COMPARATIVE STUDY OF U.S. AND GERMAN CORPORATE GOVERNANCE: SUGGESTIONS ON THE RELATIONSHIP BETWEEN INDEPENDENT DIRECTORS AND THE SUPERVISORY BOARD OF LISTED COMPANIES IN CHINA

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I. THE U.S. CORPORATE GOVERNANCE MODEL

A. Agency Theory for Public U.S. Corporations

The essence of corporate governance in U.S. public corporations lies in the separation of ownership and control.[1] Given the dispersed capital

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1. *See, e.g.,* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1932); Michael C. Jensen & William H. Meckling,

structure, there are usually collective action problem in a public corporation: shareholders typically have neither sufficient knowledge nor enough incentive to participate in the management of the corporation due to their relatively small stake in the corporation and the significant transaction costs of coordination.[2] Therefore, it is more efficient—even necessary in most cases—for experienced professionals to manage the corporation.[3] The agency theory assumes that human behavior is opportunistic in nature.[4] Inevitably there are certain situations where the managers' personal interest is in conflict with the shareholders' interest, and the managers will be tempted to act opportunistically. This is one of the costs of agency imposed on the shareholders.[5] Hence, ways to minimize agency costs have become one of the foci of the debate on corporate governance.[6] In order to solve the collective action problem, there are both monitoring and exit mechanisms in a public corporation. Corporate laws impose fiduciary duties on the board of directors to perform conflict monitoring to reduce agency costs.[7] There are multiple regulations that seek to address this problem.[8] In addition, free transferability of stocks and various types of markets allow the shareholders to "vote with their feet."[9] There are many other supporting rules such as

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Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976).

2. *See, e.g.,* ROBERT C. CLARK, CORPORATE LAW (1986); Douglas Litowitz, *Are Corporations Evil?*, 58 U. MIAMI L. REV. 811 (2004); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992).

3. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW chs. 14–15 (7th ed. 2007).

4. *See, e.g.,* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1433 (1985); Kenneth E. Scott, *Agency Costs and Corporate Governance*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 26 (Peter Newman ed., 1998).

5. Jensen & Meckling, *supra* note 1, at 310 (listing the agency costs as the sum of the monitoring expenditures of the principal, the bonding expenditures by the agent, and the residual loss); *see also* Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91 (1997).

6. *See, e.g.,* Brudney, *supra* note 4; Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459 (2005); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005); Michael B. Dorff, *Does One Hand Wash The Other?: Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255 (2005); Scott, *supra* note 4, at 26.

7. *See, e.g.,* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 221–380 (2003).

8. Robert E. Bostrom has listed multiple regulation bodies such as U.S. Department of Justice Sentencing Guidelines, Sarbanes-Oxley Act (Section 404), NYSE Listing Standards, Proposed Draft COSO Framework for Enterprise-wide Risk Management, and Public Company Accounting Oversight Board Audit Standard No. 2 regarding outside auditor review of internal controls. *See* Robert E. Bostrom, *Compliance, Risk Management and Internal Controls: A Checklist for Corporate Counsel — Part I*, 2004 METROPOLITAN CORP. COUNS. 18; Robert E. Bostrom, *Compliance, Risk Management and Internal Controls: A Checklist for Corporate Counsel — Part II,* 2004 METROPOLITAN CORP. COUNS. 21.

9. *See, e.g.,* Harry G. Hutchison & R. Sean Alley, *The High Costs of Shareholder Participation*, 11 U. PA. J. BUS. L. 964 (2009); Arthur R. Pinto, *Section III: Corporate*

disclosure requirements, to assure that the shareholders can make decisions on an informed basis.[10]

B. The Heightened Standard on Independent Director

As an integral part of the monitoring mechanism in a corporation, the institution of independent director originates from the idea of supervising management's performance in order to maximize the shareholders' interests.[11]

Under the U.S. system of federalism, there are federal law requirements and state law requirements on independent directors.[12] Under certain state laws, some committees consisting of independent directors are particularly helpful in the handling of corporate reorganizations and derivative litigations.[13] For instance, under Delaware corporate law, a majority of independent directors on a board can help the board obtain the business judgment rule presumption in a two-step tender offer where a heightened standard is usually imposed.[14] In contrast, the standard on independent directors in Michigan corporate laws is higher.[15] However, the *Sarbanes-Oxley Act of 2002* ("*Sarbanes-Oxley*") has significantly changed the boundary between federal securities laws and state corporations law on corporate governance.[16] Federal laws impose higher standards with respect

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Governance: Monitoring the Board of Directors in American Corporations, 46 AM. J. COMP. L. 317 (1998); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 716 (2007).

