MAKING MODEL

The model above shows two extreme positions. First, a decision-maker with absolute responsibility and hence no discretionary power (at P_1). This allocation of full responsibility can already be ruled out as the need for a centralized decision-maker has been established.⁶³ Arrow provides the appropriate proof for this: "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B [...]"⁶⁴ In the second position (at P_2), the centralized decision-maker has absolute authority. A firm where the centralized decision-maker is fully irresponsible is not imaginable and would equal mere gambling by the owners.⁶⁵ Under any circumstances, the owners would have the ultimate power to dissolve the firm. This second extreme position can thus be ruled out as well.⁶⁶ The centralized decision-maker is thus vested with limited authority.

The question how much authority the centralized decision-maker shall enjoy or, in other words, to what extent he is responsible is still contested and

cf. Gerald Robert Salancik & Margaret Cooper Brindle, *The Social Ideologies of Power in Organizational Decisions*, in *ORGANIZATIONAL DECISION MAKING* 111 (Zur Shapira ed., 1997), 124–28.

The following two examples shall help clarify the definition of discretion: (A) The legal obligation to formulate a financial report after the end of each fiscal year (art. 164, para. 1 Company Law) does not leave any choice to the company's management whether to make a financial report or not. There is a clear answer to this question. (B) In contrast, there is no right or wrong answer to the question whether the company shall invest in a new machine. From the outset, there also seems to be no defined purpose but a range of possible objectives, *e.g.*, reducing the production costs, increasing workplace safety, adapting to new technological inventions. The production environment in which the new machine will be operated is not clear either. Will it reduce the production costs? Will there be newer innovations which will be incompatible with the new machine? It is also unclear how to balance the interests of the various involved stakeholders (owners, management, employees, customers).

⁶³ See chapter II.A.

⁶⁴ ARROW, *supra* note 9, at 78; *see also* Davis et al., *supra* note 34, at 23; Huang, *supra* note 15, at 231.

⁶⁵ ARROW, *supra* note 9, at 76–77.

⁶⁶ *Cf.* Evans & Hupe, *supra* note 58, at 9, stating "[i]t is between the extremes of these two, complete freedom and total control, that discretion can be localized."

is the topic of two seemingly contrary⁶⁷ theories: the principal-agent theory⁶⁸ and the stewardship theory⁶⁹. This paper's and, consequently, this chapter's discourse focuses on whether the discretionary powers are to be protected (qualitative aspect). The question of how much authority or responsibility (quantitative aspect) shall be allocated to the centralized decision-maker thus has to be answered elsewhere.

But before answering the question why the discretionary power of the centralized decision-maker shall be protected, we must understand why we accept discretion at all. First, we have seen that we need a centralized decision-maker and that without any discretion (*i.e.*, full responsibility) his value dwindles, since the locus of decision-making moves to the owners. Second, humans are faced with two major problems. Hart calls them "Relative Ignorance of Fact" and "Relative Indeterminacy of Aim".⁷⁰ The first issue relates to a situation where a rule or principle ignores the existence of a fact.⁷¹ A mechanical application of the rule would lead to an unsatisfactory and inefficient result. The second issue relates to cases where competing interests need to be considered and balanced.⁷² Today's world, especially the economy, is so complex that most matters cannot be conclusively regulated by rules and principles. Hence, discretionary power is needed in order for the decision-maker to be able to (re)act.⁷³ This is the reason why we generally accept granting discretionary powers to an agent.

It is important to differentiate between accepting and protecting discretionary power. By allocating discretionary power to the decision-maker, the owner accepts that the decision-maker shall have discretion (to the extent limited at the time of its allocation). Protecting discretionary power means that the discretion once granted shall not be wrested from the agent. The first issue is thus concerned with the allocation *ex ante* the exercise of discretion. The second issue deals with the renunciation of the discretionary power *ex post* the exercise of discretion. The fact that the protection of the decision-maker's discretionary power is concerned with the *ex post* renunciation of its discretion is of particular significance as shown below.⁷⁴

Neither legal or economic scholars nor the courts seem to have suggested a general concept for justifying the protection of the centralized decision-maker's

⁶⁷ See Davis et al., *supra* note 34, at 38–40.

⁶⁸ Fama, *supra* note 34, *passim*; Davis et al., *supra* note 34, at 22–24.

⁶⁹ Davis et al., *supra* note 34, *passim*.

⁷⁰ Hart, *supra* note 62, at 661. Although Hart's explanation why we accept discretion mainly focuses on the discretion exercised by the administrative bodies and courts (*see* Hart, *supra* note 62, at 655), his findings can in my view also be more generally applied to the decision-making of the board of directors due to the generality of Hart's model.

⁷¹ Hart, *supra* note 62, at 661–62.

⁷² Hart, *supra* note 62, at 662–63.

⁷³ Cf. ALEXANDER NIKITINE, DIE AKTIENRECHTLICHE ORGANVERANTWORTLICHKEIT NACH ART. 754 ABS. 1 OR ALS FOLGE UNTERNEHMERISCHER FEHLENTSCHEIDE 165–66 (2007); *see* for a discussion of information problems and probability theories Dubois & Prade, *supra* note 43, *passim*.

⁷⁴ As far as can be seen, neither scholars nor courts have pointed out this fine but important differentiation.

discretionary power. Arguments for its protection have mainly been brought up in connection with the justification of the business judgment rule. Arguments, as will be showed later in more detail,⁷⁵ include incapability of the courts to review business decisions, inefficiency of judicial scrutiny, existence of hindsight bias, promotion of judicial efficiency, promotion of risk-taking or ripple effect on managerial freedom.⁷⁶ The model below shall help to conceptually – and not merely on a case-by-case basis – understand why it makes sense to protect discretion.

The ostensible argument says that, without protecting discretionary powers, the locus of decision-making would shift from the agent to the owner (in the following called “principal”). This lack of a centralized decision-maker would not be beneficial.⁷⁷ This argument is certainly true from a macro perspective, but not when looking at each business decision individually. There must be another reason. None of the arguments trying to justify the business judgment rule gets to the crux of the matter, while the hindsight bias argument comes closest. The root of the matter is that protecting discretionary powers means protecting business decisions from an *ex post* substantive review.

In case of an *ex post* substantive review of the agent’s business decision, we are confronted with a reversed principal-agent situation. The issue is not whether the principal shall be able to express his opinion on a certain matter or whether the agent shall exclusively handle the affairs of the firm.⁷⁸ The point is that the *ex post* substantive review shifts the problem of uncertainty in decision-making from the principal to the agent. There is no shirking or rent-seeking by the agent,⁷⁹ but sharking by the principal.⁸⁰ Sharking describes a situation where the principals “abuse their positions of authority and power within firms to act self-servingly.”⁸¹

Let us assume that the principal (P) owns a factory X for manufacturing a product A. P does not employ an agent but manages the affairs of the factory himself. P hears that the neighboring factory Y, which manufactures the same product A, is up for sale. P enters into the process of consideration and assesses whether to buy Y. P assumes that the demand for A will increase in the near future. Hence, P decides to buy Y. Six months after the acquisition of Y, a competitor launches a new product B that fully replaces A. Product A is no longer needed. P not only sits on X, but his business decision to buy Y also

⁷⁵ See chapter III.D.

⁷⁶ See the references provided for in notes 169–179; see, however, for a critical review of these arguments Aurelio Gurrea-Martínez, *Re-Examining the Law and Economics of the Business Judgment Rule: Notes for its Implementation in Non-US Jurisdictions*, 18 J. CORP. LAW STUD. 417, *passim* (2018).

⁷⁷ See chapter II.A.

⁷⁸ See with regard to the Delaware business judgment rule *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. (1984)).

⁷⁹ See with regard to the concepts of shirking and rent-seeking Orts, *supra* note 39, at 270–79; Blair & Stout, *Team Production*, *supra* note 34, at 249, n. 3–4; Alchian & Demsetz, *supra* note 44, at 780–82.

⁸⁰ See with regard to the concept of sharking Orts, *supra* note 39, at 268.

⁸¹ Orts, *supra* note 39, at 268.

turns out to have been (absolutely) wrong. Now imagine this case: P establishes a firm and hires a manager (agent M). M makes the exact same business decision as P did. P is highly unsatisfied because not only his residual claims are endangered but also his future dividends. P decides to file a lawsuit against M in order for the court to substantively review the business decision *ex post*.

There is no right or wrong *ex ante* answer to every question. This uncertainty entails costs. By reserving the right to conduct a substantive *ex post* review, the principal shifts the risk of uncertainty and the costs inherent to such uncertainty to the agent. This risk transfer decouples the natural antithetic pair of profit probability and failure probability (which equals decision uncertainty). While the principal enjoys all benefits, the risks are transferred to the agent. The agent is additionally burdened by costs that are naturally incurred by the principal. This risk transfer thus leads to sharking.

There are three solutions to solve this issue. The first solution is to prevent the principal from shifting the risk to the agent by limiting the principal's entitlement to substantively review the agent's business decisions *ex post* to a minimum. The second solution is that the agent accepts the risk transfer but demands a much higher payment considering the additional burden on his shoulders. The additional compensation requested will probably also include a premium in order to compensate for the agent's willingness to take on the risk. Assuming that the risk shift is not to be compensated would not only be unreasonable (and unfair) but also be against the principle that in a market every performance has a value and thus is to be compensated accordingly. The third solution is that the agent does not act at all but asks the principal to *ex ante* ratify each and every business decision. The principal's decision uncertainty risk is thereby transferred back from the agent to the principal. In the following, these three solutions are illustrated to help understand which of them is economically most efficient.

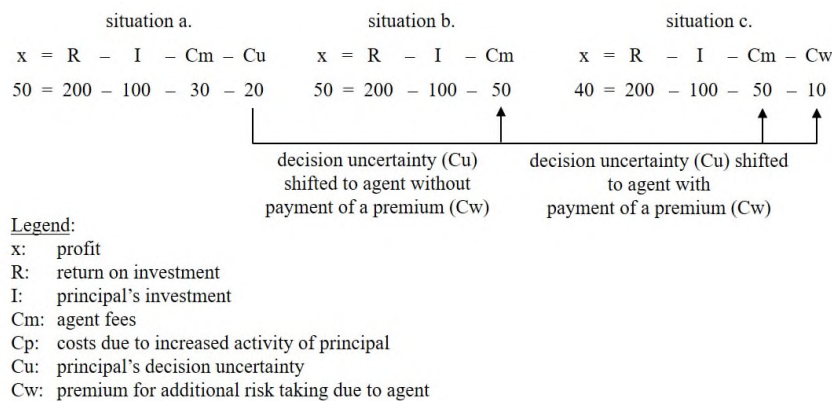


FIGURE 3. DECISION-MAKING SCENARIOS WITH (A.) AND WITHOUT (B., C.) THE PROTECTION OF THE AGENT'S DISCRETIONARY POWERS

Situation a. (*see* Figure 3 above) refers to the first solution. In this situation, the principal hires an agent M who receives agent fees (C_m) for his management activities. The decision uncertainty risk (C_u) remains with the principal since the substantive *ex post* review of the agent's business decisions is limited. The principal's utility (*i.e.*, the profit) (x) will thus be the result of the return on investment ($R = 200$) minus the principal's investment ($I = 100$) minus the agent fees ($C_m = 30$) minus the principal's decision uncertainty risk ($C_u = 20$).

Situations b. and c. (*see* Figure 3 above) refer to the second solution where the agent accepts the transfer of the principal's decision uncertainty risk. In the best case, from the perspective of the principal, the situation b. leads to a zero-sum game provided that the increase of the agent fees equals the principal's initial costs of uncertainty (*i.e.*, C_m plus C_u). In this situation, the principal's profit (x) would be the result of the return on investment ($R = 200$) minus the principal's investment ($I = 100$) minus the agent fees increased by the amount of the principal's decision uncertainty risk ($C_m = 30 + 20 = 50$). In this situation, no premium for the agent's willingness to take on the additional risk would be due. This situation is unlikely. In the worst case c., from the perspective of the principal, the costs are higher compared to situation a., in which the principal has not shifted the risk since the principal has to pay a premium to the agent for taking on the additional risk (C_w). In this situation, the principal's profit (x) would be the result of the return on investment ($R = 200$) minus the principal's investment ($I = 100$) minus the agent fees increased by the amount of the principal's decision uncertainty risk ($C_m = 30 + 20 = 50$) minus the premium due to the agent for his willingness to take on the additional risk ($C_w = 10$).

Finally, situation d. (*see* Figure 4 below) refers to the third solution where the principal is asked to ratify each and every of the agent's business decisions. The decision uncertainty risk ($C_u = 20$) is thereby transferred back from the agent to the principal. Hence, no premium is due to the agent for taking on the additional risk. The principal who wanted to save the costs for being active himself (C_p) by setting up a firm and engaging an agent again bears the costs to be active himself. Compared to situation a., the principal's profit decreases substantially and would be the result of the return on investment ($R = 200$) minus the principal's investment ($I = 100$) minus the agent fees ($C_m = 30$) minus the principal's decision uncertainty risk ($C_u = 20$) minus the additional costs due to the principal's own increased amount of activity ($C_p = 40$).⁸²

⁸² The uncertainty costs remain but are now again incurred by the principal. Compared to the example before, no C_w is due. C_p must be higher than C_m because otherwise the principal would not have engaged the agent in the first place.

situation c. $x = R - I - C_m - C_w$ $40 = 200 - 100 - 50 - 10$	situation d. $x = R - I - C_m - C_u - C_p$ $10 = 200 - 100 - 30 - 20 - 40$
decision uncertainty (Cu) shifted back to principal and increased involvement of principal (Cp)	

Legend:

- x: profit
 R: return on investment
 I: principal's investment
 Cm: agent fees
 Cp: costs due to increased activity of principal
 Cu: principal's decision uncertainty
 Cw: premium for additional risk taking due to agent

FIGURE 4. DECISION-MAKING SCENARIOS C. AND D. WITHOUT THE PROTECTION OF THE AGENT'S DISCRETIONARY POWERS

The examples above show that the principal's profits decrease if the centralized decision-makers' discretionary powers are not protected, since the costs either rise as the agent has to be compensated for taking on the principal's decision uncertainty risk or the principal has to engage himself heavily in the decision-making process. The first solution, *i.e.*, protecting the centralized decision-maker's discretionary powers, is thus the most efficient solution to the dilemma discussed above. From an economic perspective, it is therefore preferable to establish a responsibility mechanism to ensure the agent's adherence to the rules of the decision-making process (*due process*) without the necessity of conducting a substantive review.⁸³

Another important learning from the above discourse is: Decisions which do not require the centralized decision-maker to enter into the process of consideration, *i.e.*, do not require any discretion, are not worth to be protected.⁸⁴

III. DELAWARE'S BUSINESS JUDGMENT RULE

The initial formulation of the business judgment rule is traced back to the Delaware law, which established the rule in connection with the review of board decisions.⁸⁵ Over the years, many different alterations of the business

⁸³ Cf. Hart, *supra* note 62, at 664.

⁸⁴ Accord NIKITINE, *supra* note 73, at 166.

⁸⁵ Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J. L. & BUS. 27, 28–31 (2017), who deviates from the praxis (*see e.g.*, *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52, note 61 (Del. (2006))) to view the famous *Aronson v. Lewis* case dealt with by the Supreme Court of Delaware (*Aronson v. Lewis*, 473 A.2d 805 (Del. (1984))) as the rules' origin and posits that the business judgment rule was established by *Bodell v. Gen. Gas & Elec. Corp.* handled by the Supreme Court of Delaware (*Bodell v. Gen. Gas & Elec. Corp.*, 140 A. 264 (Del. (1927))); *see further* S. Samuel Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 93 (1979).

judgment rule have been suggested.⁸⁶ This paper focuses on the business judgment rule under Delaware law as the rule's "ideal model".⁸⁷

A. Corporate Framework

The Delaware Code, Title 8, Chapter 1 ("Delaware General Corporation Law" or "DGCL")⁸⁸ sets forth the framework of the corporation under Delaware law. The organizational structure of the corporation consists of the stockholder meeting (§ 211 DGCL), the board of directors (§ 141(a) DGCL) and one or more officers (§ 142(a) DGCL). The board of directors manages and directs the business and affairs of the corporation (§ 141(a) DGCL). The board of directors is not allowed "to delegate [its] duty to manage corporate enterprise".⁸⁹

The members of the board of directors are bound by three fiduciary duties, *i.e.*, the duty of care, the duty of loyalty and the duty of good faith.⁹⁰ The duty of loyalty requires the directors to act without any conflict of interest and independently in the best interest of the company.⁹¹ The duty of care stipulates that the board of directors performs its duties in the best interest of the company. The directors must thereby act like an ordinary person prudently performing their obligations and must reasonably believe that their acts are in the company's best interest.⁹² The standard of care is, thus, both objective and subjective.⁹³ With regard to the decision-making process, the duty of care obliges the directors to gather all reasonably available information.⁹⁴

B. Elements of Delaware's Business Judgment Rule

There is no generally recognized definition of the business judgment rule under Delaware law,⁹⁵ but the elements listed below are widely accepted as

⁸⁶ Lael Daniel Weinberger, *The Business Judgment Rule and Sphere Sovereignty*, 27 T. M. COOLEY L. REV. 279, 283 (2010), with further references.

⁸⁷ Sharfman, *supra* note 88, at 32–33.

⁸⁸ DEL. CODE ANN. tit. 8, § 101–§ 398 (West 2020) [hereinafter *Delaware General Corporation Law* or *DGCL*].

⁸⁹ *Lehrman v. Cohen*, 222 A.2d 800–808, 802 (Del. (1966)); *see* Gordon, *supra* note 46, at 348–49.

⁹⁰ *In re Walt Disney Co. Deriv. Lit.*, 731 A.2d 342, 353 (Del. Ch. (1998)); *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. (2011)); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. (1998)); *see, however, In re Think3 Inc.*, 529 B.R. 147–213, 178 (Bkrcty.W.D.Tex. (2015)).

⁹¹ *Instead of many Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361–66 (Del. (1993)); *In re Think3 Inc.*, 529 B.R. 147–213, 175 (Bkrcty.W.D.Tex. (2015)); Robert S. Reder & Tiffany M. Burba, *Delaware Court Dismisses Duty of Loyalty Claim Against Disinterested, Independent Directors*, 69 VAND. L. REV. EN BANC 235, 235–36 (2016).

⁹² *Instead of many Melvin A. Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 439–40 (1993) [hereinafter *Standards*].

⁹³ Eisenberg, *Standards*, *supra* note 92, at 439–40; NIKITINE, *supra* note 73, at 99; *seemingly contra* Clark W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware*, 2009 UTAH L. REV. 1061, 1084–85 (2009) [hereinafter *Good Faith*].

⁹⁴ *In re Think3 Inc.*, 529 B.R. 147–213, 172 (Bkrcty.W.D.Tex. (2015)); *Brehm v. Eisner*, 746 A.2d 244, 246 (Del. (2000)); *cf.* Eisenberg, *Standards*, *supra* note 92, at 440.

⁹⁵ NIKITINE, *supra* note 73, at 104–05.

being pertinent to the business judgment rule. The business judgment rule presumes that in making⁹⁶ a business decision, the board of directors:

- 1) did not act fraudulently or illegally;⁹⁷
- 2) was free of any conflict of interest;⁹⁸
- 3) considered all reasonably available material information;⁹⁹
- 4) acted in good faith (and honestly believed that the business decision was in the company's best interest).¹⁰⁰

As authority cannot go unlimited,¹⁰¹ business decisions shall be substantively reviewed if the above-mentioned criteria are not met.¹⁰²

1. No Fraudulent or Illegal Act. Acts against the law (be it fraud or illegal acts as such) do not justify an abstention from substantively reviewing the business decision.¹⁰³ In addition, fraudulent behavior which does not constitute a criminal offense could well be captured by the good faith condition.¹⁰⁴

2. No Conflict of Interest. Interested (*i.e.*, conflicted) directors cannot rely upon the business judgment rule.¹⁰⁵ A director is interested when he shows self-interest in a certain business matter.¹⁰⁶ The self-interest must materially affect the director's independence.¹⁰⁷ In addition, not only self-interested directors are deemed to have a conflict of interest but also directors who follow

⁹⁶ Only an actual decision, *i.e.*, an effective act, is subject to the business judgment rule (Aronson v. Lewis, 473 A.2d 805, 813 (Del. (1984)); Weinberger, *supra* note 86, at 285.

⁹⁷ See note 119 for references.

⁹⁸ See note 125 for references.

⁹⁹ See note 134 for references.

¹⁰⁰ See note 139 for references.

¹⁰¹ ARROW, *supra* note 9, at 79; Dooley, *supra* note 11, at 468.

¹⁰² This question is not to be confused with that of what directors are allowed or not allowed to do. This is not a matter of when a business decision can be substantively examined, but is to be governed by the rights and duties of the board of directors and other laws (*e.g.*, criminal law); see for an explanation how the business judgment rule works chapter III.C.

¹⁰³ Brehm v. Eisner, 746 A.2d 244, 266 (Del. (2000)); Schlensky v. Wrigley, 237 N.E.2d 776–781, 780 (Ill. App. Ct. (1968)); Davis, Louisville Gas & Elec. Co., 142 A. 654, 659 (Del. Ch. (1928)); Weinberger, *supra* note 86, at 287; Sharfman, *supra* note 88, at 39; Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355, 1367–68 (1992); Arsh, *supra* note 85, at 122–24.

¹⁰⁴ See chapter IV.B.3.

¹⁰⁵ Aronson v. Lewis, 473 A.2d 805, 812 (Del. (1984)); see also Brehm v. Eisner, 746 A.2d 244, 247 (Del. (2000)); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. (1993)); *In re Think3 Inc.*, 529 B.R. 147–213, 175 (Bkrcty.W.D.Tex. (2015)); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. (1985)); Weinberger, *supra* note 86, at 286–87; Sharfman, *supra* note 88, at 55; Hansen, *supra* note 106, at 1364–65.

¹⁰⁶ Aronson v. Lewis, 473 A.2d 805, 812 (Del. (1984)); Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 267 (Del. (1927)); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. (1985)); instead of many Weinberger, *supra* note 86, at 286; Furlow, *Good Faith*, *supra* note 93, at 1085–86.

¹⁰⁷ Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362–64 (Del. (1993)); *In re Think3 Inc.*, 529 B.R. 147–213, 175 (Bkrcty.W.D.Tex. (2015)).

another interest than the one stipulated by the applicable law.¹⁰⁸ As the board of directors is a multi-member organ, the business judgment rule can only be rebutted when the majority of directors were conflicted.¹⁰⁹

3. Consideration of Reasonably Available Material Information. *Aronson v. Lewis* stipulated that in order “to invoke the [business judgment] rule’s protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.”¹¹⁰ *Brehm v. Eisner* made clear that the board of directors only has to consider “material facts that are *reasonably* available, not those that are immaterial or out of [its] reasonable reach.”¹¹¹ If the director fails to consider all material information, he does not properly exercise his power of discretion, namely to consider all probable interests, values and consequences at stake.¹¹² Delaware law applies the standard of gross negligence.¹¹³

4. Good Faith Act. The business judgment rule presumes that the directors act in good faith.¹¹⁴ Good faith is a vague legal concept.¹¹⁵ Because the interpretation of the concept of good faith may vary from one jurisdiction to the other, no in-depth analysis of good faith under Delaware law shall be made at this point.¹¹⁶ Some aspects, however, remain noteworthy. The duty of good faith is concerned with the directors’ intention behind the decision¹¹⁷ and

¹⁰⁸ See *Borden v. Sinskey*, 530 F.2d 478, 495 (3d Cir. (1976)) (not under Delaware law, however); Hansen, *supra* note 106, at 1364–65; Furlow, *Good Faith*, *supra* note 93, at 1086.

¹⁰⁹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984)); see *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364–65 (Del. (1993)); cf. Mark A. Underberg, *Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 607 (1979), with further references.

¹¹⁰ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984)); see also *Brehm v. Eisner*, 746 A.2d 244, 258–60 (Del. (2000)); *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. (1985)); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367–68 (Del. (1993)); instead of many: *Weinberger*, *supra* note 86, at 285; *Sharfman*, *supra* note 88, at 48–50; Hansen, *supra* note 106, at 1363, 1372.

¹¹¹ *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. (2000)) (italics in the original text); see also *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. (1985)) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984))); *Weinberger*, *supra* note 86, at 285–86.

¹¹² This conclusion can be derived from the definition of discretion (see chapter II.B). The effect of not properly exercising discretion equals the situation where no discretion was allocated at all. This justifies that the final decision is subject to a substantive review.

¹¹³ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984)); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. (1985)); see also *Sharfman*, *supra* note 88, at 48–49; *Weinberger*, *supra* note 86, at 286.

¹¹⁴ *Aronson v. Lewis*, 473 A.2d 805, 805 (Del. (1984)); *Smith v. Van Gorkom*, 488 A.2d 858, 859 (Del. (1985)); *Brehm v. Eisner*, 746 A.2d 244, 247 (Del. (2000)); Hansen, *supra* note 106, at 1361; *Bainbridge, Abstention*, *supra* note 20, at 88–90.

¹¹⁵ Cf. Furlow, *Good Faith*, *supra* note 93, at 1062; cf. Elizabeth A. Nowicki, *A Director’s Good Faith*, 55 BUFFALO LAW REVIEW 457, 478–80 (2007).

¹¹⁶ See for a discussion of the concept of good faith under Chinese law chapter IV.B.3; see for a number of references to scholarly works on this topic Nowicki, *supra* note 118, at 478, n. 48.

¹¹⁷ Furlow, *Good Faith*, *supra* note 93, at 1092; see *Bodell v. Gen. Gas & Elec. Corp.*, 140 A. 264, 267 (Del. (1927)), which did not use the term “good faith” but “improper motive”; similarly, *Schlensky v. Wrigley*, 237 N.E.2d 776–781, 780 (Ill. App. Ct. (1968)).

does not lead to a review of the decisions' substantive merits.¹¹⁸ The good faith concept is dependent either on the legislator (typically in civil law jurisdictions) or the courts (in common law jurisdictions) to decide which intention is good or bad. *In re Think3 Inc.* posits that the "duty of good faith relate[s] to a fiduciary's state of mind to act within the best interests of the corporation and its shareholders."¹¹⁹ Accordingly, Delaware case law developed the following two categories of cases which imply bad faith:¹²⁰

- 1) intentional act to harm the company;¹²¹ and
- 2) "intentional dereliction of duty, a conscious disregard for one's responsibilities."¹²²

These two categories are still vague, but the case law provides some further guidance. The courts held that cases of egregiousness¹²³, irrationality¹²⁴ and waste¹²⁵ show that the decisions were made in the absence of good faith. The courts seem to apply both a subjective and an objective standard. It is, on the one hand, asked what the directors believed (subjective aspect) and, on the other hand, if such a belief is in line with what a reasonably prudent person would have believed (objective aspect).¹²⁶

¹¹⁸ *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. (2000)); *cf.* *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. (1984)); *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52 (Del. (2006)) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984))); *Bainbridge, Abstention*, *supra* note 20, at 90.

¹¹⁹ *In re Think3 Inc.*, 529 B.R. 147–213, 151 (Bkrcty.W.D.Tex. (2015)).

¹²⁰ *In re Think3 Inc.*, 529 B.R. 147–213, 178 (Bkrcty.W.D.Tex. (2015)); *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 67 (Del. (2006)); *Stephen M. Bainbridge, et al., The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 588 (2007); *Bainbridge, Abstention*, *supra* note 20, at 88; *see with regard to the stand-alone character of the duty of good faith Hillary A. Sale, Delaware's Good Faith*, 89 CORNELL L. REV. (JANUARY) 456, 482–86 (2003); *Robert Baker, In Re Walt Disney: What It Means to the Definition of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation*, 4 FLA. ST. U. BUS. REV. 261, 267–68 (2004); criticizing this approach and arguing that good faith is not a stand-alone fiduciary duty, *see Furlow, Good Faith*, *supra* note 93, at 1062–63.

¹²¹ *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 64 (Del. (2006)); *In re Think3 Inc.*, 529 B.R. 147–213, 178 (Bkrcty.W.D.Tex. (2015)) (quoting *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 64 (Del. (2006))).

¹²² *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 66 (Del. (2006)); *In re Think3 Inc.*, 529 B.R. 147–213, 178–179 (Bkrcty.W.D.Tex. (2015)) (quoting *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 66–67 (Del. (2006))).

¹²³ *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. (1984)); *In re Citigroup Inc.*, 964 A.2d 106, 108 (Del. Ch. (2009)); *In re Walt Disney Co. Deriv. Lit.*, 731 A.2d 342, 346 (Del. Ch. (1998)).

¹²⁴ *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. (2000)), with further references; *In re Citigroup Inc.*, 964 A.2d 106, 110 (Del. Ch. (2009)); *Hansen, supra* note 106, at 1366, with further references; *Weinberger, supra* note 86, at 287.

¹²⁵ *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. (2000)); *In re Walt Disney Co. Deriv. Lit.*, 731 A.2d 342, 369 (Del. Ch. (1998)); *In re Citigroup Inc.*, 964 A.2d 106, 110 (Del. Ch. (2009)); *Hansen, supra* note 106, at 1365, with further references.

¹²⁶ *See In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 62 (Del. (2006)); *cf. Hansen, supra* note 106, at 1366; *cf. Furlow, Good Faith, supra* note 93, at 1091–92; *cf. Melvin A. Eisenberg, Whether the Business-Judgment Rule Should Be Codified*, 28 CALIFORNIA LAW REVISION COMMISSION 33, 41 (1995) [hereinafter *Codification*]; the question of whether to apply a subjective or objective standard (or a mixture of it) seems to be still contested, *see in this regard e.g., Nowicki, supra* note 118, at 525–26, n.193, with further references.

C. Function of Delaware's Business Judgment Rule

The business judgment rule protects the board's decisions from a substantive review unless certain standards (*i.e.*, the elements discussed before¹²⁷) in making the concerned decision have been violated. The business judgment rule is thus concerned with due process, but not the decision's merit.¹²⁸ In addition, the business judgment rule presumes that the directors adhered to the said procedural standards in making the concerned business decision.¹²⁹ It thereby assigns the burden of proof to demonstrate that the directors violated these standards to the plaintiffs who intend to challenge the board decision (with the exception of decisions concerning hostile takeovers¹³⁰ or the sale of the company¹³¹).¹³² Upon rebutting the presumption of the business judgment rule, the burden of proof is assigned to the directors who have to demonstrate that their decision was entirely fair.¹³³

D. Justification

Different explanations have been offered by courts and scholars to justify the business judgment rule.¹³⁴ First, courts are seen, and see themselves, as being not well equipped enough to judge the directors' decisions and as being

¹²⁷ See chapter III.B.

¹²⁸ *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. (2000)); Hansen, *supra* note 106, at 1361; Bainbridge, *Abstention*, *supra* note 20, at 99–100; Sharfman, *supra* note 88, at 68.

¹²⁹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984)); see *Schlensky v. Wrigley*, 237 N.E.2d 776–781, 780 (Ill. App. Ct. (1968)); *In re Think3 Inc.*, 529 B.R. 147–213, 181 (Bkrtcy.W.D.Tex. (2015)) (quoting *Emerald Partners v. Berlin*, 787 A.2d 85, 90–91 (Del. (2011))); Sharfman, *supra* note 88, at 42; Bainbridge, *Abstention*, *supra* note 20, at 87; similarly, *Weinberger*, *supra* note 86, at 284–85; *Arsht*, *supra* note 85, at 130–33; Hansen, *supra* note 106, at 1361.

¹³⁰ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. (1985)); see for an in-depth discussion of the Unocal test in connection with the business judgment rule Frank Cara & Peter F. Lane, *The Business Judgment Rule and UNOCAL: Twin Barriers to Shareholder Welfare*, 5 ST. JOHN'S J. LEGAL COMMENT. 195 (1989); D. Gordon Smith, *The Modern Business Judgment Rule*, at 13 (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2620536 (last visited Mar. 1, 2020); see further *NIKITINE*, *supra* note 73, at 107; Hutchinson, *supra* note 34, at 1144–57; Bainbridge, *Director Primacy*, *supra* note 8, at 797, n. 33.

¹³¹ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. (1986)); for an in-depth discussion, see Clark W. Furlow, *Reflections on the Revlon Doctrine*, 11 U. PA. J. BUS. L. 519 (2008) [hereinafter *Revlon*]; see Hutchinson, *supra* note 34, at 1150–51; see also *NIKITINE*, *supra* note 73, at 108.

¹³² *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. (1984)); *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. (2011)); *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52 (Del. (2006)); Hansen, *supra* note 106, at 1361.

¹³³ *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. (2011)); *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52 (Del. (2006)); see with regard to the concept of “entire fairness” Sharfman, *supra* note 88, at 40, with further references; *NIKITINE*, *supra* note 73, at 106–07.

¹³⁴ See *e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *In re Think3 Inc.*, 529 B.R. 147, 181 (Bkrtcy.W.D.Tex. 2015); *Schlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968); Bainbridge, *supra* note 20, at 109–29; Sharfman, *supra* note 85, at 43–55; *Weinberger*, *supra* note 86, at 290–94; Kenneth B. Davis, JR., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 573–96 (2000); Eisenberg, *Codification*, *supra* note 126, at 43–45; Hanewicz, *supra* note 20, at 528–31; Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 612 (1983).

subject to the hindsight bias.¹³⁵ Second, the business judgment rule contributes to judicial efficiency as the courts do not have to conduct a full-fledged substantive review of board decisions.¹³⁶ Third, the business judgment rule upholds risk-taking as it prevents the courts from meddling with risky business decisions.¹³⁷ The fact that the directors take risks is important because “[t]he corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk.”¹³⁸ Fourth, the business judgment rule limits judicial scrutiny because it cannot effectively monitor business decisions and would even undermine the internal monitoring mechanism.¹³⁹ Fifth, it is the (Delaware) corporate law’s guiding idea that the business is managed by the directors.¹⁴⁰

The business judgment rule – understood as a general concept – has not been left uncriticized. Aurelio Gurrea-Martínez, for example, believes that the economic justification of the business judgment rule relies on wrong assumptions.¹⁴¹ Others posit that shielding the directors from liability risks is more costly than increasing the risk of liability for the directors,¹⁴² or that giving the directors preferential treatment regarding their liability compared to other professionals is unreasonable.¹⁴³ In addition, Todd M. Aman denied that the costs and benefits of the business judgment rule can be determinately analyzed. Therefore, according to Aman, the pro-arguments for the business judgment rule based on a cost-benefit-analysis fail.¹⁴⁴

While the criticism above cannot be analyzed *en détail* within the confines of this paper, it shall be noted that all of the contra-arguments entirely ignore the underlying concept of the business judgment rule, *i.e.*, the protection of the directors’ discretionary power and the values behind this concept.¹⁴⁵ On closer

¹³⁵ *In re Think3 Inc.*, 529 B.R. 147–213, 181 (Bkrcty.W.D.Tex. (2015)); *Schlensky v. Wrigley*, 237 N.E.2d 776–781, 780 (Ill. App. Ct. (1968)); Weinberger, *supra* note 86, at 290–91, with further references; Bainbridge, *Abstention*, *supra* note 20, at 117–24.

¹³⁶ Weinberger, *supra* note 86, at 292; Arsht, *supra* note 85, at 99–100.

¹³⁷ *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997); *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) [quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)]; *In re Caremark Intern. Inc. Deriv. Lit.*, 698 A.2d 959, 967–968, note 16 (Del. Ch. 1996); Weinberger, *supra* note 86, at 291–92, with further references; Bainbridge, *Abstention*, *supra* note 20, at 122–24; Melvin A. Eisenberg, *Corporate Legitimacy, Conduct, and Governance — Two Models of the Corporation*, 17 CREIGHTON L. REV. 1, 444–45 (1983) [hereinafter *Models*].

¹³⁸ *In re Caremark Intern. Inc. Deriv. Lit.*, 698 A.2d 959, 968, note 16 (Del. Ch. (1996)); *see also* Eisenberg, *Standards*, *supra* note 92, at 444–45; Eisenberg, *Codification*, *supra* note 126, at 44–45; Bainbridge, *Abstention*, *supra* note 20, at 122–24.

¹³⁹ Bainbridge, *Abstention*, *supra* note 20, at 125–27.

¹⁴⁰ *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993); Weinberger, *supra* note 86, at 293.

¹⁴¹ Gurrea-Martínez, *supra* note 76, at 424–29.

¹⁴² Todd M. Aman, *Cost-Benefit Analysis of the Business Judgment Rule: A Critique in Light of the Financial Meltdown*, 74 ALB. L. REV. 1, 21 (2010), with further references.

¹⁴³ Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion*, 67 S. CAL. L. REV. 287, 336–37 (1993).

¹⁴⁴ Aman, *supra* note 142, at 32–45.

¹⁴⁵ *See* chapter II.

inspection, the assumptions identified by Gurrea-Martínez, for example, are not assumptions but objectives embedded into the business judgment rule. The main argument for justifying the business judgment rule is, in my view, that the corporate law needs to value the authority of the directors.¹⁴⁶

IV. CORPORATE LAW FRAMEWORK OF THE CHINESE JOINT STOCK LIMITED COMPANY

A. Organizational Structure

The business judgment rule is embedded in the corporate context. The Stock Company under the Company Law is an independent legal person and is liable with its assets (art. 3, para. 1 Company Law).¹⁴⁷ The Stock Company follows the dual board structure model where a board of supervisors (art. 117, para. 1 Company Law) supervises the board of directors (or management board) (art. 108, para. 1 Company Law).¹⁴⁸

Stock Companies listed and traded on a stock exchange (“Listed Stock Company”) are not only subject to special provisions set forth by the Company Law (art. 120 *et seqq.* Company Law) but also need to adhere to the code of corporate governance of listed companies (“Corporate Governance Code”)¹⁴⁹, the guidelines regarding the articles of association of listed companies (“Bylaws Guidelines”)¹⁵⁰ and the 2007 notice to strengthen the corporate governance of listed companies issued by China’s Securities Regulatory Commission (“Sec. Reg. Comm’n.”).¹⁵¹ In addition, Listed Stock Companies need to follow the rules of the stock exchange on which they are listed (either the rules of the Shanghai Stock Exchange [SSE] or the Shenzhen Stock Exchange [SZSE]).¹⁵²

¹⁴⁶ See chapter II; see also Bainbridge, *Abstention*, *supra* note 20, at 85; Arrow, *supra* note 9, at 68–70.