10. *See, e.g.,* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron,* 89 CORNELL L. REV. 394 (2004)*;* John F. Olson, *Looking Beyond the Efficient Markets Hypothesis: A Comment on Professor Macey's Post-Enron Analysis*, 89 CORNELL L. REV. 527 (2004).

11. *See, e.g.,* Victor Brudney, *The Independent Director-Heavenly City or Protemkin Village?*, 95 HARV. L. REV. 597, 599 (1982).

12. *See* Dallas, *supra* note 5, at 92 (providing a detailed study on the evolution of corporate governance practice with the focus of attention on boards of directors). In addition, as corporation laws are generally under state jurisdiction, the standard on independent directors may vary from state to state.

13. *See* Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004). In addition, the use of a committee of independent directors can effectively shift the burden of persuasion, which to some extent is outcome determinative. *See* Shaunna L. Wolpert, In re *JCC Holding Co., Inc. Shareholders Litigation*, 29 DEL. J. CORP. L. 257 (2004).

14. *See In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002).

15. *See* MICH. COMP. LAWS ANN. § 450.1107(3)(b)–(c) (West 2002); MICH. COMP. LAWS ANN. § 450.1107(3)(d)(i)–(iii) (West 2002).

16. *See, e.g.,* Roberta S. Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 79 (2005); Jonathan H. Gabriel, Note*, Misdirected?: Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud*, 38 SUFFOLK U. L. REV. 641 (2005).

to independent directors.[17] One of the reasons for the enhanced standard derives from the backlash against a series of corporate scandals in the United States.[18] However, as might be expected, the new rules received mixed reactions from both practitioners and corporate legal scholars.[19]

An institution should be tested both by theories and by empirical research. The institution of independent directors is no exception. The theoretical economic model demonstrates that the institution of independent director is efficient if appropriate incentive and constraint mechanisms are structured.[20] However, the "power coalition theory" provides another perspective, because the theory posits that a board performs relational functions,[21] which is as important as the conflict monitoring function. In a word, there is by no means a consistent theoretical analysis of this institution in academia.[22]

As might be expected, the empirical findings on the correlation between the board composition and company performance are inconsistent. The differences may come from the different assumptions and/or different statistical methodology. For instance, based on a sample of 154 large publicly traded domestic corporations, Ira M. Millstein and Paul W.

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17. *See, e.g.*, Holly Gregory, *Comparison of Sarbanes Oxley, SEC and Listing Rule Provisions Related to the Composition and Functioning of the Board of Directors of a Publicly Traded Company*, *in* DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE (6th ed., 2008).

18. *See, e.g.,* James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731 (2009); 14 WILLIAM MEADE FLETCHER, ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6831.70 (perm. ed. 2003 & Supp. 2010); James L. Buchwalter, Annotation, *Construction and Application of Whistleblower Provision of Sarbanes-Oxley Act*, *18 U.S.C.A. § 1514A(a)(1),* 15 A.L.R. FED. 315 (2006).

19. *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002); Michael J. Borden, *The Role of Financial Journalists in Corporate Governance*, 12 FORDHAM J. CORP. & FIN. L. 311 (2007).

20. *See, e.g.,* ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 159–290 (2001) (introducing several models such as monitoring, tournaments, risk-sharing, and billing-in-oil, etc.).

21. *See* Dallas, *supra* note 5, at 95.

> [T]he board provides the corporation with relational resources that decrease the corporation's uncertainty and enhance its chances of survival. These resources include coordination with the external environment, information access and exchange, support of corporate business, advice on various subjects, legitimacy and status in the eyes of relevant communities, monitoring, and control. Under this theory, functions of boards in addition to conflicts monitoring are economically significant. Independent directors, however, may not always be in a position to provide all of these resources.