¹⁴⁷ See Gu, *supra* note 25, at 24–25.

¹⁴⁸ Wei, *Corporate Governance*, *supra* note 25, at 368–70; Gu, *supra* note 25, at 135–38; Virginia Harper Ho, *Corporate Governance as Risk Regulation in China: A Comparative View of Risk Oversight, Risk Management, and Accountability*, 3 EUR. J. RISK REGUL. 463, 470 (2012).

¹⁴⁹ Shangshi Gongsi Zhili Zhunze (2018 Xiuding) [上市公司治理准则(2018修订)] [Announcement No. 29 of the China Securities Regulatory Commission — Code of Corporate Governance of Listed Companies (2018 Revision)] (promulgated by China Sec. Reg. Comm’n., effective Sept. 30, 2018) [hereinafter *Corporate Governance Code*].

¹⁵⁰ Shangshi Gongsi Zhangcheng Zhiyin (2019 Xiuding) [上市公司章程指引(2019修订)] [Guidelines for Articles of Association of Listed Companies (2019 Revision)] (promulgated by China Sec. Reg. Comm’n., effective Apr. 17, 2019) [hereinafter *Bylaws Guidelines*].

¹⁵¹ Guanyu Kaizhan Jiaqiang Shangshi Gongsi Zhili Zhuanxiang Huodong Youguan Shixiang de Tongzhi (关于开展加强上市公司治理专项活动有关事项的通知) [Notice on the Matters concerning Carrying out a Special Campaign to Strengthen the Corporate Governance of Listed Companies] (promulgated by China Sec. Reg. Comm’n., effective Apr. 16, 2007).

¹⁵² The rules are available in English and can be accessed online via SSE, *SSE Rules*, <http://english.sse.com.cn/start/rules/sse/public/> (last visited Mar. 2, 2020) and SZSE, *SZSE Rules*, <http://www.szse.cn/English/rules/siteRule/index.html> (last visited Mar. 2, 2020).

1. Shareholders' Assembly. The shareholders' assembly comprises all shareholders and is the most powerful organ of the Stock Company (art. 98 Company Law).¹⁵³ The shareholders' assembly is vested with various powers (art. 99 i.c.w. art. 37 Company Law). It does, among other things, also determine the Stock Company's operational guidelines and investment plans (art. 99 i.c.w. art. 37, no. 1 Company Law). While it does not come as a surprise that the shareholders have the final say on questions related directly to their residual claim (*i.e.*, merger, split-up, dissolution, or liquidation of the company) and the distribution of the profit, it is remarkable that the shareholders also determine the Stock Company's operational guidelines and investment plans and, hence, take on powers which are directly interlinked with the management of the Stock Company's business affairs.¹⁵⁴ This power allocation is in line with the Company Law's general principle according to which the shareholders shall not only enjoy capital proceeds and elect the managers but also participate in the making of important decisions (art. 4 Company Law).

2. Board of Directors. The board of directors of a Stock Company shall be composed of five to nineteen persons (art. 108, para. 1 Company Law)¹⁵⁵ and is responsible to the shareholders' assembly (art. 108, para. 4 i.c.w. art. 46, para. 1 Company Law).¹⁵⁶ The board of directors has various functions and, among other things, determines the business and investment plans (art. 108, para. 4 i.c.w. art. 46, no. 3 Company Law), formulates the plans related to financial budget and profit distribution (art. 108, para. 4 i.c.w. art. 46, nos. 4 and 5 Company Law), and prepares the increase or reduction of the registered capital, the issuance of corporate bonds or a merger, the split or dissolution of the company or a change of its form (art. 108, para. 4 i.c.w. art. 46, nos. 6 and 7 Company Law). Moreover, the board of directors is responsible for the establishment of internal management departments (art. 108, para. 4 i.c.w. art. 46, no. 8 Company Law), the formulation of the basic management system (art. 108, para. 4 i.c.w. art. 46, no. 10 Company Law) and the hiring or

¹⁵³ Gu, *supra* note 25, at 138–39; Wei, *Corporate Governance*, *supra* note 25, at 370–71.

¹⁵⁴ See Gu, *supra* note 25, at 142–43; cf. Wei, *Corporate Governance*, *supra* note 25, at 370–71; Wei, *Directors' Duties*, *supra* note 28, at 35; Qu Charles Zhen, *The Role of the Shareholders' Meeting's Reserve Power in Corporate Governance in China*, 25 LAW CONTEXT: A SOCIO-LEGAL J. 53, 56 (2007), with further references; James V. Feinerman, *New Hope for Corporate Governance in China?*, 2007 CHINA Q. 590, 598 (2007); Hong, *supra* note 28, at 549–50; Cindy A. Liu Schipani & Junhai, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 34 (2002); Mieke Olaerts, *Euro-Chinese Company Models: An Exploratory Journey into the Position of Directors, Shareholders and Stakeholders in Chinese and European Company Law*, 16 MAASTRICHT JOURNAL OF EUROPEAN AND COMPARATIVE LAW 171, 182–86 (2009).

¹⁵⁵ See instead of many Gu, *supra* note 25, at 166–67.

¹⁵⁶ *Id.* at 193.

dismissal of the company's management (art. 108, para. 4 i.c.w. art. 46, no. 9 Company Law).

The list above of the board of directors' functions includes powers which suggest that the board of directors is not merely a recipient of the shareholders' assembly's orders but substantially manages the Stock Company's affairs.¹⁵⁷

3. Board of Supervisors. A Stock Company is required to set up a board of supervisors of at least three members (art. 117, para. 1 Company Law)¹⁵⁸ which is responsible for assessing and supervising the financial affairs (art. 118, para. 1 i.c.w. art. 53, no. 1 Company Law; art. 47 Corporate Governance Code) and the duty-related acts of both the board of directors and the senior management (art. 118, para. 1 i.c.w. art. 53, no. 2 Company Law; *see also* art. 47 Corporate Governance Code).¹⁵⁹ The board of supervisors requests a director or senior manager to correct his acts if they violate the Stock Company's interests (art. 118, para. 1 i.c.w. art. 53, no. 3 Company Law) and initiates actions against the directors or senior managers (art. 118, para. 1 i.c.w. art. 53, no. 6 Company Law).¹⁶⁰ The board of supervisors may also start an investigation if it believes that the company is running "abnormally" (art. 118, para. 1 i.c.w. art. 54, para. 2 Company Law).¹⁶¹

4. The Allocation of the Decision-Making Power. The shareholders' assembly is the Stock Company's "organ of power" (art. 98 Company Law) and enjoys various rights, including the right to determine the operational guidelines and investment plans.¹⁶² The shareholders shall, by virtue of the law, participate in the making of important decisions (art. 4 Company Law).¹⁶³ This circumstance led many scholars to describe the board of directors as a weak body, merely executing the decisions of the shareholders' assembly.¹⁶⁴ The question whether the board of directors is "weak" or "strong" refers to its

¹⁵⁷ *See* Hong, *supra* note 28, at 518; *contra* Zhang Kan, *Corporate Governance in China: How Does the State Influence Its Own Enterprises*, 9 INT'L L. & MGMT. REV. 111, 130 (2012); *cf. also* Wei, *Directors' Duties*, *supra* note 28, at 36.

¹⁵⁸ For a criticism of this requirement, *see* Feinerman, *supra* note 157, at 607.

¹⁵⁹ *See* Wei, *Corporate Governance*, *supra* note 25, at 375–376; Michael Irl Nikkel, *Chinese Characteristics in Corporate Clothing: Questions of Fiduciary Duty in China's Company Law*, 80 MINN. L. REV. 503, 528 (1995); *contra* Schipani & Liu, *supra* note 157, at 55; *see also* Huang, *supra* note 15, at 241.

¹⁶⁰ Gu, *supra* note 25, at 217; *see* Schipani & Liu, *supra* note 157, at 55; *see* for a general criticism of the board of supervisors' powers relating to the Company Law before it was revised in 2005 Feinerman, *supra* note 157, at 606–07.

¹⁶¹ Gu, *supra* note 25, at 217; Schipani & Liu, *supra* note 157, at 55; *see also* Feinerman, *supra* note 157, at 607.

¹⁶² *See* chapter IV.A.1.

¹⁶³ *Id.*

¹⁶⁴ Gu, *supra* note 25, at 142–43; Wei, *Corporate Governance*, *supra* note 25, at 370–71; Wei, *Directors' Duties*, *supra* note 28, at 35; Qu, *supra* note 157, at 56; Feinerman, *supra* note 157, at 598; Hong, *supra* note 28, at 549–50; Schipani & Liu, *supra* note 157, at 34; Yongxin Song, *Some Special Features of the Organs of Governance of Chinese Business Corporations*, 24 CAP. U. L. REV. 207, 213–14 (1995).

authority, *i.e.*, whether it can give or must take orders.¹⁶⁵ The amount of authority which the board of directors (and the board of supervisors) has depends on how much discretionary power it enjoys.¹⁶⁶ The business judgment rule is concerned with the protection of the directors' discretion.¹⁶⁷ As this paper intends to establish whether there is a need for a business judgment rule in China and how such a rule can be implemented, the question as to how much discretionary powers the board of directors (and the board of supervisors) shall enjoy is secondary. It is, however, important to establish whether the board of directors and the board of supervisors enjoy discretionary powers *at all*, as otherwise a business judgment rule would be obsolete.¹⁶⁸

Although the shareholders' assembly enjoys a wide range of powers, the board of directors is not merely an executing body.¹⁶⁹ The board of directors determines the Stock Company's business and investment plans¹⁷⁰ and the basic management systems, and has a say in the hiring and dismissal of managers and their compensation. The notice on issuing the guidelines for corporate governance of commercial banks issued by the China Banking Regulatory Commission clarifies that shareholders of a commercial bank shall not interfere with the decision-making and management powers assigned to the board of directors and not directly intervene in the management of the commercial bank's affairs.¹⁷¹ While these guidelines are only applicable to commercial banks, they can serve as an indication of how the role of the board of directors is generally understood. In addition, the Corporate Governance Code seems to suggest that the shareholders (which is in line with art. 4 Company Law) *and* the board of directors are to make important decisions.¹⁷² Neither the Corporate Governance Code nor the Company Law stipulates what important decisions are. However, the Company Law provides guidance by

¹⁶⁵ Arrow, *supra* note 9, at 63; *see also* chapter II.B.

¹⁶⁶ *See* for the in-depth discussion of the concept of discretionary power chapter II.B.

¹⁶⁷ *See* for details the analysis of Delaware's business judgment rule chapter III.

¹⁶⁸ Seemingly *contra* Gu, *supra* note 25, at 196.

¹⁶⁹ *Accord* Olaerts, *supra* note 157, at 186.

¹⁷⁰ In the English version of the Company Law, there seems to be an overlap of duties as both the shareholders' assembly (art. 99 i.c.w. art. 37, no. 1 Company Law) and the board of directors (art. 108, para. 4 i.c.w. art. 46, no. 3 Company Law) seem to have the power to determine the investment plans. The Chinese version of the Company Law, however, uses two different terms. As to the shareholders' assembly's powers, the Company Law uses the characters "投资计划" (Touzi Jihua) (art. 37, no. 1 Company Law). In connection with the board of directors, the characters "投资方案" (Touzi Fang'an) (art. 46, no. 3 Company Law) are used. While "计划" refers to a more abstract plan, "方案" relates to a step-by-step plan or program. In this light, it could be understood that the shareholders' assembly provides rough guidelines while the board of directors has to implement these and determine the details (*accord* Song, *supra* note 167, at 213–14).

¹⁷¹ Zhongguo Yinjianhui Guanyu Yinfa Shangye Yinhang Gongsì Zhili Zhiyin de Tongzhi (中国银监会关于印发商业银行公司治理指引的通知) [Notice of the China Banking Regulatory Commission on Issuing the Guidelines on the Corporate Governance of Commercial Banks] (promulgated by the China Banking Reg. Comm., effective July 19, 2013).

¹⁷² Corporate Governance Code, art. 65.

establishing certain (non-delegable)¹⁷³ shareholder powers. From these powers it can be derived that an important decision relates to any matter which more or less directly affects the shareholders' residual claim (*e.g.*, purchase or sale of important assets or provision of guarantees which exceed 30% of the Stock Company's total assets within a year, change in the registered capital, issuance of bonds, merger, split-up, dissolution, liquidation),¹⁷⁴ the constitution of the Stock Company (art. 99 i.c.w. art. 37, para. 1, no. 10 Company Law) and the Stock Company's profit or loss.¹⁷⁵

The daily and long-term management of a company requires a lot more decisions than those listed above. In fact, Mingkang Gu suggests that in practice, most shareholders of a Stock Company are not involved in the management at all.¹⁷⁶ In addition, a study published in 2001 found that the board of directors of Listed Stock Companies is the main decision-making organ.¹⁷⁷ Thus it can be concluded that the decision-making power is not uniquely assigned to the shareholders' assembly; the board of directors also enjoys a certain amount of decision-making power and does not merely execute orders from the shareholders' assembly without having gone through the process of consideration.¹⁷⁸

In contrast, the board of supervisors is not established as a decision-making body but as a supervisory organ. Therefore, it is no surprise that the board of supervisors does not enjoy any decision-making powers regarding the day-to-day management of the company. This does not mean that the board of supervisors does not enjoy discretionary powers at all. The board of supervisors may require the directors or senior managers to correct their actions (art. 118, para. 1 i.c.w. art. 53, no. 6 Company Law), raise questions at the meetings of the board of directors, make suggestions regarding the meeting agenda (art. 118, para. 1 i.c.w. art. 54, para. 1 Company Law), as well as initiate an investigation (art. 118, para. 1 i.c.w. art. 54, para. 2 Company Law). However, applying the model of discretion introduced before,¹⁷⁹ the discretionary power of the board of supervisors will be limited in most cases.

We have thus established that, *in principal*, the board of directors of a Stock Company enjoys discretionary power which – as outlined before¹⁸⁰ – is worth

¹⁷³ See the clarification set out by the Corporate Governance Code, art. 14 and the Bylaws Guidelines, art. 40.

¹⁷⁴ See in this regard the related powers of the shareholders' assembly as stipulated by the Company Law, *supra* note 24, art. 121 and art. 99 i.c.w. art. 37, para. 1, nos. 7, 8, and 9.

¹⁷⁵ See in this regard the related powers of the shareholders' assembly as stipulated by the Company Law, *supra* note 24, art. 99 i.c.w. art. 37, para. 1, nos. 5 and 6.

¹⁷⁶ Gu, *supra* note 25, at 139; see in this regard also Hong, *supra* note 28, at 517; cf. Wei, *Corporate Governance*, *supra* note 25, at 373–374.

¹⁷⁷ Sonja Oppen & Wong Sonia M. L., *The Power Structure in China's Listed Companies: The Company Law and its Enforcement* (2001), https://www.researchgate.net/publication/228464981_The_Power_Structure_in_China's_Listed_Companies_The_Company_Law_and_its_Enforcement (last visited Nov. 3, 2020).

¹⁷⁸ See chapter II.B.

¹⁷⁹ See chapter II.B.

¹⁸⁰ See chapter II.

to be protected. However, we need to consider one more factor which is linked to the substantive *ex post* review of the board of directors' decisions. As elucidated before, a fully substantive *ex post* review eventually leads to a shift of the decision-making power with the consequence that the board of directors does not enjoy any power of discretion.¹⁸¹ This is precisely where the business judgment rule steps in. It is needless to say that the (limited) discretionary powers of the board of supervisors are equally worth to be protected.

B. Directors' and Supervisors' Duties

The Delaware business judgment rule, being the original model, is a rule of due process.¹⁸² The business judgment rule's precondition that the directors do not act fraudulently or illegally¹⁸³ is evident; the Company Law provides for a similar rule stipulating that the directors and supervisors of Stock Companies must comply with the law, administrative regulations and bylaws, and are liable in case of a violation causing damages to the Stock Company (art. 147, para. 1 and art. 149 Company Law).¹⁸⁴ In addition, the following three directors' duties play a decisive role in context with the business judgment rule:¹⁸⁵ the duty of loyalty (*i.e.*, no conflict of interest),¹⁸⁶ the duty of care (*i.e.*, consideration of all reasonably available material information)¹⁸⁷ and the duty of good faith (*i.e.*, honest belief that the business decision is in the company's best interest).¹⁸⁸ In order to assess whether and how the business judgment rule can be implemented into the Company Law, it must be understood whether the Company Law provides for such duties of Stock Company directors and supervisors.

1. Duty of Loyalty. The Company Law stipulates that the directors and supervisors shall bear the duty of loyalty (art. 147, para. 1 Company Law; *see also* art. 4 Corporate Governance Code).¹⁸⁹ In addition, the Company Law prescribes in its general part that no director or supervisor shall infringe upon the company's interest by taking advantage of his relationship to the company

¹⁸¹ See chapter II.B.

¹⁸² *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000); Bainbridge, *Abstention*, *supra* note 20, at 92; Hansen, *supra* note 103, at 1356.

¹⁸³ See chapter III.B.1.

¹⁸⁴ *Accord* Wang, *supra* note 28, at 95.

¹⁸⁵ See in general chapter III.A.

¹⁸⁶ See chapter III.B.2.

¹⁸⁷ See chapter III.B.3.

¹⁸⁸ See chapter III.B.4.

¹⁸⁹ GU, *supra* note 25, at 181 (according to which the Chinese characters “忠实义务” (Zhongshi Yiwu) stand for “duty of loyalty”); Xu et al., *supra* note 28, at 59–60 (pointing out that the Company Law did not stipulate any duty of loyalty before its revision 2005); *see also* Lee Rebecca Wing Chi, *Fiduciary Duty without Equity: Fiduciary Duties of Directors under the Revised Company Law of the PRC*, 47 VA. J. INT'L L. 897, 902 (2006); Fang Ma, *Director's Duties in China: The Corporate Opportunity Doctrine*, [J]FIN. CRI., https://researchportal.port.ac.uk/portal/files/4185741/Directors_Duties_in_China.pdf (last visited Nov. 3, 2020) [hereinafter *Director's Duties*].

(art. 21 Company Law). Moreover, art. 148, para. 1 Company Law non-conclusively lists several prohibited behaviors which can be seen as a clarification of the duty of loyalty (*see also* art. 97 Bylaws Guidelines).¹⁹⁰ Generally speaking, these behaviors all constitute an action detrimental to the Stock Company's interest (*e.g.*, misappropriation of the company's funds, lending the company's funds to others without the relevant consent and seeking business opportunities belonging to the company for one's own benefits [art. 148, para. 1, nos. 1, 3, and 5]).¹⁹¹ In addition, the Company Law stipulates that directors shall abstain from exercising their voting rights concerning a resolution regarding a third party which they have a relationship with (art. 124 Company Law; art. 119 Bylaws Guidelines).

Against this background, it is worth mentioning that the SZSE issued two guidelines regarding director (and supervisor) conduct (SZSE Guidelines on Conduct of Corporate Directors of SME Board Listed Companies ["SZSE Guide of Conduct"]¹⁹² and SZSE Guidelines on Good Faith for SME Board Companies ["SZSE Good Faith Guidelines"]).¹⁹³ The SZSE Guide of Conduct stipulates that a director shall "[be] loyal to the company's and shareholders' interests, exercising his power within the scope of his duties and functions, and strictly avoiding conflicts of self-interest with that of the company."¹⁹⁴ In addition, the SZSE Good Faith Guidelines prescribe that the directors and supervisors "shall perform their respective duties in a loyal [...] way."¹⁹⁵

Scholars occasionally criticize that the duty of loyalty stipulated by the Company Law is too imprecise, does not address the standard of care and requires further clarification.¹⁹⁶ For the present purpose, it suffices that we have established that directors and supervisors are subject to the duty of loyalty, *i.e.*, shall be free of any conflict of interest.¹⁹⁷

2. Duty of Care. The Company Law stipulates that directors and supervisors shall bear the obligation of diligence towards the company (art. 147, para. 1 Company Law), hence explicitly prescribes the duty of care.¹⁹⁸ While the Company Law as such is silent with regard to what the

¹⁹⁰ Gu, *supra* note 25, at 181; Xu et al., *supra* note 28, at 60; *see also* Lee, *supra* note 189, at 902–03.

¹⁹¹ *See* Gu, *supra* note 25, at 181; Lee, *supra* note 192, at 906–07; Ma, *Director's Duties*, *supra* note 192, at 2–3.

¹⁹² SZSE, *Guidelines on Conduct of Corporate Directors of SME Board Listed Companies* (2005), http://www.szse.cn/English/rules/siteRule/t20050725_559486.html (last visited Nov. 3, 2020) [hereinafter *SZSE Guide of Conduct*].

¹⁹³ SZSE, *Guidelines on Good Faith for SME Board Companies* (2004), http://www.szse.cn/English/rules/siteRule/t20041112_559487.html (last visited Nov. 3, 2020) [hereinafter *SZSE Good Faith Guidelines*].

¹⁹⁴ SZSE Guide of Conduct, *supra* note 192, art. 4, para. 1, no. 1.

¹⁹⁵ SZSE Good Faith Guidelines, *supra* note 193, art. 22.

¹⁹⁶ Ma, *Director's Duties*, *supra* note 189, at 3; Xu et al., *supra* note 28, at 61; Wei, *Directors' Duties*, *supra* note 28, at 43.

¹⁹⁷ *Cf.* Wang, *supra* note 28, at 95.

¹⁹⁸ Wei, *Directors' Duties*, *supra* note 28, at 42–43; Ma, *Director's Duties*, *supra* note 189, at 2; Wang, *supra* note 28, at 80; Xu et al., *supra* note 28, at 59–60; *contra* Gu, *supra* note 25, at 185.

features of the duty of care are and which standard of care is applied,¹⁹⁹ it is important to note for the purpose of this paper that the Company Law stipulates a duty of care for both the directors and the supervisors.

The Bylaws Guidelines help to further understand what elements the duty of care might include.²⁰⁰ Accordingly, directors shall prudently, seriously and diligently exercise their rights in order to ensure compliance of the company's activities with the laws, administrative regulations, state policies and the scope of business as prescribed by the business license (art. 98, para. 1, no. 1 Bylaws Guidelines). In addition, the directors shall treat the shareholders equally (art. 98, para. 1, no. 2 Bylaws Guidelines; *see also* art. 26, para. 2 Corporate Governance Code),²⁰¹ ensure the veracity, accuracy and integrity of information disclosed by the company (art. 98, para. 1, no. 4 Bylaws Guidelines), as well as provide the board of supervisors with the relevant information and materials in a truthful manner and not hinder its work (art. 98, para. 1, no. 5 Bylaws Guidelines). The directors are also obliged to acquaint themselves with the company's affairs (art. 98, para. 1, no. 3 Bylaws Guidelines).²⁰²

3. Good Faith. Neither U.S. law nor China's Company Law provides a clear definition of the concept of good faith.²⁰³ The SZSE Good Faith Guidelines also abstain from presenting a conclusive definition.²⁰⁴ As to the content of the duty of good faith derived from art. 147 para. 1 Company Law and art. 7 General Provisions of the Civil Law²⁰⁵, most scholars seem to agree that the duty of good faith obliges the directors to act in the company's interest and to honestly fulfil their duties.²⁰⁶ There are, however, valid reasons to assume that the duty of good faith under the Company Law includes not only the Stock Company's interests but also the interests of its stakeholders.²⁰⁷ The Company Law stipulates, for example, that the Stock Company must protect the interests of its employees (art. 17 Company Law; *see* art. 85 Corporate Governance Code) and shall bear social responsibilities (art. 5 Company Law;

¹⁹⁹ *See* for critics: Wei, *Directors' Duties*, *supra* note 28, at 42–43; Ma, *Director's Duties*, *supra* note 189, at 2–3; Wang, *supra* note 28, at 96; Xu et al., *supra* note 28, at 61–63; Nikkel, *supra* note 159, at 540.

²⁰⁰ *Cf.* Xu et al., *supra* note 28, at 60.

²⁰¹ *See* Xu et al., *supra* note 28, at 60.

²⁰² *See* Xu et al., *supra* note 28, at 60.

²⁰³ *Cf.* in connection with Delaware's business judgment rule *Aronson v. Lewis*, 473 A.2d 805, 805 (Del. 1984); Hansen, *supra* note 103, at 1361; Bainbridge, *Abstention*, *supra* note 15, at 88–90.

²⁰⁴ *See* SZSE, *Good Faith Guidelines*, *supra* note 193.

²⁰⁵ Minfa Zongze (民法总则) [General Provisions of the Civil Law] (promulgated by the Nat'l People's Cong., Mar. 15, 2017, effective Oct. 10, 2017), art. 7, CLI.1.291593(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *General Provisions of the Civil Law*].

²⁰⁶ Wei, *Directors' Duties*, *supra* note 28, at 49; Gu, *supra* note 25, at 181–82; Wang, *supra* note 28, at 97; *cf. also* Ma, *Director's Duties*, *supra* note 189, at 2.

²⁰⁷ *Cf.* Olaerts, *supra* note 154, at 184; accord Yan Wenjia, *Independent Directors: Decision-Makers in the us, Powerless Advisers in China*, 3 EUROPEAN JOURNAL OF COMPARATIVE LAW AND GOVERNANCE 70, 95 (2016).

see art. 87 Corporate Governance Code).²⁰⁸ The Corporate Governance Code clarifies that the board of directors shall respect the interests of stakeholders (art. 26, para. 2 Corporate Governance Code). Listed Stock Companies are obliged to undertake the necessary measures in order to safeguard the stakeholders' rights and interests (art. 82 Corporate Governance Code). China seems to pursue the subjective standard when asking the question whether a director acted in good faith.²⁰⁹

For the purpose of this paper, it is important that we have established that the directors as well as the supervisors (*cf.* art. 147, para. 1 Company Law) are obliged to act in the best interest of the Stock Company and, in certain situations, of its stakeholders.

V. REVIEW OF BUSINESS DECISIONS

We have previously established that, from an economic viewpoint, a firm needs to have a centralized decision-maker vested with discretionary powers that must be protected from a substantive *ex post* review.²¹⁰ The discretionary powers of the centralized decision-maker are endangered if a third party, be it the shareholders or the judiciary, is permitted to carry out a substantive review of the decision-maker's business decisions *ex post*.²¹¹ In order to evaluate whether there is a potential harm to the discretionary powers of the board of directors and the board of supervisors of a Stock Company under the Company Law, it is necessary to understand to which extent business decisions are subject to a substantive *ex post* review, and if so, how the courts handle such a review.

A. Review Framework

The Company Law generally stipulates that resolutions of the board of directors which violate any laws or administrative regulations are null and void (art. 22 Company Law). The Bylaws Guidelines clarify that resolutions are not only invalid if they disrespect procedural rules but also if their *content* is in violation of the laws and administrative regulations (art. 34, para. 1 Bylaws Guidelines).

In case the procedures for calling a meeting of the board of directors or the voting methods applied during the board meeting violate any laws, administrative regulations or the bylaws, the shareholders may, within 60 days from the day the resolution was made, request a court to revoke it (art. 22, para. 2 Company Law). In addition, a revocation may also be requested if a resolution of the board of directors violates the Stock Company's bylaws

²⁰⁸ See in this regard Olaerts, *supra* note 154, at 180–82.

²⁰⁹ Gu, *supra* note 25, at 182; Xu et al., *supra* note 28, at 69; unclear whether suggesting that the courts apply a subjective test, *see* Wang, *supra* note 28, at 97–98.

²¹⁰ See chapter II.

²¹¹ See chapter II.B.

(art. 22, para. 2 Company Law).²¹² Again, the Bylaws Guidelines clarify that a violation of the bylaws may also be caused by the *content* of the resolution (art. 34, para. 2 Bylaws Guidelines). In one of its interpretations, the Supreme People's Court stated that if the errors in the calling of the board meeting or the applied voting method are minor and have no material impact on the resolution, the courts shall not support the shareholders' request for revocation.²¹³

The Company Law further stipulates that the directors are responsible for the resolutions of the board of directors. If directors participated in adopting a resolution violating either laws, administrative regulations, the bylaws or a resolution of the shareholders assembly and if such violation caused serious loss to the Stock Company, they shall make compensation (art. 112, para. 3 Company Law; *see also* art. 23 Corporate Governance Code). Finally, directors or supervisors violating any law, administrative regulation or the bylaws in the course of performing their duties shall be liable for compensation if such violation causes any loss to the company (art. 149 Company Law).²¹⁴

Jun Wang postulates that the examination of the director's conduct is mostly procedural unless the legitimacy of the conduct set forth under the bylaws is to be assessed.²¹⁵ He thus concludes that the legislator intended to prevent the courts from meddling with the business affairs of the company.²¹⁶ Wang seems to ignore that the Company Law (as well as the bylaws in a particular case) stipulates that the company, and thus its organs, shall comply with social and business morality and bear social responsibilities (art. 5 Company Law) as well as protect its employees' rights (art. 17 Company Law). In addition, the directors and supervisors must act in the interest of the company and its stakeholders (art. 147, para. 1 Company Law).²¹⁷ The Company Law does not limit the review of business decisions to their procedural aspects, *i.e.*, to the question as to how the decision-making process was carried out. Therefore, the Company Law allows a substantive review of a business decision in order to assess whether the decision harmed the company or not, *i.e.*, whether the decision was a "good" or "bad" one.²¹⁸

²¹² In August 2017, the Supreme People's Court issued provisions clarifying that the courts shall accept a case where a shareholder, director or supervisor requests the court to declare a resolution of the shareholders assembly or the board of directors to be void or to never have been formed (Zuigao Renmin Fayuan Guanyu Shiyong "Zhonghua Renmin Gongheguo Gongsifa" Ruogan Wenti de Guiding (Si)) (最高人民法院关于适用《中华人民共和国公司法》若干问题的规定(四)) [Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China (IV)] (issued by Sup. People's Ct., Aug. 25, 2017, effective Sept. 1, 2017), art. 1, CLI3.300958(EN), *translated by* Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Company Law Provisions 4*].

²¹³ Company Law Provisions 4, *supra* note 212, art. 4.

²¹⁴ Within the confines of this paper, the procedural aspects of a lawsuit against directors or supervisors cannot be further discussed. *See* instead for a thorough discussion of the topic Huang, *supra* note 15, *passim*.

²¹⁵ Wang, *supra* note 28, at 81; *accord* Xu et al., *supra* note 28, at 69.

²¹⁶ Wang, *supra* note 28, at 81.

²¹⁷ *See* chapter IV.B.3.

²¹⁸ *E.g.*, due to a loss in connection with an investment project in which case it could be stipulated that not only the duty of care was violated but the investment was also not in the company's interest; *accord* Zhao Jingchen, *A More Efficient Derivative Action System in China: Challenges and Opportunities through*

Another important factor relating to the review of board decisions is the allocation of the burden of proof. According to China's Civil Procedure Law and the corresponding interpretation of the Supreme People's Court, the party who makes claims bears the burden of evidence for its claims, unless otherwise prescribed by law (art. 64, para. 1 Civil Procedure Law;²¹⁹ art. 90, para. 1 Interpretation of Civil Procedure Law²²⁰).²²¹ The Supreme People's Court's Interpretation of Civil Procedure Law further states that if the party fails to provide sufficient evidence to support its claims, it shall bear the respective adverse consequences (art. 90, para. 2 Interpretation of Civil Procedure Law). In the absence of any explicit rule on the allocation of the burden of proof in cases requesting a revocation of a resolution of the board of directors or the board of supervisors or in liability cases against directors or supervisors of a Stock Company, the plaintiff filing a liability lawsuit bears the burden of proof (*see* art. 90, para. 1 Civil Procedure Law).²²²

To summarize, the foregoing shows that the resolutions of the board of directors and the board of supervisors are subject to a substantive *ex post* review by the judiciary.²²³ By virtue of the statutory law and due to the absence of a

Corporate Governance Theory, 64 N. IR. LEGAL Q. 233, 242 (2013) [hereinafter *Derivative Action*]; accord Hong, *supra* note 28, at 542.

²¹⁹ Minshi Susong Fa (民事诉讼法) [The Civil Procedure Law] (promulgated by Standing Comm. Nat'l People's Cong., June 27, 2017, effective July 1, 2017), art. 64, para. 1, CLI.1.297379(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Civil Procedure Law*].

²²⁰ Zuigao Renmin Fayuan Guanyu Shiyong "Zhonghua Renmin Gongheguo Minshi Susong Fa" de Jieshi (最高人民法院关于适用《中华人民共和国民事诉讼法》的解释) [Interpretation of the Supreme People's Court on the Application of the Civil Procedure Law of the People's Republic of China] (issued by Sup. People's Ct., Jan. 30, 2015, effective Feb. 4, 2015), art. 90, para. 1, CLI.3.242703(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Interpretation of Civil Procedure Law*].

²²¹ The Rules on Evidence in Civil Procedures issued by the Supreme People's Court also confirm the general rule that the party which fails to provide evidence for its allegations bears the adverse consequences of the burden of proof (Zuigao Renmin Fayuan Guanyu Minshi Susong Zhengju de Ruogan Guiding (最高人民法院关于民事诉讼证据的若干规定) [Some Provisions of the Supreme People's Court on Evidence in Civil Procedures] (issued by Sup. People's Ct., Dec. 16, 2008, effective Dec. 31, 2008), CLI.3.219034(EN), art. 2, para. 2 translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Rules on Evidence in Civil Procedures*]). On December 25, 2019, the Supreme People's Court decided to amend the Rules on Evidence in Civil Procedures which has come into force on May 1, 2020. The Amended Rules on Evidence in Civil Procedure seem no longer to specifically address the consequences of the failure to provide sufficient evidence (Zuigao Renmin Fayuan Guanyu Xiugai "Guanyu Minshi Susong Zhengju De Ruogan Guiding" de Jueming (最高人民法院关于修改《关于民事诉讼证据的若干规定》的决定) [Decision of the Supreme People's Court to Amend the Some Provisions on Evidence in Civil Procedures] (issued by Sup. People's Ct., Dec. 25, 2019, effective May. 1, 2020), CLI.3.338186(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Amended Rules on Evidence in Civil Procedures*]).

²²² Ma, *Director's Duties*, *supra* note 192, at 10–11; Ma Fang, *Business Integrity v. Business Efficiency: the Corporate Opportunity Doctrine in China*, 23 JOURNAL OF FINANCIAL CRIME 201, 209 (2016) [hereinafter *Business Integrity*], confirming his view of the allocation of the burden of proof; *cf.* Mo Zhang & Paul J. Zwier, *Burden of Proof: Developments in Modern Chinese Evidence Rules*, 10 TULSA J. COMP. & INT'L L. (SPRING) 419, 435–38 (2002).

²²³ The focus of China's Company Law lies on the resolutions of the board of directors and does not specifically mention the resolutions of the board of supervisors. The supervisors are, however, likewise liable if they violate any law, administrative regulation or the bylaws in performing their duties and thereby cause damage to the Stock Company (art. 149 Company Law).

statutory business judgment rule,²²⁴ the review is not limited to the procedural aspects of the resolutions but also includes the *content* of the resolutions.²²⁵ Thus, the question arises as to how the courts handle the review of board resolutions, *i.e.*, business decisions,²²⁶ in practice. The burden to prove the allegation that the board resolution violates laws, administrative regulations or the bylaws and/or that directors or supervisors breached their duty of loyalty, duty of care or duty of good faith rests on the plaintiff.

B. Application of the Business Judgment Rule by Chinese Courts

1. Literature Review. Before analyzing specific court cases, the findings of works from English-speaking scholars on this topic are summarized below.²²⁷

Gu states that “[...] the business judgment rule has not yet been adopted [...]” in China.²²⁸ It is not entirely clear whether Gu refers to a statutory recognition of the rule or also its application by the courts. The wide-ranging wording suggests that both are the case. Neither is there a statutory business judgment rule nor do the courts recognize the unwritten principle of the business judgment rule. A similar statement is made by Donald C. Clarke who, without providing any evidence, holds that “Chinese courts and regulators have not developed a doctrine of deference to board decisions”.²²⁹

In his study of court cases mentioned above as well as earlier in this paper,²³⁰ Wang finds that only few courts carried out a substantive review of board resolutions.²³¹ Moreover, Wang finds that “the senior officers will be free from any liability if their business actions are deemed reasonable and acceptable in accordance with the specific circumstances of the company.”²³² However, Wang’s statement that the courts are not averse to a substantive review of the business decisions contradicts the foregoing.²³³

Guangdong Xu, Tianshu Zhou, Bin Zeng and Jin Shi share Wang’s opinion and postulate that the courts limit themselves and apply the provisions of the law, administrative regulations and the bylaws mechanically when assessing

²²⁴ Gu, *supra* note 25, at 196–97; Sun, *supra* note 25, at 105; Osgathorpe, *supra* note 25, at 504; Wei, *Corporate Governance*, *supra* note 25, at 373; Yuan Anyuan, *Foreign Direct Investments in China — Practical Problems of Complying with China’s Company Law and Laws for Foreign-Invested Enterprises*, 20 *NW. J. INT’L L. & BUS.* 475, 493 (1999).