Id.

22. *See, e.g.*, Seth W. Ashby, Note, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521 (2005); Oliver Krackhardt, *New Rules for Corporate Governance in the United States and Germany: A Model for New Zealand?,* 36 VICT. U. WELLINGTON L. REV. 319 (2005).

MacAvoy found that the corporations with active and independent boards performed much better than those with passive boards.[23] In contrast, some empirical studies demonstrate that some corporations by increasing the independence of their boards of directors do not necessarily enhance the corporations' performances.[24] Moreover, some commentators found that the "one size fits all approach" is inefficient and impractical per se.[25] However, some empirical studies provide different assessments of the importance of directorial independence by criticizing the aforementioned empirical studies. "Power coalition theory" is one of them. They are of the opinion that as some non-independent directors may be in a better position to perform the relational functions than independent directors, it is erroneous to attribute the overall corporate performance merely to the level of directorial independence.[26] Accordingly, they find the positive correlation between the directorial independence and the effectiveness of the conflict monitoring of the companies.[27] This Article tends to agree with the last theory because in reality, there are different types of directors who play different roles in a corporation. Barry D. Baysinger and Henry N. Butler have nicely categorized the directors' functions into three types: executive, instrumental, and monitoring.[28] Therefore, it seems that there are at least two possible options for establishing corporate governance structure: one is to have a unitary board to perform all these functions, or the other is to divide the board and have different directors perform distinct functions. In reality, U.S. corporate law adopted a pragmatic approach in which different committees are to be established on an *ad-hoc* basis. In this way,

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23. This empirical study not only compared "independence" of the boards, but also the "activeness" of the boards, and thus to some extent diluted the positive contribution by "directorial independence" to the superior performance of those companies. *See* Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Largest Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998).

24. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002); *see also* Lisa M. Fairfax, *Spare the Rod, Spoil the Director?: Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393 (2005); Ribstein, *supra* note 19.

25. *See, e.g.*, Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards,* 30 SEC. REG. L.J. 370, 372 (2002); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1065 (1993).

26. Dallas, *supra* note 5, at 112.

27. *See, e.g.,* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 432 (1988).

28. "Executive function" generally means ordinary administrative work. "Instrumental function" includes providing business and/or legal advice. "Monitoring function" focuses on supervising management and conflict checking. *See* Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 109–10 (1985).

U.S. corporate law intends to separate management from supervision while maintaining certain flexibilities.

II. German Corporate Governance Model

A. The Dual-Board Institution in German Corporations

The cornerstone of German corporate governance is its dual-board institution in a corporation. Under that governance structure, the management board ("*Vorstand*") and supervisory council ("*Aufsichtsrat*") perform different functions. Furthermore, the members of one body are strictly prohibited to be in the other body. The management board assumes the responsibility for directing corporate activities, while the supervisory council has the power to appoint, dismiss and supervise the management board. In addition, the supervisory council assumes the responsibility for examining the corporation's financial records.[29]

B. Separation of Management and Supervision

The major goal of the dual-board institution is to separate the responsibility for monitoring from the actual managing of the corporation.[30] Noticeably, some commentators argue that there is convergence between German corporations and U.S. corporations in terms of the separation of management and supervision:[31] in a German corporation, the management power and supervision power is allocated between the management board and supervisory council;[32] and in a U.S. corporation, the management power and supervision power is allocated between the executive officers and the unitary board of directors.[33] Also, the increasing number of independent directors on boards in U.S. corporations would suggest convergence in that their role of a supervisor is becoming more preponderant. Nonetheless, the German approach is more rigid, because the members of each body are strictly prohibited from serving on the other body.

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29. *See generally,* MASAHIKO AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM (1984); JEAN DU PLESSIS ET AL., GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 203 (2007).

30. *See* AOKI, *supra* note 29, at 156–57; Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. L. 555, 561 (2000); Thomas J. Andre, *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 TUL. L. REV. 69, 84 (1998).

31. Dallas, *supra* note 5, at 141.

32. Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKELEY BUS. L.J. 131, 189 (2008).

33. *See* Dallas, *supra* note 5, at 138.

III. PRACTICAL REASONS FOR DIVERGENT GOVERNANCE MODELS

Board composition is a vital part of corporate governance.[34] *The distinct board composition depends on the other constituents of the overall regulatory regime and the capital markets.*[35]

A. Divergent Objectives

Corporate governance is an instrument by which a country achieves its objective vis-à-vis corporations. The major goal of a typical U.S. corporation is to maximize shareholders' interests, although there are some debates over the tension between the interests of other constituents and shareholders' interests in certain situations.[36]

In contrast, the German dual-board structure is based on the concept of co-determination.[37] According to this theory, labor and capital co-determine a corporation's activities, so accordingly labor is given certain influence in management through participation in the process of selecting management.[38]

B. Litigation Devices Regarding Directors' Liabilities

Procedural devices can reinforce substantive rights. In the United States, shareholders may bring direct, derivative, and class action lawsuits under

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34. *See, e.g.,* Baysinger & Butler, *supra* note 28; JOHN H. FARRAR, CORPORATE GOVERNANCE: THEORIES, PRINCIPLES, AND PRACTICE (2005).

35. *See, e.g.,* FARRAR, *supra* note 34; Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333 (2009); Marc Goldstein, *Mitigating Dysfunctional Deference Through Improvements in Board Composition and Board Effectiveness*, 103 NW. U. L. REV. COLLOQUY 490, 491–92 (2009).

36. *See, e.g., In re Global Service Group, LLC*, 316 B.R. 451, 460 (Bankr. S.D.N.Y., 2004) ("once insolvency ensues, the fiduciary duties of corporate officers and directors also extend to creditors. As a result, the officers and directors owe duties to multiple constituencies whose interests may diverge."); *see also,* Lynda J. Oswald, *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1, 2 (1998); Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 N.Y.U. ANN. SURV. AM. L. 85; Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992); Rima Fawal Hartman, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH & LEE L. REV. 1761 (1993).

37. *See* Mark J. Roe, *German Codetermination and German Securities Market*, 1998 COLUM. BUS. L. REV. 167, 170; Bernd Singhof & Oliver Seiler, *Shareholder Participation in Corporate Decision-Making Under German Law: A Comparative Analysis*, 24 BROOK. J. INT'L L. 493, 537 & n.166 (1998); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

38. *See, e.g.,* Roe, *supra* note 37, at 172; Butler, *supra* note 30, at 561–63; Detlev F. Vagts, *Reforming the Modern Corporation: Perspectives from the German*, 80 HARV. L. REV. 23 (1966); Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1141 (1999); AOKI, *supra* note 29, at 170.

both federal laws and state laws.[39] In addition, there is a group of lawyers who are specialized in advocating these types of suits.[40] In contrast, in Germany, usually neither derivative suits nor class action suits are allowed.[41] A theoretical explanation is that the rigid separation of management and supervision in the German corporations eliminates the need for such litigation devices. However, it is far from settled whether the supervisory council or shareholders are in a better position to monitor management.[42]

C. Role of Banks and other Institutional Investors

In Germany, banks play an essential role in the corporate governance.[43] Banks are the embodiment of shareholder and debt holder power and have a significant influence on the governance mechanism. In addition, there is no division between commercial banks and investment banks in Germany.[44] In contrast, in the United States, the *Glass-Steagal Act* separates commercial banks from investment banks, and prohibits commercial banks from conducting investment business.[45] Additionally, vis-à-vis the banks in Germany, U.S. banks do not have such a dominant influence on corporate governance.[46] However, there are certain institutional investors who have been pressing the SEC to perform more "watching" functions and exert more influence. Nonetheless, the desirability of having institutional investors supervise managers is still debatable[47] and their influence on corporate governance is still limited by the collective action problem.[48]

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39. *See, e.g.,* Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75 (2008); Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004).

40. *See, e.g.,* Thompson & Thomas, *supra* note 39; Daniel R. Fischel & Michael Bradley, *The Role Of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986); Cunningham, *supra* note 28, at 1138.