²²⁵ Seemingly *contra* Wang, *supra* note 28, at 81.

²²⁶ See with regard to the definition of the term “business decision” chapter II.B.

²²⁷ It is acknowledged that by only reviewing the works from English-speaking scholars, not the full picture may be provided here; but it still shows a certain tendency of how scholars perceive the judiciary’s work.

²²⁸ Gu, *supra* note 25, at 196.

²²⁹ Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 *Del. J. Corp. L.* 125 213 (2006).

²³⁰ See chapter IV.B.2; Wang, *supra* note 28.

²³¹ Wang, *supra* note 28, at 92.

²³² Wang, *supra* note 28, at 92.

²³³ Wang, *supra* note 28, at 94.

the director's duties.²³⁴ However, Xu et al. also list cases in which the courts have not limited their role to mechanically applying the legal regulations.²³⁵ More interestingly, Xu et al. found that in one case a standard similar to the business judgment rule was applied.²³⁶

Yongxin Song states that the business judgment rule is a recognized legal doctrine.²³⁷ In the absence of any further explanations, however, it is unclear whether Song believes that the business judgment rule is an established doctrine in China and, if so, why Song reaches this conclusion.²³⁸

Finally, Charlie Xiao-Chuan Weng finds that China's judiciary is meddling with the business decisions of the board of directors and, thus, suggests that the courts should abstain from a substantive review of the business decisions.²³⁹

Based on the literature review above, no conclusive answer can be gained as to whether the business judgment rule has been recognized by Chinese courts so far. However, there are at least indications that this might be the case. In the following, three court cases will be discussed that have recognized the idea behind the business judgment rule.²⁴⁰

2. Review of Court Cases. On October 25, 2010, the Minhang District People's Court of Shanghai Municipality ("Minhang District People's Court") issued a judgment in connection with a lawsuit brought by the plaintiff (who was a shareholder and acted as supervisor) against the defendant (being a shareholder as well) who served as executive director and was in charge of the company's affairs.²⁴¹ The defendant was alleged to have sold all the company's assets and to have transferred the company in early 2009. Without making any further explanations, the Minhang District People's Court held that the company's autonomy and the business decisions of the directors are to be

²³⁴ Xu et al., *supra* note 28, at 69.

²³⁵ Xu et al., *supra* note 28, at 69–73.

²³⁶ Xu et al., *supra* note 28, at 71–72.

²³⁷ Song, *supra* note 167, at 223.

²³⁸ See Song, *supra* note 167, at 223.

²³⁹ Weng, *supra* note 26, at 141–42; cf. Ponsford, *supra* note 26, at 3.

²⁴⁰ On February 6 and February 7, 2020, I searched for Chinese court cases relating to the business judgment rule using the Chinese version of the pkulaw.cn platform operated by Chinalawinfo Co., Ltd. The following two keywords were used: "Yewu Panduan Guize" (业务判断规则) and "Shangye Panduan Guize" (商业判断规则). Both keywords can be translated into the English term "business judgment rule". The search resulted in 29 court cases. The three cases discussed herein were selected based on their importance (*i.e.*, the Supreme People's Court's guiding case no. 10; see *infra* note 310) and their information value for the present purpose.

²⁴¹ Liu a Yu Sun a Qita yu Gongsu Youguan de Jiufen An (刘a与孙a其他与公司有关的纠纷案) [Company-related Dispute among Liu A, Sun A and a Third Party], (2010) 闵民二(商)初字第215号 (Minhang Dist. People's Ct. of Shanghai Oct. 25, 2010) (China), CLIC.67473215, Chinalawinfo Co., Ltd., en.pkulaw.cn, no English translation available [hereinafter *Minhang Case*].

protected by the business judgment rule.²⁴² The Minhang District People's Court finally dismissed the plaintiffs' claims.²⁴³

On September 18, 2012, the Supreme People's Court issued the guiding case no. 10 regarding a dispute about the revocation of a resolution of the board of directors, which rests on a judgment made by the No. 2 Intermediate People's Court of Shanghai Municipality on June 4, 2010.²⁴⁴ The Plaintiff Li Jianjun ("Plaintiff") brought a lawsuit against Shanghai Jiadongli Environmental Protection Technologies Co. Ltd. ("Defendant") before the People's Court of Huangpu District, Shanghai Municipality ("Basic People's Court") and requested the revocation of the resolution of the Defendant's board of directors to remove the Defendant's general manager.²⁴⁵ The Plaintiff alleged that, besides procedural errors, the content of the resolution infringed the Company Law.²⁴⁶ On February 5, 2010, the Basic People's Court revoked the board resolution; the Defendant appealed.²⁴⁷ On June 4, 2010, the No. 2 Intermediate People's Court of Shanghai Municipality ("Intermediate People's Court") revoked the judgment of the Basic People's Court and dismissed the

²⁴² Minhang Case, *supra* note 307.

²⁴³ Minhang Case, *supra* note 307.

²⁴⁴ Zhidao Anli 10 Hao: Lijianjun Su Shanghai Jia Dongli Huanbao Keji Youxian Gongsigongsi Jueyi Chexiao Jiufen An (指导案例10号: 李建军诉上海佳动力环保科技有限公司公司决议撤销纠纷案) [Guiding Case No.10: Li Jianjun v. Shanghai Jiadongli Environmental Protection Technologies Co., Ltd. (Dispute over Revocation of a Company's Resolution)], 指导案例10号 (issued by Sup. People's Ct. on Sept. 18, 2012, decided by Shanghai No. 2 Interm. People's Ct. Apr. 4, 2010) (China), CLIC.877357(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Guiding Case No. 10*].

A research on the Chinese version of the pkulaw.cn platform operated by Chinalawinfo Co., Ltd. on April 19, 2020 using the keyword "Zhidao Anli 10 Hao" (指导案例10号) [guiding case no. 10] showed that ten court cases explicitly refer to the Supreme People's Courts' guiding case no. 10. Out of these ten cases, only four court cases related to the review of board resolutions (Yuan Mou yu Wan X Qiye Gufen Youxian Gongsigongsi Jueyi Chexiao Jiufen Shangsu An (袁某与万X企业股份有限公司公司决议撤销纠纷上诉案) [Yuan v. Wan X Enterprise Inc. (Appeal on Revocation of a Company's Resolution)], (2017)粤03民终8666号 (Interm. People's Ct. of Shenzhen Mun., Guangdong Prov., Mar. 14, 2017) (China), CLIC.11157882, Chinalawinfo Co., Ltd., en.pkulaw.cn, no English translation available; Zhang Mou yu Wan X Qiye Gufen Gongsigongsi Jueyi Chexiao Jiufen Shangsu An (张某与万X企业股份有限公司公司决议撤销纠纷上诉案) [Zhang v. Wan X Enterprise Inc. (Appeal on Revocation of a Company's Resolution)], (2017)粤03民终8665号 (Interm. People's Ct. of Shenzhen Mun., Guangdong Prov., Mar. 14, 2018) (China), CLIC.11157881, Chinalawinfo Co., Ltd., en.pkulaw.cn, no English translation available; Qi Bolin yu Ren Yuanguo, Yin Baoku Deng Gongsigongsi Jueyi Chexiao Jiufen Yishen Minshi Panjueshu (齐柏林与任远国、尹宝库等公司决议撤销纠纷一案一审民事判决书) [Qi Bolin v. Ren Yuanguo & Yin Baoku (Dispute over Revocation of a Company's Resolution)], (2017)内0702民初384号 (People's Ct. of Hailar Dist., Hulunbuir Mun., Inner Mongolia Autonomous Reg., Aug. 8, 2018) (China), CLIC.67164123, Chinalawinfo Co., Ltd., en.pkulaw.cn, no English translation available; Li Jiao Long yu Jiangxi Shi Long Shiye Gufen Youxian Gongsigongsi Laodong Zhengyi Yishen Minshi Panjueshu (李角龙与江西世龙实业股份有限公司劳动争议一审民事判决书) [Li Jiaolong v. Jiangxi Shilong Industrial Co., Ltd. (First Trial Civil Judgment Concerning a Labor Dispute)], (2019)赣0281民初2304号 (People's Ct. of Leping City, Jiangxi Prov., Nov. 21, 2019) (China), CLIC.94145320, Chinalawinfo Co., Ltd., en.pkulaw.cn, no English translation available.

²⁴⁵ Guiding Case No. 10, *supra* note 244, at basic facts.

²⁴⁶ Guiding Case No. 10, *supra* note 244, at basic facts.

²⁴⁷ Guiding Case No. 10, *supra* note 244, at judgment.

claims of the Plaintiff.²⁴⁸ The Intermediate People's Court held that the Defendant's bylaws were not infringed by the board resolution and:

Even if the reason for the resolution of the board of directors to remove Li Jianjun from his position as general manager did not exist, it still did not give rise to the revocation of the resolution. First, the Company Law respected corporate autonomy. *Generally, the internal legal relations of a company should be regulated through the corporate autonomy mechanism, and the judicial authorities should not intervene in the internal affairs of a company.* [...] The court should respect corporate autonomy and would not examine whether there did exist a reason for the board of directors of Jiadongli Company to remove a manager of company [sic!]. In other words, the court would not examine whether the facts based on which the resolution was made were true and whether the grounds were well-founded.²⁴⁹

The reasoning of the Intermediate People's Court above is a good illustration of the application of the business judgment rule which works as an abstention rule for the courts.²⁵⁰ The Supreme People's Court reaffirmed the Intermediate People's Court's reasoning by issuing the case as a guiding case²⁵¹ and repeated that the content of a board resolution is not subject to a substantive review unless the content violates the bylaws.²⁵² As pointed out before, this understanding is problematic as it allows a wide interpretation of which conduct violates the bylaws.²⁵³ This aspect is to be considered when discussing the obstacles of the implementation of a statutory business judgment rule.²⁵⁴

On May 24, 2018, the Intermediate People's Court of Hefei Municipality, Anhui Province ("Hefei Intermediate People's Court") decided a lawsuit brought against two senior managers claiming compensation for damages to the company's interests.²⁵⁵ The plaintiff claimed that the two senior managers had signed a supplementary agreement without the prior consent of the company's board of directors. According to the plaintiff, this agreement had ultimately damaged the company's interests.²⁵⁶ The plaintiff argued that the senior managers' conduct violated the company's bylaws because of a breach of their duty of loyalty and duty of care (*cf.* art. 149, para. 1 i.c.w. art. 147,

²⁴⁸ Guiding Case No. 10, *supra* note 244, at judgment.

²⁴⁹ Guiding Case No. 10, *supra* note 310, at judgment's reasoning (italics added by the author).

²⁵⁰ See with regard to the legal theory that the business judgment rule is a rule of abstention Bainbridge, *Abstention*, *supra* note 20, *passim* as well as chapter III.B.

²⁵¹ See Deng Jinting, *The Guiding Case System in Mainland China*, 10 FRONTIERS L. CHINA 1, *passim* (2013) (discussing the importance of guiding cases); Gao Fengping, *China's Guiding Cases System as the Instrument to Improve China's Case Guidance System, Which Includes Both Guiding Cases and Typical Cases*, 45 INT'L J. LEGAL INFO. 230, *passim* (2017).

²⁵² Guiding Case No. 10, *supra* note 244, at judgment's key points.

²⁵³ See the discussion under chapter V.A.

²⁵⁴ See chapter VI.B.1.

²⁵⁵ Fan Qiang, Jiang Nianbao Sunhai Gongsi Liyi Zeren Jiufen Ershen Minshi Panjueshu (范强、蒋年保损害公司利益责任纠纷二审民事判决书) [Civil Judgment of the Second Instance of the Dispute over the Liability of Fan Qiang and Jiang Nianbao for Damaging the Company's Interests], CLIC.55216441, Chinalawinfo Co., Ltd., en.pkulaw.cn (Hefei Intern. People's Ct. of Anhui Prov. May 24, 2018) (China) [hereinafter *Hefei Case*].

²⁵⁶ Hefei Case, *supra* note 255.

para. 1 Company Law).²⁵⁷ The Hefei Intermediate People's Court noted that a senior manager making a business decision shall be deemed to have acted in good faith and to have diligently fulfilled his obligations if (i) he was disinterested in the concerned matter, (ii) had legitimate reasons to believe that the collected information was correct, reliable and sufficient, and (iii) the business decision was in the company's interest.²⁵⁸ The requirements set forth by the Hefei Intermediate People's Court are reminiscent of the elements of Delaware's business judgment rule.²⁵⁹

Of course, these few cases do not allow concluding in general that the Chinese judiciary uniformly recognizes the business judgment rule. More quantitative and qualitative research is needed in this regard. The judgments discussed above show, however, that China's judiciaries are aware of the business judgment rule and that the general proposition that China has not recognized the business judgment rule so far²⁶⁰ oversimplifies the role of the business judgment rule in China. The fact that the Supreme People's Court explicitly recognized that the courts shall respect the company's authority under certain circumstances is a strong signal for the courts to exercise restraint when reviewing business decisions.²⁶¹ However, the foregoing judgments also show that there seems to be a lack of a uniform understanding of the definition of the business judgment rule. The ruling issued by the Minhang District People's Court did not elucidate on the specifics of the applied business judgment rule at all. The judgment of the Hefei Intermediate People's Court formulated other requirements than the Guiding Case No. 10 issued by the Supreme People's Court. This suggests that there seems to be a need for a uniform understanding of the business judgment rule and its elements.

VI. TRANSPLANTATION OF THE BUSINESS JUDGMENT RULE INTO CHINA'S COMPANY LAW

A. *Need for Recognition of the Business Judgment Rule*

At the beginning of this paper, an in-depth analysis of the economic aspects of the business judgment rule was carried out.²⁶² It resulted in two important findings: First, complex firms (*i.e.*, firms with multiple owners) need a centralized decision-maker.²⁶³ Second, the discretionary power of the centralized decision-maker has to be protected from a full substantive *ex post* review. The *ex post* review needs to be limited to the procedural aspects of the decision-making process.²⁶⁴ It was later established that the Chinese Stock

²⁵⁷ Hefei Case, *supra* note 255.

²⁵⁸ Hefei Case, *supra* note 255.

²⁵⁹ See chapter III.B.

²⁶⁰ Cf. GU, *supra* note 25, at 196.

²⁶¹ See Guiding Case No. 10, *supra* note 244, *passim*.

²⁶² See chapter II.A.

²⁶³ See chapter II.A.

²⁶⁴ See chapter II.B.

Company has two centralized decision-makers, *i.e.*, the board of directors and the board of supervisors, which enjoy limited discretionary powers.²⁶⁵ Based on the economic concept established earlier,²⁶⁶ Chinese Company Law needs to protect the discretionary powers of the board of directors and the board of supervisors albeit the powers' limited scope. The business judgment rule serves as an instrument to protect the centralized decision-makers' discretionary powers.²⁶⁷ The Company Law must, therefore, adopt the business judgment rule. Different factors have to be considered in this regard, such as doctrinal, legislative, enforcement-related, sociological and economical aspects. Before we discuss these aspects, two examples of the business judgment rule's transplant into two civil law jurisdictions, that of Switzerland and that of Germany, shall be presented.

B. Examples of Legal Transplants

In the following, two examples of civil law jurisdictions which transplanted the business judgment rule into their corporate law framework are discussed. The discussion aims at giving an overview of how the rule was incorporated into these foreign frameworks. In addition, the discourse below maps out essential aspects that are relevant when considering introducing the business judgment rule into the Company Law.

1. Example of Business Judgment Rule in Switzerland. The Swiss Federal Act on the Amendment of the Swiss Civil Code ("Swiss Code of Obligations" or "CO")²⁶⁸ provides the framework for companies limited by shares (art. 620 *et seq.* CO) ("Swiss Corporation"). The organizational structure of the Swiss Corporation consists of the general shareholders meeting (art. 698, para. 1 CO) and the board of directors (art. 707, para. 1 CO).

The general meeting of shareholders is the supreme governing body of the Swiss Corporation (art. 698, para. 1 CO). It not only determines and amends the articles of association (art. 698, para. 2, no. 1 CO) but also elects and discharges the members of the board of directors (art. 698, para. 2, no. 2 and art. 698, para. 2, no. 5 CO), elects the external auditors (art. 698, para. 2, no. 2 CO) and approves the management report, the financial statements and the resolutions on the allocation of the disposable profit (art. 698, para. 2, no. 3 and art. 698, para. 2, no. 4 CO). It also passes resolutions regarding matters which are reserved to the general meeting by law or by the articles of association (art. 698, para. 2, no. 6 CO). It is noticeable that the general elements of the

²⁶⁵ See chapter IV.A.

²⁶⁶ See chapter II.

²⁶⁷ Cf. chapter III.C.

²⁶⁸ BUNDESGESETZ BETREFFEND DIE ERGÄNZUNG DES SCHWEIZERISCHEN ZIVILGESETZBUCHES (FÜNFTER TEIL: OBLIGATIONENRECHT) [OR], LOI FÉDÉRALE COMPLÉTANT LE CODE CIVIL SUISSE (LIVRE CINQUIÈME: DROIT DES OBLIGATIONS) [CO], LEGGE FEDERALE DI COMPLEMENTO DEL CODICE CIVILE SVIZZERO (LIBRO QUINTO: DIRITTO DELLE OBBLIGAZIONI) [CO] [Federal Act on the Amendment of the Swiss Civil Code. Part Five: Code of Obligations] Mar. 30, 1911, SR 220, RS 220 (Switz.).

Swiss Corporation are similar to those of the corporation under Delaware law,²⁶⁹

The board of directors manages the company's business unless it has delegated this management responsibility (art. 716, para. 2 CO). The board of directors has, however, several non-transferable and inalienable duties which are mostly concerned with the overall management of the company, strategic decisions and supervision (art. 716, para. 1 CO). The board members are obliged to perform their duties with due care and to protect the interests of the company in good faith (art. 717, para. 1 CO) (duty of care and loyalty). The board members, however, do not owe any success.²⁷⁰ Under the Swiss Code of Obligations, board decisions are not refutable.²⁷¹ However, board decisions can be declared null and void (art. 714 CO). The Swiss courts restrain from declaring nullity, which is considered an exception.²⁷² Therefore, the review of board decisions is mostly related to liability lawsuits against the members of the board of directors who are liable to both the company and the individual shareholders and creditors for any losses or damages arising from any intentional or negligent breach of their duties (art. 754, para. 2 CO). A breach of duties mostly concerns a breach of the afore-mentioned duties under art. 717, para. 1 CO.

The Swiss Code of Obligations does not incorporate a business judgment rule.²⁷³ However, Swiss courts have been reluctant to substantively review business decisions.²⁷⁴ In 2012, the Federal Supreme Court explicitly

²⁶⁹ NIKITINE, *supra* note 73, at 97.