41. *See* Cunningham, *supra* note 28, at 1186; *but see* Fischel & Bradley, *supra* note 40, at 286–87 (reasoning that the most likely explanation for the survival of the derivative suit is its role in deterring large one-shot frauds such as a decision to destroy all of a firm's assets in response to a hostile takeover attempt).

42. *See, e.g.,* Butler, *supra* note 30, at 602.

43. *See generally* AOKI, *supra* note 29; Thomas J. Andre, Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 TUL. L. REV. 1819 (1996); Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513 (1993).

44. *See*, *e.g.,* Mark E. Nance & Bernd Singhof, *Banking's Influence over Non-Bank Companies After Glass-Steagall: A German Universal Comparison*, 14 EMORY INT'L L. REV. 1305, 1306–07 (2000).

45. *Banking Act of 1933*, ch. 89, 48 Stat. 162 (1933).

46. Cunningham, *supra* note 38, at 1139–40.

47. *See,* e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 841 (1992); Ronald J. Gilson & Reinier

D. Capital Market as a Check

The capital market functions as a check on the management of a corporation.[49] The ability to sell is a significant "stick" in the bundle of rights that the shareholders enjoy in a U.S. public corporation.[50] There are public markets available where free transferability is allowed and conducted. In addition, during tender offers, shareholders are able to tender their shares for a premium and might consequently allow the raider to take over the management. This is arguably an incentive mechanism to optimize management.[51]

IV. Theoretical Foundation of the Divergence of Corporate Governance

Theoretical rationales are needed not only in explaining the divergence, but also in prescribing appropriate normative suggestions for reform.

A. Theory of Path Dependence

Professor Lucian Bebchuk and Mark Roe have proposed the "path dependence theory" in corporate ownership, the theory that corporate law structure depends on the structures with which the economy was started. In addition, corporate rules, which affect ownership structures, will themselves depend on the corporate structures with which the economy was started.[52]

Kraakman, *Reinventing the Outside Directors: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 866 (1991); Mark J. Roe, *Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1931–32 (1993); Jeffery N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445 (1991).

48. *See, e.g.,* Butler, *supra* note 30.

49. *See* Estreicher, *supra* note 43.

50. *See generally* Pinto, *supra* note 9.

51. For the discussions of the management-related dynamics in tender-offers, see for example, John C. Coffee Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21–22, 41 (1988); CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (Alan J. Auerbach ed., 1988); Christian Kirchner & Richard W. Painter, *Takeover Defenses Under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law*, 50 AM. J. COMP. L. 451 (2002); Gregory R. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865 (1987); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

52. *See* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Governance and Ownership*, 52 STAN. L. REV. 127, 127 (1999); *cf.* S. J. Liebowitz

This theory certainly shed some light on the persistence of the different forms of corporate governance in advanced economies.[53] Furthermore, the path dependence theory serves a normative function as it may be utilized to predict the future of a nation's corporate governance structure.[54] In light of the "path dependence theory," U.S. hostility towards excessive wealth accumulation and other inherent cultural endowment effects prevent U.S. corporations from replacing the U.S. corporate governance model with the German model.[55] On the other hand, the existence of the dual-board system and the significant participation of labor render it much less feasible for German corporate governance to switch to the U.S. model.[56]

B. Economic Development and Legal Infrastructure

The development of legal infrastructure is the means through which to achieve economic development.[57] In turn, economic development can facilitate advancement in the legal infrastructure.[58] The costs of legal reform in civil law countries and common law countries are different in both form and quantity.[59] Judge Posner insightfully recognizes the fundamental tradeoff between making an investment in developing rules and in the judiciary.[60] Accordingly, he argues that enacting comprehensive

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& Stephen E. Margolis, *Path Dependence, Lock-In, and History*, 11 J.L. ECON. & ORG. 205, 205–06 (1995) (challenging path-dependence theory).