²⁷⁰ Dieter Gericke & Stefan sel. Waller, *Entwicklungslinien der bundesgerichtlichen Rechtsprechung zur aktienrechtlichen Verantwortlichkeit 2007–2017 (das Jahrzehnt der Richterinnen)* [Developments in Federal Supreme Court Rulings on Corporate Accountability 2007–2017 (The Decade of the Female Judges)], 137(2) ZSR, 259, 266 (2018); cf. Christoph B. Bühler, *Art. 717 / II. Sorgfaltspflicht (Abs. 1) / B. - D.*, [Art. 717 / Duty of Care (para. 1) / B. - D.], in *ZÜRCHER KOMMENTAR* 979, 985 (Handschin Lukas ed., 3d ed., 2018).

²⁷¹ Bundesgericht [BGer] [Swiss Federal Supreme Court] Mar. 21, 1950, 76 ENTScheidungen des SCHWEIZERISCHEN BUNDESGERICHTS [BGE] [Decisions of the Swiss Federal Supreme Court] 51, 61-66 (Switz.); Bundesgericht [BGer] [Swiss Federal Supreme Court] Feb. 28, 2018, 144 ENTScheidungen des SCHWEIZERISCHEN BUNDESGERICHTS [BGE] [Decisions of the Swiss Federal Supreme Court] 100, 103 (Switz.); Maria Walter, *Gedanken zum einstweiligen Rechtsschutz gegen pflichtwidriges Handeln von Verwaltungsräten* [Thoughts on Interim Relief Against Breaches of Duty by Members of the Board of Directors], 5 SZW 531, 532 (2018).

²⁷² Bundesgericht [BGer] [Swiss Federal Supreme Court] Feb. 28, 2018, 144 ENTScheidungen des SCHWEIZERISCHEN BUNDESGERICHTS [BGE] [Decisions of the Swiss Federal Supreme Court] 100, 104 (Switz.); Walter, *supra* note 271, at 532–33.

²⁷³ Frank Gerhard, *Business Judgment Rule und Rechtsrisiken* [Business Judgment Rule and Legal Risks], 3 SZW 254, 256 (2016).

²⁷⁴ NIKITINE, *supra* note 73, at 125–30; Urs H. Hoffmann-Nowotny, *Aktienrechtliche Verantwortlichkeit: Zur gerichtlichen Prüfungsbefugnis im Anwendungsbereich der Business Judgment Rule (Zurückhaltungsregel)* [Responsibility under the Corporation Law: On the Judicial Review Authority within the Scope of the Business Judgment Rule (Restraint Rule)], 5 SZW 454, 456–57 (2019); Hans Ueli Vogt & Michael Bänziger, *Das Bundesgericht anerkennt die Business Judgment Rule als Grundsatz des schweizerischen Aktienrechts* [The Federal Supreme Court Recognizes the Business Judgment Rule as Principle of the Swiss Corporation Law], 7(4) GESKR 607, 610 (2012); Gerhard, *supra* note 273, at 256; Kunz, *supra* note 23, at 276–77; Daniel Brugger & Hans Caspar von der Crone, *Gerichtliche Beurteilung von*

recognized that the courts should restrain from *ex post* reviews of business decisions that were taken on the basis of adequate information and sound decision-making and were free from any conflict of interests.²⁷⁵

Before we discuss what the elements of the business judgment rule are, we must question what it means that the Federal Supreme Court recognized this rule. Switzerland is a civil law country with the legislative power in the field of civil law exclusively vested in the federal legislator (art. 122 Federal Constitution of the Swiss Confederation²⁷⁶).²⁷⁷ Swiss courts (on any level) are, however, empowered to interpret the laws.²⁷⁸ In the absence of any statutory rule, a preponderant majority of Swiss scholars thus argue that the business judgment rule can be derived from the interpretation of art. 717, para. 1 CO, which sets forth the duties of the directors.²⁷⁹ In addition, the legislator, currently discussing a reform of the Swiss Code of Obligations concerning the Swiss Corporation, has not found it necessary to legislate the business judgment rule.²⁸⁰ Judgments of the Federal Supreme Court are not legally binding for courts on lower levels.²⁸¹ However, the Federal Supreme Courts' judgments do not only have a lighthouse effect but are also considered to have a *de facto* binding effect.²⁸²

The relevant cumulative elements of the business judgment rule developed by the Federal Supreme Court are:²⁸³

Geschäftsentscheiden [Judicial Review of Business Decisions], 2 SZW 178, 182 (2013); Gericke & Waller, *supra* note 270, at 265.

²⁷⁵ Bundesgericht [BGer] [Swiss Federal Supreme Court] June 18, 2012, 4A_74/2012, para. 5.1 (Switz.); confirming *e.g.*, Bundesgericht [BGer] [Swiss Federal Supreme Court] Nov. 20, 2012, 139 ENTSCHEIDUNGEN DES SCHWEIZERISCHEN BUNDESGERICHTS [BGE] [Decisions of the Swiss Federal Supreme Court] 24, 26 (Switz.); see Vogt & Bänziger, *supra* note 274, at 610–11; Gericke & Waller, *supra* note 270, at 266; Hoffmann-Nowotny, *supra* note 274, at 456.

²⁷⁶ Bundesverfassung der Schweizerischen Eidgenossenschaft [BV] [Federal Constitution of the Swiss Confederation] Apr. 18, 1999, SR 101 (Switz.).

²⁷⁷ To some extent, however, judicial law-making exists but is limited to specific and rather rare cases, see AXEL TSCHENTSCHER ET AL., ÖFFENTLICHES RECHT [Public Law] 17–18 (2d ed. 2019).

²⁷⁸ See *id.* at 16–17.

²⁷⁹ See instead of many Vogt & Bänziger, *supra* note 274, at 616; Markus Vischer, *Kritische Sicht auf die vom Bundesgericht im Verantwortlichkeitsrecht verwendete Business Judgement Rule (BJR)* [Critical View on the Business Judgment Rule Applied by the Federal Supreme Court in the Area of Liability Law], 114 SJZ 53, 60–61 (2018); Gerhard, *supra* note 273, at 256; *contra* Kunz, *supra* note 23, at 276.

²⁸⁰ See for an overview on the current status of the reform Peter Forstmoser & Marcel Küchler, *Schweizerische Aktienrechtsreform: Die Schlussrunde ist eingeläutet!* [Revision of the Swiss Corporation Law: The Final Round Has Begun!] JUSLETTER, Feb. 10, 2019, at 1, *passim*.

²⁸¹ Cf. Bundesgericht [BGer] [Swiss Federal Supreme Court] Jan. 15, 1997, 123 ENTSCHEIDUNGEN DES SCHWEIZERISCHEN BUNDESGERICHTS [BGE] [Decisions of the Swiss Federal Supreme Court] 16, 18–19 (Switz.).

²⁸² This *de facto* binding effect mainly stems from the fact that the barriers to appeal a judgment from a cantonal instance to the Federal Supreme Court are rather limited (in civil law cases, the minimum dispute value limit is for example as low as CHF 30,000), see BUNDESGESETZ ÜBER DAS BUNDESGERICHT [BGG], LOI SUR LE TRIBUNAL FÉDÉRAL [LTF], LEGGE SUL TRIBUNALE FEDERALE [LTF] [Federal Supreme Court Act] Dec. 19, 2008, SR 272, RS 272, art. 74, para. 1, lit. b (Switz.).

²⁸³ Gerhard, *supra* note 273, at 256–57; NIKITINE, *supra* note 73, at 105, who also lists the criteria of rationality as a stand-alone criteria; Vogt & Bänziger, *supra* note 274, at 614–16; Kunz, *supra* note 23, at 277–

- 1) questionable act was a business decision;
- 2) no conflict of interest;
- 3) decision was made based on appropriate information; and
- 4) directors acted in good faith and in the honest belief that the decision is in the best interest of the company.

While the Federal Supreme Court never explicitly defined what a business decision is, there seems to be a tendency that any act which requires discretion of the board of directors shall be subject to the business judgment rule.²⁸⁴ Decisions which violate the law, the articles of association, as well as the organizational regulations are carved out from the application of the business judgment rule.²⁸⁵

The Federal Supreme Court applies an objective standard to assess whether a director adhered to his duties. The director's actions are compared to the actions which can be reasonably expected from a properly acting person in a similar situation.²⁸⁶

Other than under Delaware law,²⁸⁷ the Swiss business judgment rule as applied by the Swiss courts does not function as a presumption.²⁸⁸ Such wide interpretation of art. 717, para. 1 CO would be against the rule of law.²⁸⁹ In liability cases, the general rule stipulated by art. 8 Civil Code²⁹⁰ is applicable. Art. 8 Civil Code stipulates that the burden of proving the existence of an alleged fact rests on the person who asserts rights from that fact unless the law provides otherwise. Thus, the plaintiff of a lawsuit against the directors has to prove that there is (i) a breach of duty, (ii) a damage and (iii) a causal connection between the breach of duty and the damage.²⁹¹ However, the burden of proof that there was no fault rests on the defendant (*i.e.*, the directors).²⁹²

There is no agreement among Swiss scholars whether a limited substantive review of business decisions shall be conducted even if the elements of the business judgment rule are fulfilled. While some scholars argue that there is no

78; Hoffmann-Nowotny, *supra* note 274, at 455; Nicolas Facincani & Reto Sutter, *Responsabilité au regard du droit de la SA et business judgment rule* [Liability under the Corporation Law and the Business Judgment Rule], 6 TREX 350, 351 (2019); *see* Gericke & Waller, *supra* note 270, at 266, positing, however, that in case of "inactivity", a certain degree of abstention shall be exercised (Gericke & Waller, *supra* note 270, at 271–72).

²⁸⁴ Gericke & Waller, *supra* note 270, at 270–71.

²⁸⁵ NIKITINE, *supra* note 73, at 169–70.

²⁸⁶ Bundesgericht [BGer] [Swiss Federal Supreme Court] Nov. 2, 2012, 139 ENTSCHEIDUNGEN DES SCHWEIZERISCHEN BUNDESGERICHTS [BGE] [Decisions of the Swiss Federal Supreme Court] 24, 26 (Switz.); *see* Gericke & Waller, *supra* note 270, at 264, criticizing the standard of objectivity.

²⁸⁷ *See* chapter III.C.

²⁸⁸ Vogt & Bänziger, *supra* note 274, at 613; Gerhard, *supra* note 273, at 257.

²⁸⁹ *See* Vogt & Bänziger, *supra* note 274, at 613, noting that an amendment of the law would be required in order to incorporate the presumption mechanism.

²⁹⁰ SCHWEIZERISCHES ZIVILGESETZBUCH [ZGB], CODE CIVIL SUISSE [CC], CODICE CIVILE SVIZZERO [CC] [Swiss Civil Code] Dec. 10, 1907, SR 210, RS 210 (Switz.).

²⁹¹ NIKITINE, *supra* note 73, at 278; Vogt & Bänziger, *supra* note 274, at 627; Gerhard, *supra* note 273, at 257; Hoffmann-Nowotny, *supra* note 274, at 462.

²⁹² NIKITINE, *supra* note 73, at 278; Vogt & Bänziger, *supra* note 274, at 613, with further references.

need for a review, others posit that decisions which are clearly wrong shall be subject to a limited review.²⁹³ Others claim that it is important to review whether the decision was made in the best interest of the company.²⁹⁴ The Federal Supreme Court ruled that, even in cases where the conditions of the business judgment rule are met, the court will assess whether the business decision is reasonable.²⁹⁵ If the decision is deemed unreasonable, a breach of duty exists.²⁹⁶ However, it is not clear yet which standard of reasonableness the Federal Supreme Court applies; indications exist that a decision shall only be deemed unreasonable in extreme cases.²⁹⁷ The main difference to the Delaware business judgment rule seems to be that the Federal Supreme Court substantively reviews the decision and not the motives of the directors.²⁹⁸

The arguments for justifying the business judgment rule as abstention rule²⁹⁹ are similar to those brought forward to legitimate Delaware's business judgment rule. The reasons include: (i) the judges are subject to a hindsight bias,³⁰⁰ (ii) risk-taking lies in the nature of the corporation's aim to make a profit,³⁰¹ (iii) it is questionable whether judges are able to substantively review a business decision,³⁰² and (iv) the separation between membership and management must be recognized and, thus, the discretion assigned to the board of director must be protected.³⁰³

Regarding the transplant of Delaware's business judgment rule, the Swiss example teaches us the following: First, the corporate structure, *i.e.*, the allocation of authority to the centralized decision-maker calls for protection of the director's discretion. Second, the board of directors does not owe any success to the company's shareholders. Third, only business decisions shall be protected by the business judgment rule. Fourth, the business judgment rule is subject to the general principles regarding the allocation of the burden of proof. Fifth, there is no need for a statutory business judgment rule as the courts are allowed to interpret the law.

²⁹³ Gericke & Waller, *supra* note 270, at 267, with further references; Hoffmann-Nowotny, *supra* note 274, at 458.

²⁹⁴ Gericke & Waller, *supra* note 270, at 267, with further references; Hoffmann-Nowotny, *supra* note 274, at 458.

²⁹⁵ Bundesgericht [BGer] [Swiss Federal Supreme Court] Sept. 8, 2015, 4A_219/2015, para. 4.2.1 (Switz.); Gericke & Waller, *supra* note 270, at 268, with further references; Hoffmann-Nowotny, *supra* note 274, at 458–60.

²⁹⁶ Gericke & Waller, *supra* note 270, at 268.

²⁹⁷ Hoffmann-Nowotny, *supra* note 274, at 458–62, with further references.

²⁹⁸ See the discussion of the duty of good faith in chapter III.B.4.

²⁹⁹ See Gericke & Waller, *supra* note 270, at 264.

³⁰⁰ Gericke & Waller, *supra* note 270, at 261–62; Brugger & von der Crone, *supra* note 277, at 182; Gerhard, *supra* note 273, at 256, with further references.

³⁰¹ Gericke & Waller, *supra* note 270, at 263; *cf.* Vogt & Bänziger, *supra* note 274, at 611; Gerhard, *supra* note 273, at 256; *cf.* NIKITINE, *supra* note 73, at 165–66.

³⁰² Gericke & Waller, *supra* note 270, at 263.

³⁰³ Vogt & Bänziger, *supra* note 274, at 611–12; *see* Vischer, *supra* note 282, at 55; NIKITINE, *supra* note 73, at 120–21.

2. Example of Business Judgment Rule in Germany. The German Stock Corporation Act (“AktG”)³⁰⁴ sets forth the framework for the stock corporation (“German Corporation”). The liability is solely limited to the German Corporation’s assets (§ 1, para. 1, sentence 2 AktG). The organizational structure of the German Corporation consists of the general meeting (§ 118, para. 1 AktG), the supervisory board (§ 95 AktG) and the management board (§ 76, para. 1 AktG).

The stockholders exercise their rights at the general meeting (§ 118, para 1, sentence 1 AktG). The general meeting adopts resolutions as assigned by the law or the bylaws, including, among others, the appointment of the members of the supervisory board (subject to certain exemptions) (§ 119, para. 1, no. 1 AktG), approval of the actions taken by members of the management board and the granting of discharge to them (§ 119, para. 1, no. 1 AktG), the appropriation of the net income (§ 119, para. 1, no. 2 AktG) and the amendment of the bylaws (§ 119, para. 1, no. 5 AktG). However, the general meeting may only take decisions regarding the company’s management matters if the management board asks the general meeting to do so (§ 119, para. 2 AktG).

The supervisory board appoints (§ 84, para 1, sentence 1 AktG) and supervises the management board (§ 111, para. 1 AktG), while the management board is vested with the management of the company (§ 76, para. 1 AktG).³⁰⁵ Neither the general meeting nor the supervisory board is allowed to manage the affairs of the company.³⁰⁶ The actions to be taken by the management board are not transferable to the supervisory board (§ 111, para. 4, sentence 1 AktG). Certain types of business transactions may, however, be subject to the supervisory board’s prior approval as determined by the bylaws or the supervisory board (§ 111, para. 4, sentence 2 AktG). While it must be highlighted that the supervisory board’s veto right is not a right to co-decision,³⁰⁷ the authority is shifted, at least partly, from the management board to the supervisory board when applying Arrow’s theory.³⁰⁸ The members of the supervisory board have the same duty of care and liability as the members of the management board (§ 116, sentence 1 AktG) (*see below*).

The management board is obliged to act in the interest of the company.³⁰⁹ The members of the management board are obliged to exercise their duties

³⁰⁴ AKTIENGESETZ [AKTG] [STOCK CORPORATION ACT], translation at [http://www.gesetze-im-internet.de/englisch_aktg/\(Ger.\)](http://www.gesetze-im-internet.de/englisch_aktg/(Ger.)).

³⁰⁵ See regarding this dual system *e.g.*, Holger Fleischer, *AktG § 76 Leitung der Aktiengesellschaft* [AktG § 76 Management of the Stock Corporation], in *KOMMENTAR ZUM AKTIENGESETZ* no. 1, no. 4 (Gerald Spindler & Eberhard Stilz eds., 2007) [hereinafter *AktG § 76*].

³⁰⁶ Instead of many *id.* at no. 7, with further references.

³⁰⁷ Gerald Spindler, *AktG § 111 Aufgaben und Rechte des Aufsichtsrats* [AktG § 111 Duties and Rights of the Supervisory Board], in *KOMMENTAR ZUM AKTIENGESETZ* no. 1, no. 62 (Gerald Spindler & Eberhard Stilz eds., 2007) [hereinafter *AktG § 111*].

³⁰⁸ Cf. ARROW, *supra* note 9, at 77–78.

³⁰⁹ Fleischer, *AktG § 76*, *supra* note 305, at no. 10.

according to the standard of care which can be expected from an ordinary and prudent manager complying with his duties (§ 93, para. 1 AktG). The German Stock Corporation Act thus applies an objective standard of care.³¹⁰ A success of any kind is not owed.³¹¹ Members of the management board who breach their duties are jointly and individually liable for the damages resulting from the breach (§ 93, para. 2 AktG). If called into question, the management members bear the burden to prove that they exercised the standard of care of a prudent manager who faithfully complies with his duties (§ 3, para. 2 AktG).

§ 93, para. 1, sentence 2 AktG incorporates the business judgment rule which was applied by the German courts before.³¹² The business judgment rule is applicable to both the members of the management board and the supervisory board (§ 116, sentence 1 AktG i.c.w. § 93, para. 1 AktG).³¹³ It reads as follows:

No dereliction of duties shall be given in those instances in which the member of the management board, in taking an entrepreneurial decision, was within his rights to reasonably assume that he was acting on the basis of adequate information and in the best interests of the company.³¹⁴

Only entrepreneurial decisions, in other words business decisions, are subject to the German business judgment rule.³¹⁵ A decision has an entrepreneurial character if the members of the management board or the supervisory board enjoy discretion in making the decision and if there is some need for a prognosis.³¹⁶ Decisions which violate the law or the articles of

³¹⁰ Thomas Ritter, § 24 *Haftung von Vorstands- und Aufsichtsratsmitgliedern* [§ 24 Liability of the Members of the Board of Directors and the Board of Supervisors], in MÜNCHENER ANWALTSHANDBUCH AKTIENRECHT no. 1, no. 25 (Matthias Schüppen & Bernhard Schaub eds., 3d ed. 2018) [hereinafter *AktG* § 24], NIKITINE, *supra* note 73, at 289.

³¹¹ Holger Fleischer, *AktG* § 93 *Sorgfaltspflicht und Verantwortlichkeit der Vorstandsmitglieder* [AktG § 93 Duty of Care and Liability of the Members of the Board of Directors], in KOMMENTAR ZUM AKTIENGESETZ no. 1, no. 61 (Gerald Spindler & Eberhard Stilz eds., 2007) [hereinafter *AktG* § 93]; Gerald Spindler, *AktG* § 116 *Sorgfaltspflicht und Verantwortlichkeit der Aufsichtsratsmitglieder* [AktG § 116 Duty of Care and Liability of the Members of the Board of Supervisors], in KOMMENTAR ZUM AKTIENGESETZ no. 1, no. 43 (Gerald Spindler & Eberhard Stilz eds., 2007) [hereinafter *AktG* 116].

³¹² See Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 21, 1997, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1926, 1997 (Ger.); Wolfgang Hölters, *AktG* § 93 *Sorgfaltspflicht und Verantwortlichkeit der Vorstandsmitglieder* [AktG § 93 Duty of Care and Liability of the Members of the Board of Directors], in AKTIENGESETZ no. 1, no. 29 (Wolfgang Hölters ed., 3d ed. 2017); NIKITINE, *supra* note 73, at 290–92; Oliver Sieg & Simon-Alexander Zeidler, § 3. *Business Judgment Rule*, in CORPORATE COMPLIANCE no. 1, no. 3, no. 17 (Christoph E. Hauschka et al. eds., 3d ed. 2016); Fleischer, *AktG* § 93, *supra* note 311, at 61.

³¹³ Sieg & Zeidler, *supra* note 312, at 22.

³¹⁴ AKTIENGESETZ [AKTG] [STOCK CORPORATION ACT], § 93, para. 1, sentence 2 (Ger.).

³¹⁵ Accordingly, non-activity is not covered by the business judgment rule (see instead of many Markus Roth, *Outside Director Liability: German Stock Corporation Law in Transatlantic Perspective*, 8 JOURNAL OF CORPORATE LAW STUDIES 337, 355 (2008)).

³¹⁶ NIKITINE, *supra* note 73, at 292–93; Sieg & Zeidler, *supra* note 312, at 19; Fleischer, *AktG* § 93, *supra* note 311, at no. 67–69a; Dirk Kocher, *Zur Reichweite der Business Judgment Rule* [On the Scope of the Business Judgment Rule], CCZ 215, 216 (2019); see, however, Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 21, 1997, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1926, 1997 (Ger.), according to which the discretionary powers of the supervisory board are limited in scope.

association are not subject to the business judgment rule.³¹⁷ Scholars sometimes consider the German business judgment rule's condition that the decision-maker shall have reasonably assumed that he acted in the best interest of the company as a limited *ex post* review of the entrepreneurial decision.³¹⁸ Noticeably, the standard applied as to whether the decision-maker acted in the best interest of the company is a mixture of both subjective and objective conditions.³¹⁹ It is to be assessed whether the director assumed and could reasonably assume that he acted in the company's best interest.³²⁰ The absence of a conflict of interest has not been included in the statutory rule but is considered to be an unwritten condition.³²¹

The German business judgment rule is doctrinally tied to the question of the breach of duty but not the fault. This means that if the conditions of the business judgment rule are fulfilled, no breach of duty exists.³²²

The major difference to Delaware's business judgment rule is that the German business judgment rule is not a presumption and has no procedural element.³²³ Thus, the members of the management board or of the supervisory board bear the burden of proof that they exercised due care.³²⁴ In this context, the business judgment rule is said to function as a "safe harbor"³²⁵ The reason for this distribution of the burden of proof is that the defendant is better situated to submit the proof than the plaintiff.³²⁶ It has been criticized that this distribution of the burden of proof harms the business judgment rules' purpose to protect the directors.³²⁷

The reasons to justify the German business judgment rule are similar to those brought forward in connection with that of Delaware and Switzerland. Scholars as well as the German Federal Court of Justice argue (i) that risks are

³¹⁷ Sieg & Zeidler, *supra* note 312, at 19; Fleischer, *AktG § 93*, *supra* note 311, at 67; criticizing this approach Kocher, *supra* note 320, at 216–19.

³¹⁸ NIKITINE, *supra* note 73, at 293–94; see Fleischer, *AktG § 93*, *supra* note 311, at 73–75.

³¹⁹ Roth, *supra* note 315, at 349.

³²⁰ Roth, *supra* note 315, at 349.

³²¹ NIKITINE, *supra* note 73, at 292; Fleischer, *AktG § 93*, *supra* note 311, at 72; Spindler, *AktG § 116*, *supra* note 307, at 47.

³²² See Ritter, *AktG § 24*, *supra* note 314, at 23; cf. Fleischer, *AktG § 93*, *supra* note 311, at 65; Thomas Ritter, § 22 *Vorstand*, in MÜNCHENER ANWALTSHANDBUCH AKTIENRECHT no. 1 (Matthias Schüppen & Bernhard Schaub eds., 3d ed. 2018), no. 88 [hereinafter *AktG § 22*].

³²³ Roth, *supra* note 315, at 349; *contra* regarding the presumptive nature but *accord* regarding the absence of a procedural element Walter G. Paefgen, *Die Darlegungs- und Beweislast bei der Business Judgment Rule* [The Burden of Demonstration and Proof Concerning the Business Judgment Rule] NZG 891, 892 (2009). [hereinafter *Business Judgment Rule*].

³²⁴ NIKITINE, *supra* note 73, at 294; see Sieg & Zeidler, *supra* note 312, at 4; Fleischer, *AktG § 93*, *supra* note 311, at 77; Ritter, *AktG § 22*, *supra* note 314, at 89; Roth, *supra* note 315, at 349–50.

³²⁵ Gurrea-Martínez, *supra* note 79, at 420.

³²⁶ Sieg & Zeidler, *supra* note 312, at 4, note. 10.

³²⁷ NIKITINE, *supra* note 73, at 294; cf. Sieg & Zeidler, *supra* note 312, at 4; Roth, *supra* note 315, at 349–50; see also Paefgen, *supra* note 327, at 892–94.

inherent in the management of a company,³²⁸ (ii) that it is difficult to *ex post* review an entrepreneurial decision due to the hindsight bias³²⁹ and (iii) that the business judgment rule protects the discretionary power of the management board.³³⁰

What can we gain from the comparative review of Germany's business judgment rule? First, while courts seem to have exercised restraint regarding substantive reviews of entrepreneurial decisions, the legislator saw a necessity to codify the business judgment rule. Second, the German dualistic organizational system is different from the organizational structure of the Delaware Corporation and the Swiss Corporation, which both pursue a monistic model. Undoubtedly, the business judgment rule is applicable to both the supervisory board and the management board. The structural difference, however, restricts the applicability of the business judgment rule to the supervisory board as it is limited to entrepreneurial decisions only.³³¹ Third, neither does the German business judgment rule stipulate a presumption that the members of the management board and the supervisory board acted with due care, nor does it have any procedural element. Fourth, the management board does not owe any success.

C. Feasibility of a Transplant into China's Company Law

The close analysis of China's Company Law concerning Stock Companies reveals that the business judgment rule fits well into its DNA. The business judgment rule developed by Delaware's law, and for example adopted by Switzerland³³² and Germany³³³, is based on three pillars. First, the management of the company is structurally independent from the shareholders.³³⁴ Second, the members of the board of directors have three core duties: the duty of loyalty, the duty of due care, and the duty of good faith.³³⁵ Third, the board of directors enjoys (limited) authority.³³⁶ These three pillars can also be found in China's Company Law for Stock Companies. Not only is the management of a Stock Company structurally divided,³³⁷ but the board of directors (and, in some circumstances, also the board of supervisors) is also vested with authority albeit

³²⁸ Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 21, 1997, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1926, 1997 (Ger.); see Sieg & Zeidler, *supra* note 312, at 29; Kocher, *supra* note 320, at 216.

³²⁹ Kocher, *supra* note 320, at 216.

³³⁰ See Paefgen, *Business Judgment Rule*, *supra* note 327, at 893.

³³¹ Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 21, 1997, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1926, 1997 (Ger.).

³³² See chapter VI.B.1.

³³³ See chapter VI.B.2.

³³⁴ See chapter A; cf. Aronson v. Lewis, 473 A.2d 805, 811 (Del. (1984)); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. (1985)); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. (1993)).

³³⁵ See chapters III.B.2 (duty of loyalty), III.B.3 (duty of care) and III.B.4 (duty of good faith).

³³⁶ See chapter VI.A; see also Aronson v. Lewis, 473 A.2d 805, 811 (Del. (1984)); Weinberger, *supra* note 86, at 293; Gordon, *supra* note 46, at 348–49.

³³⁷ See chapter IV.A.

limited.³³⁸ In addition, the directors and supervisors are subject to the duties of loyalty, due care and good faith.³³⁹ The directors and supervisors do not owe any success of their actions to the shareholders.³⁴⁰ Therefore, as regards Stock Companies, China's Company Law thus has all prerequisites to incorporate the business judgment rule. The following four objections may, however, be raised against the incorporation of the business judgment rule into China's Company Law:³⁴¹

- 1) The business judgment rule is a U.S. common law concept and, therefore, does not fit into China's civil law system (doctrinal aspect);³⁴²
- 2) A statutory business judgment rule is not needed in China and would not work, as the judiciary would have to develop the relevant case law (legislative aspect);³⁴³
- 3) The business judgment rule will not be enforceable, as the judges will not be able to properly apply the business judgment rule (enforcement aspect);³⁴⁴ and
- 4) The business judgment rule cannot be implemented, as it is not compatible with the Chinese culture (sociological aspect).³⁴⁵

These four objections shall be analyzed in more detail below. The objection that there is no need for a business judgment rule (economic aspect) has been discussed at length throughout this paper and, hence, is not part of the analysis below.³⁴⁶ In short, it has been shown that the protection of the discretionary powers of the centralized decision-maker is crucial for an efficient decision-making process. The business judgment rule is the tool for ensuring such protection.³⁴⁷

1. Doctrinal Aspect: Whether the Business Judgment Rule Is Compatible with China's Civil Law System. The assertion that the business judgment rule cannot be recognized by China's legal system, as it is a U.S. common law concept, suggests that a codification of the business judgment rule is impossible. When is codification impossible? It seems that this is hardly ever the case if, to some extent, it is clear *what* is to be regulated. In fact, it appears

³³⁸ See chapter IV.A.4.

³³⁹ See chapter IV.B.

³⁴⁰ See chapter VI.B.1.

³⁴¹ There might be more possible arguments against the implementation of a business judgment rule into China's Company Law. The listed objections seem, however, to cover most of the relevant aspects.

³⁴² Cf. the discussion on the feasibility of the transplantation of the fiduciary duty concept into China's company law Lee, *supra* note 192, *passim*; cf. with regard to the Serbian law Mirko Vasiljević, *Civil Law and Business Judgment Rule*, 60 АНАЛИ ПРАВНОГ ФАКУЛТЕТА У БЕОГРАДУ 7, *passim* (2012).

³⁴³ Cf. regarding the codification of the fiduciary duty concept Xu et al., *supra* note 28, at 61.

³⁴⁴ Cf. Lee, *supra* note 192, at 920.

³⁴⁵ Cf. Song, *supra* note 167, at 214.

³⁴⁶ See chapters II, IV.A.4 and VI.A.

³⁴⁷ See chapter II.

that almost every concept or principle, no matter how vague, can be codified.³⁴⁸ The business judgment rule was first introduced by U.S. Delaware courts and, lacking any codified rule, was further developed by the courts over the years.³⁴⁹ Although different variations of the business judgment rule exist, its four elements discussed before are widely accepted.³⁵⁰ Thus, the subject matter of the business judgment rule is fairly clear, and its codification is not impossible. For that reason, a U.S. scholar suggested a codification of the business judgment rule.³⁵¹ A definition of the business judgment rule was included in the Revised Model Business Corporation Act as well as in the American Law Institute's Principles of Corporate Governance.³⁵² In addition, Germany as a civil law country codified the business judgment rule.³⁵³

The codification of the business judgment rule would be possible, but would its equitable nature (*i.e.*, no liability for "honest mistakes in judgment"³⁵⁴)³⁵⁵ fit into China's civil law system?³⁵⁶ Would it be in conflict with China's civil law concept of fault?³⁵⁷ As a civil law jurisdiction, China's legal system does not differentiate between law and equity as common law jurisdictions do.³⁵⁸ Does China's legal system thus not provide "a method of adjusting conflicting human interests in accordance with ideals of decent and honorable conduct in an ethically maturing society"?³⁵⁹ Although China's legal system lacks a law of equity, it still values equity. The equity principles have merely "lost their separate identity"³⁶⁰ The equity principle's core elements of "good faith, honesty and generosity" were codified as general legal norms.³⁶¹ The Company Law specifically recognizes the good faith element of the equity principle and obliges the company to act accordingly (art. 5 Company Law). In addition, the directors are obliged to act with due care, to be loyal to the company and to exercise good faith.³⁶² China's legal system, like civil law systems in general, leaves it to the court to apply the statutory provision to the

³⁴⁸ Every jurisdiction has its own examples of codified vague concepts. As for China, we may refer to the company's duty to comply with "social morality" and "business morality" (art. 5, para. 1 Company Law).

³⁴⁹ See Sharfman, *supra* note 88, at 28–33; cf. Bainbridge, *Abstention*, *supra* note 20, at 89–90; Arshat, *supra* note 85, at 97–100.

³⁵⁰ See chapter III.

³⁵¹ Eisenberg, *Codification*, *supra* note 129, at 49–50.

³⁵² Eisenberg, *Codification*, *supra* note 129, at 37–38, 49–50.

³⁵³ See chapter VI.B.2.

³⁵⁴ Sharfman, *supra* note 85, at 33.

³⁵⁵ Sharfman, *supra* note 85, at 33–42; Hinsey IV, *supra* note 134, at 610; cf. Davis, JR., *supra* note 137, at 587.

³⁵⁶ Cf. Lee, *supra* note 189, *passim*.

³⁵⁷ Cf. Vasiljević, *supra* note 342, at 35–38.

³⁵⁸ Lee, *supra* note 189, at 899; cf. Ralph A. Newman, *Equity in Comparative Law*, 17 ICLQ 807, 830 (1968); G. M. Razi, *Reflections on Equity in the Civil Law Systems*, 13 AM. U. L. REV. 24, 24 (1963).

³⁵⁹ Newman, *supra* note 358, at 812.

³⁶⁰ Newman, *supra* note 358, at 830.

³⁶¹ Newman, *supra* note 358, at 831.

³⁶² See chapter VI.B; cf. Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 678 (2008).

individual case and to interpret the application of the law. While the common and civil law systems may differ in terms of their mechanisms, they ultimately follow the same ideals.³⁶³ It turns out that the equitable nature of the business judgment rule is no counterargument against its recognition under Chinese law, but speaks for its codification because principles of equity find their way into civil law through their formulation as statutory norms.

In addition, the business judgment rule does not conflict with China's concept of fault. This proposition is based on a misunderstanding of the directors' and supervisor's liability under the Company Law. Directors and supervisors are liable if their actions violate any law, administrative regulations or the bylaws when performing their duties (art. 149 Company Law). The business judgment rule does not change the standard of conduct but merely limits the standard of review if certain requirements are fulfilled.³⁶⁴ Therefore, the business judgment rule is not opposed to the concept of fault. On the contrary, it is part of the directors' and supervisors' liability framework. That is why for example Swiss scholars postulate that there is no need for the business judgment rule to be codified, as it can be derived from interpretation of the statutory norm on directors' liability.³⁶⁵ Moreover, directors and supervisors do not owe any success under the Company Law but are responsible for adhering to their duties of loyalty, due care and good faith. Not recognizing the business judgment rule contradicts the current concept of liability. A substantive *ex post* review of business decisions ultimately equals a review of the business decisions' result and thus an analysis of the directors' success which is not owed under the Company Law.

Hence, the suggestion that the business judgment rule does not fit into China's civil law system has been proven to be incorrect.

2. Legislative Aspect: Whether a Statutory Business Judgment Rule Is Feasible. In connection with the codification of the fiduciary duties, it is posited that a codification is difficult and that the concept of fiduciary duties needs to be developed by case law.³⁶⁶ The same argument can be made with regard to the business judgment rule. Two questions are concerned: First, is it necessary to codify the business judgment rule, or can the courts develop the rule accordingly? Second, is it difficult to codify the business judgment rule? The second question has already been answered in the negative under the

³⁶³ Razi, *supra* note 358, at 44.

³⁶⁴ Vogt & Bänziger, *supra* note 274, at 615–16; Eisenberg, *Standards*, *supra* note 95, at 440–45; cf. Vischer, *supra* note 279, at 60.

³⁶⁵ Vogt & Bänziger, *supra* note 274, at 616; Vischer, *supra* note 279, at 60–61; Gerhard, *supra* note 273, at 256; *see*, however, with regard to China chapter VI.C.2.

³⁶⁶ Xu et al., *supra* note 28, at 61.

previous chapter.³⁶⁷ We shall thus turn to the first question and establish whether a statutory provision is needed.

China is a civil law jurisdiction.³⁶⁸ The legislative power is vested in the National People's Congress and its Standing Committee (art. 58 Constitution; *see also* art. 7, para. 1 Legislation Law³⁶⁹). Various matters, including the basic system of civil matters must be governed by laws (art. 8 Legislation Law). Legal provisions must be definite, specific, pertinent and enforceable (art. 6 Legislation Law). Precedents are not legally binding.³⁷⁰ The power to interpret the laws (including the Constitution) is vested with the Standing Committee of the National People's Congress ("Standing Committee") (art. 67, para. 1, no. 1 and 4 Constitution; art. 45, para. 1 Legislation Law). A law shall be interpreted by the Standing Committee if the specific meaning of a legal provision requires clarification or if new circumstances appear after the enactment of the law that require a basic clarification in order to apply the law (art. 45, para. 2, no. 1 and 2 Legislation Law). The Supreme People's Court may, however, make interpretations on the specific *application* of laws in the context of legal disputes (art. 104, para. 1 Legislation Law).³⁷¹ In 2010, though, the Supreme People's Court established the so-called guiding case system, which is seen as a form of judicial law-making.³⁷²

We have seen that neither the Company Law provides for a statutory business judgment rule nor have China's courts established a uniform rule, although the basic principle of abstention in cases regarding business decisions seems to have been recognized by some courts (including the Supreme People's Court).³⁷³ This circumstance causes uncertainty. Therefore, a clear and uniform business judgment rule needs to be formulated. China still is a civil law country appreciating the "certainty and stability of law".³⁷⁴ Hence, it is, in my view, advisable to codify the business judgment rule. As the example of Switzerland shows,³⁷⁵ one could, however, argue that the business judgment rule can be derived from interpreting the directors and supervisors' obligation to adhere to the duty of loyalty and the duty of good care (*cf.* art. 149 i.c.w.

³⁶⁷ *See* chapter VI.C.1.

³⁶⁸ Instead of many Shucheng Wang, *Guiding Cases as a Form of Statutory Interpretation: Expansion of Supreme People's Court's Judicial Lawmaking Authority in China*, 48 HONG KONG L. J. 1067, 1067 (2018), pointing out that China's legal system employs, however, some special characteristics; Chen Albert H. Y., *The Developing Chinese Law and the Civil Law Tradition*, in CHINA REVIEW, *passim* (M. Brosseau et al. eds., 1996).

³⁶⁹ Lifa Fa (立法法) [Legislation Law] (promulgated by Nat'l People's Cong., Mar. 15, 2015, effective Mar. 15, 2015), CLI.1.245693(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Legislation Law*].

³⁷⁰ Wang, *supra* note 368, at 1073; *see, however*, with regard to the binding force of guiding cases Wang, *supra* note 372, at 1081–86.

³⁷¹ *See* Li Wei, *Judicial Interpretation in China*, 5 WILLAMETTE J. INT'L L. & DIS. RES. 87, *passim* (1997); *see also* Wei, *supra* note 371, at 93–94.

³⁷² Wang, *supra* note 368, *passim*.

³⁷³ *See* chapter V.B.

³⁷⁴ Newman, *supra* note 358, at 831.

³⁷⁵ *See* chapter VI.B.1.

art. 147, para. 1 Company Law).³⁷⁶ It would, thus, be possible for the Standing Committee to issue a targeted interpretation. However, in my view, China's civil law system calls for a codification of the business judgment rule and not just an interpretation by the Standing Committee. In addition, an interpretation of the Company Law by the Supreme People's Court to implement the business judgment rule would be both unsatisfactory and legally doubtful. The business judgment rule leads to the judiciary's restraint from substantive reviews of business decisions. The Supreme People's Court would thus refrain from conducting a full substantive review and hence would *limit* the application of art. 149 i.c.w. art. 147, para. 1 Company Law. As mentioned above, the Supreme People's Court is solely empowered to make interpretations regarding the *specific application* of the law, *i.e.*, interpreting laws on a case-by-case basis. However, if the Supreme People's Court applies the business judgment rule without any legal basis, it would not fully apply art. 149 i.c.w. art. 147, para. 1 Company Law. It is doubtful whether the Supreme People's Court's power of interpretation could go this far.³⁷⁷

The proposition that the business judgment rule cannot be codified but needs to be developed by the courts is a century-long hidden attack on the civil law's very mechanics. This topic cannot be discussed within the confines of this paper.³⁷⁸ For our purpose, it is sufficient to note that this proposition ignores that the civil law provides general principles to be applied by the judges on a case-by-case basis.³⁷⁹ Within the frame of interpretation, the judges will not consider precedents as sources of law but as guidelines.³⁸⁰ It is characteristic for the Supreme People's Court to issue guiding cases in order to establish a uniform application of the law.³⁸¹ This system requires people's courts at all levels not to use guiding cases as a source of law but as a reference when trying similar cases (art. 7 Guiding Case Provisions).³⁸² Against this background, it seems both feasible and necessary that the legislator amends the Company Law and codifies the business judgment rule. Inasmuch as the Supreme People's Court deems it appropriate to establish a uniform

³⁷⁶ I specifically refrain from mentioning the duty of good faith, as it is not explicitly stated by art. 147, para. 1 Company Law (*see also* chapter IV.B.3).

³⁷⁷ There are, however, interpretations according to which the Supreme People's Court amended the law and even created new legal provisions (Wei, *supra* note 375, at 101–03).

³⁷⁸ *See* in this regard for example the discussion of various misconceptions of civil law E. M. Meijers, *Case Law and Codified Systems of Private Law*, 33 INT'L & COMP. L.Q. 8, *passim* (1951) [hereinafter *Private Law*].

³⁷⁹ *See* Joseph Dainow, *The Civil Law and the Common Law: Some Points of Comparison*, 15 AM. J. COMP. L. 419, 424, 426 (1966) [hereinafter *Civil Law and Common Law*].

³⁸⁰ Dainow, *Civil Law and Common Law*, *supra* note 379, at 426–27; Meijers, *Private Law*, *supra* note 378, at 10–11.

³⁸¹ *See* with regard to the purposes and functions of the guiding case system Deng, *supra* note 251, at 6–9.

³⁸² Zuigao Renmin Fayuan Yinfa “Guanyu Anli Zhidao Gongzuo de Guiding” de Tongzhi (最高人民法院印发《关于案例指导工作的规定》的通知) [Notice of the Supreme People's Court on Issuing the Provisions on Case Guidance] (promulgated by Sup. People's Ct., Nov. 26, 2010, effective Nov. 26, 2010), CLI.3.143870(EN), translated by Chinalawinfo Co., Ltd., en.pkulaw.cn [hereinafter *Guiding Case Provisions*].

understanding of the *specific application* of the business judgment rule, it may then issue both judicial interpretations and guiding cases.

3. Enforcement Aspect: Whether the Business Judgment Rule Would Be Enforceable. It has been suggested that Chinese judges will have difficulties in interpreting the business judgment rule due to their lack of judicial expertise.³⁸³ This supposition questions the enforceability of the business judgment rule. This paper cannot evaluate whether the judges indeed lack judicial expertise or not, but it could be said that the above proposition may stem from the misconception that the judges usually only apply rules rigidly. As noted multiple times, the civil law comprises of general principles which are to be applied on a case-by-case basis.³⁸⁴ For centuries, it has been the task of civil law judges (also in China) to *interpret* legal principles when applying them. Without any statistical evidence, the said proposition cannot be supported.

Regarding the business judgment rule, one cannot readily assume an enforcement problem. On the contrary, the business judgment rule alleviates the burden of interpretation resting on the shoulders of the judges because it limits the judicial review to mainly procedural aspects and does not allow a substantive review of business decisions. The argument that judges will find it difficult to interpret the business judgment rule thus seems to be indefensible.

4. Sociological Aspect: Whether the Business Judgment Rule Is Compatible with the Chinese Culture. The assertion that the business judgment rule cannot be transplanted into the Company Law due to cultural barriers is of a very general nature. The business judgment rule ultimately prevents the courts, and hence the shareholders, to question the result of the directors' and the supervisors' exercise of their discretionary power *ex post*. The business judgment rule would only be incompatible with the Chinese culture if the Chinese culture required that directors and supervisors shall be held fully responsible for any and each of their acts. The question whether China's culture permits directors and supervisors to have discretionary powers cannot be answered here. As stressed before, the business judgment rule is about *protecting* discretionary power. In addition, it has been established that,

³⁸³ Lee, *supra* note 189, at 920

³⁸⁴ See in this regard again Meijers, *Private Law*, *supra* note 378, at 9–11, debunking this and further misconceptions about the civil law.

according to the Company Law, directors and supervisors in fact *enjoy* discretionary powers.³⁸⁵

Much has been written about Chinese management methods.³⁸⁶ However, there seems to be little literature with regard to the aspect of responsibility (or accountability) in the Chinese corporate context.³⁸⁷ Many scholars suggest that Chinese family-led firms have a highly hierarchical structure with a patriarchal, centralized authority exercised by the owner of the firm.³⁸⁸ Chee Kiong Tong posits that there is a need for tight control in Chinese (family) firms due to a general distrust towards persons who are not part of a distinct social group.³⁸⁹ The ownership structure, the installation of family members in key positions and the “dense interlocking of directorships across the business group” are key elements of such a control framework.³⁹⁰ Tong and Pit Kee Yong highlight that trust may only be expressed if there is a sufficient control framework in place.³⁹¹ Jing-Lih Farh and Bor-Shiuan Cheng, however, point out that young professionals with a high level of education may no longer be in favor of the paternalistic and authoritarian leadership model.³⁹² In addition, Jinlong Zhao finds that minority shareholders in China are also subject to the rational apathy phenomenon and are not enthusiastic about getting involved with company matters.³⁹³ Up to now, the perception of the two antipodes of the decision-

³⁸⁵ See chapter IV.A; cf. Song, *supra* note 167, at 214–15; see Tong Chee-Kiong, *Rethinking Chinese Business*, in CHINESE BUSINESS, 4 (Tong Chee-Kiong ed., 2014), [hereinafter *Rethinking Business*]; see also Farh Jiing-Lih & Cheng Bor-Shiuan, *A Cultural Analysis of Paternalistic Leadership in Chinese Organizations*, in MANAGEMENT AND ORGANIZATIONS IN THE CHINESE CONTEXT 84, 99–104 (Li Jiatao et al. eds., 2000) [hereinafter *Cultural Analysis*]; see further LIAO CHUN, *THE GOVERNANCE STRUCTURES OF CHINESE FIRMS* 102 (2009)

³⁸⁶ See for example, CHINESE BUSINESS: RETHINKING GUANXI AND TRUST IN CHINESE BUSINESS NETWORKS (Tong Chee-Kiong ed., 2014); MANAGEMENT AND ORGANIZATIONS IN THE CHINESE CONTEXT (Li Jiatao et al. eds., 2000); LIAO, *supra* note 385; STEPHEN TODD RUDMAN, *THE MULTINATIONAL CORPORATION IN CHINA* (2006); Andrew Keay & Zhao Jingchen, *Ascertaining the Notion of Board Accountability in Chinese Listed Companies*, 46 HONG KONG L. J. 671 (2016) [hereinafter *Board Accountability*]; Andrew Keay & Zhao Jingchen, *Accountability in Corporate Governance in China and the Impact of Guanxi as a Double-Edged Sword*, 11 BROOK. J. CORP. FIN. & COM. L. 377 (2017) [hereinafter *Corporate Governance*]; David Smith, *Guanxi, Mianzi and Business: the Impact of Culture on Corporate Governance in China*, 26 PRIV. SECTOR OPINION 1 (2012).

³⁸⁷ Keay & Zhao, *Corporate Governance*, *supra* note 386, at 382.

³⁸⁸ Tong Chee-Kiong & Yong Pit Kee, *Personalism and Paternalism in Chinese Business*, in CHINESE BUSINESS 63, 69–71 (Chee-Kiong Tong ed., 2014) [hereinafter *Paternalism*]; LIAO, *supra* note 385, at 96–103; Farh & Cheng, *Cultural Analysis*, *supra* note 385, at 85–104.

³⁸⁹ Tong, *Rethinking Business*, *supra* note 385, at 6–8; Tong Chee-Kiong, *Centripetal Authority, Differentiated Networks: The Social Organization of Chinese Firms in Singapore*, in CHINESE BUSINESS 21, 38 (Tong Chee-Kiong ed., 2014) [hereinafter *Authority*].

³⁹⁰ Tong, *Rethinking Business*, *supra* note 385, at 7; cf. LIAO, *supra* note 385, at 96–97.

³⁹¹ Tong Chee-Kiong & Yong Pit Kee, *Guanxi Bases, Xinyong and Chinese Business Networks*, in CHINESE BUSINESS 41, 54 (Tong Chee-Kiong ed., 2014) [hereinafter *Guanxi*].

³⁹² Farh & Cheng, *Cultural Analysis*, *supra* note 385, at 111.

³⁹³ Zhao Jinlong, *Electronic Proxy Solicitation and Relevant Regime Construction of Shareholder Democracy in China*, 8 FRONTIERS L. CHINA 211, 229 (2013); Zhao Jinlong, *Electronic Proxy Solicitation and Relevant Regime Construction of Shareholder Democracy in China*, 8 FRONTIERS L. CHINA 211, 229 (2013) [hereinafter *Proxy Solicitation*].

making process, *i.e.*, responsibility and authority, has, however, neither been thoroughly analyzed by English-speaking sociological scientists nor attracted the attention of English-speaking legal scholars.

The confines of this paper do not allow studying these sociological questions. As the findings above are of a purely schematic nature, they make it impossible to draw a conclusion as to whether China's corporate world would be in favor of the business judgment rule or reject it. There is no clear-cut answer. On the one hand, it seems that Chinese family firms might be opposed to the business judgment rule because of the owners' needs to control. On the other hand, younger generations might value authority (*i.e.*, discretionary power) more and be more willing to protect it (especially in the context of bigger Chinese firms and listed Chinese companies).

D. Proposal for a Codified Business Judgment Rule

We have established that the business judgment rule is not only codifiable but also fits well into China's civil law system.³⁹⁴ In addition, legal certainty and stability call for a codification of the business judgment rule in order to facilitate the development of its uniform understanding. The recognition of the business judgment rule by way of judicial interpretation of the directors' and supervisors' duties (art. 147, para. 1 Company Law) raises doubt as to its legality and is thus not feasible.³⁹⁵ There are no indications that the rule's codification will hinder its enforcement. In contrast, since the codified business judgment rule is mainly concerned with the formality of the decision-making process (due process), the judges' room for interpretation is limited.³⁹⁶ Finally, while there are no conclusive answers, indications exist that the Chinese corporate society may welcome or at least not reject the recognition of the business judgment rule and its codification.³⁹⁷ Now that we have established that a codification of the business judgment rule is advisable, we are left with one final task which is to propose a corresponding wording amalgamating the knowledge we have gained from our analysis. The business judgment rule is proposed as a new second paragraph to art. 149 Company Law³⁹⁸ and might read as follows:

Article 149 [...]

A director or supervisor³⁹⁹ having made a business decision⁴⁰⁰ is not subject to any civil liability if he:

³⁹⁴ See chapter VI.C.1.

³⁹⁵ See chapter VI.C.2.

³⁹⁶ See chapter VI.C.3.

³⁹⁷ See chapter VI.C.4.

³⁹⁸ See GU, *supra* note 25, at 197, who also proposed to include a statutory business judgment rule as art. 150, para. 2 Company Law (which today would be art. 149, para. 2 Company Law).

³⁹⁹ See chapters IV.A and VI.B.2.

⁴⁰⁰ See chapter II.B.

- 1) has not acted fraudulently or illegally;⁴⁰¹
- 2) was free of any conflict of interest;⁴⁰²
- 3) considered all reasonably available material information and reasonably foreseeable risks;⁴⁰³ and
- 4) acted in good faith and in the honest belief that the decision is in the best interest of the company or its stakeholders as prescribed by the law.⁴⁰⁴

The proposed wording is similar to Delaware's business judgment rule. There are, however, some subtle differences. First, the business judgment rule is applicable to both directors and supervisors (the latter do not exist in Delaware⁴⁰⁵). Second, the director or supervisor is required to consider not only all reasonably available material information but also all reasonably foreseeable risks. This additional requirement is unknown to Delaware's,⁴⁰⁶ Switzerland's⁴⁰⁷ and Germany's business judgment rule.⁴⁰⁸ Not only was it established herein that the duty of care under China's Company Law can be interpreted in a way that the directors need to prudently analyze the available information and the involved risks⁴⁰⁹, but also that a review of business decisions shall focus on the decision-making *process*.⁴¹⁰ Risks are inherent in doing business. The uncertainty as to whether the risks will materialize was one of the arguments against the substantive review of board decisions.⁴¹¹ In addition, it was shown that company owners in China may have high control needs. Against this background, it seems appropriate and just to demand that the business decisions made by directors and supervisors are based on a sound decision-making process in which reasonably foreseeable risks are considered. This does not open the door for the courts to conduct a substantive review of the board decision as such. The judges only need to assess whether the risks foreseeable from an *ex ante* perspective have been carefully evaluated during the process of consideration. Third, the directors and supervisors are required to act in good faith and in the honest belief that they are acting in the best interest of both the company and its stakeholders if so prescribed by the law. This is a unique feature not known to the foreign business judgment rules discussed herein.⁴¹² It reflects the Chinese characteristic that the directors have to respect and give account to interests of the company's stakeholders as

⁴⁰¹ See chapters III.B.1 and V.A.

⁴⁰² See chapters III.B.2 and IV.B.1; this condition reflects the duty of loyalty (art. 147, para. 1 Company Law).

⁴⁰³ See chapters III.B.3 and IV.B.2; this condition reflects the duty of care (art. 147, para. 1 Company Law).

⁴⁰⁴ See chapters III.B.4 and IV.B.3.

⁴⁰⁵ See chapter III.A; see, however, the discussion of Germany's dual board model under chapter VI.B.2).

⁴⁰⁶ See chapter III.

⁴⁰⁷ See chapter VI.B.1.

⁴⁰⁸ See chapter VI.B.2.

⁴⁰⁹ See chapter IV.B.2.

⁴¹⁰ See chapter II.B.

⁴¹¹ See chapter III.D.

⁴¹² See chapters III.B.4 (Delaware), VI.B.1 (Switzerland) and VI.B.2 (Germany).

stipulated by the Company Law.⁴¹³ Admittedly, it may not be evident from the outset which interest shall prevail in practice. However, this uncertainty is not caused by the proposed wording of the business judgment rule but by the existing Company Law.

The proposed wording does not suggest a reversal of the burden of proof as for example stipulated by Germany's business judgment rule. The business judgment rule has to be adapted to the relevant regulatory system. China's Civil Procedure Law prescribes that the party making claims shall bear the burden to provide the respective evidence (art. 64, para. 1 Civil Procedure Law; art. 2, para. 1 Rules on Evidence in Civil Procedures).⁴¹⁴ A reversal of the burden of proof is thus not appropriate.

VII. CONCLUSION

This paper began with a seminal assumption: China's Company Law needs to provide an efficient decision-making mechanism for Stock Companies. The business judgment rule is one of the legal tools to ensure such a process. Corporate law, be it case or statutory law, needs to define how much authority is to be granted to a centralized decision-maker. The business judgment rule ensures that the authority granted to the centralized decision-maker is not unreasonably withdrawn by a substantive *ex post* review of business decisions. Such a withdrawal would be unreasonable because it obliterates the value of authority and is economically inefficient.⁴¹⁵ Jurisdictions around the globe therefore recognize the significance of the business judgment rule.⁴¹⁶

In the absence of a statutory business judgment rule and a common understanding of it among scholars and courts in China, this paper suggests that the business judgment rule in the form proposed herein fits well into China's Company Law for Stock Companies. As China has abandoned planned economy and operates under the mode of socialist market economy, it is time that the Company Law "incorporate[s] the value of authority"⁴¹⁷ and fully adopts the business judgment rule with Chinese characteristics.⁴¹⁸

⁴¹³ See chapter IV.B.3.

⁴¹⁴ This rule equals both Switzerland's (chapter VI.B.1) and Delaware's business judgment rule (chapter III.C).

⁴¹⁵ See chapter II; *contra* Aman, *supra* note 142, at 32–45.

⁴¹⁶ See chapters III (Delaware), VI.B.1 (Switzerland) and VI.B.2 (Germany).

⁴¹⁷ Bainbridge, *Abstention*, *supra* note 20, at 85.

⁴¹⁸ See chapter VI.D.