53. *See, e.g.,* Helmut Kohl, *Corporate Governance: Path Dependence and German Corporate Law: Some Skeptical Remarks from the Sideline*, 5 COLUM. J. EUR. L. 189 (1999); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 361 (1996); Oona A. Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, 86 IOWA L. REV. 601 (2001); Richard A. Posner, *Path-Dependency, Pragmatism, and Critique of History in Adjudication and Legal Scholarship*, 67 U. CHI. L. REV. 573 (2000); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996).

54. *See* Roe, *supra* note 53.

55. Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L. J. 723, 764–65 (2003); Hathaway, *supra* note 53.

56. *See* Andre, *supra* note 30, at 105, 107; *see also* Bebchuk & Roe, *supra* note 52, at 150.

57. There have been significant researches on the relationship between legal infrastructure and economic development, see for example, Daniel M. Klerman, *Legal Infrastructure, Judicial Independence, and Economic Development*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 427 (2007); Tom Ginsburg, *Does Law Matter for Economic Development?: Evidence from East Asia*, 34 LAW & SOC'Y REV. 829 (2000); Gerald M. Meier, *Asian Drama: An Inquiry into the Poverty of Nations*, 21 STAN. L. REV. 962 (1969) (book review); Richard E. Messick, *Judicial Reform and Economic Development: A Survey of the Issues*, 14 WORLD BANK RES. OBSERVER 117 (1999).

58. *See generally* Messick, *supra* note 57.

59. *See generally* Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13 WORLD BANK RES. OBSERVER 1 (1998); Hathaway, *supra* note 53.

60. *See* Posner, *supra* note 59, at 7.

rules is more efficient than cultivating a sophisticated judiciary for a developing nation.[61]

V. STATUS QUO OF CHINESE CORPORATE GOVERNANCE AND SUGGESTIONS

A. Importance of Independent Directors in China

In 1978, China began a major program of economic reform.[62] It is no accident that the period of reform has coincided with the period of "legalization": the effort by the government to enhance the role of law and legal institutions in Chinese society. China started to operate securities markets in Shanghai and Shenzhen for several reasons, including, *inter alia*, attracting investment and promoting the reorganization of state owned enterprises.[63]

Adequate protection for public shareholders is critical for the development of a capital market.[64] However, there is insufficient protection for public shareholders of the listed companies in China due to the inadequate capital market control and the inefficient monitoring system. In many listed companies, controlling shareholders dominate the nomination and appointment of the directors.[65] Hence, a robust supervisory body is needed urgently.

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61. *See id.*

62. For discussions on China's economic reform, see for example, Joseph E. Stiglitz, Keynote Address, *Whither Reform?: Ten Years of the Transition, in* ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS 1999 27 (Boris Pleskovic & Joseph E. Stiglitz eds., 2000); Lawrence J. Lau et al., *Reform Without Losers: An Interpretation of China's Dual-Track Approach to Transition,* 108 J. POL. ECON. 120 (2000); Yingyi Qian, *The Process of China's Market Transition (1978-1998): The Evolutionary, Historical, and Comparative Perspectives*, 156 J. INST'L & THEORETICAL ECON. 151 (2000).

63. For an overview of the development of securities markets in China, see Yuwa Wei, *The Development of the Securities Market and Regulation in China*, 27 LOY. L.A. INT'L & COMP. L. REV. 479 (2005).

64. *See generally* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

65. Some scholars describe these listed companies as "so-called public companies," because only a certain portion of the shares of these companies is listed and made available for relatively free public trading. *See* Nicholas C. Howson, *Regulation of Companies with Publicly Listed Share Capital in the People's Republic of China*, 38 CORNELL INT'L L.J. 237, 237 (2005). With respect to the problem of dominating shares, some scholars describe it in the following way:

> The modern corporations are still in the initial stage of development. During this period, the development of listed companies is established on the basis of bailing out state-owned enterprises. During the conversion into public companies, the original state-owned enterprises still retain its [sic] reserved assets in the form of state shares and corporate shares and these shares cannot be circulated, thus giving the domineering position of state shares. Although there are the shareholders' meeting, board meeting and supervisory board meeting, the result is that the shareholders'

B. Status Quo of the Corporate Governance in China

Although it is not required to have a supervisory board in a listed company, there is usually a supervisory board that consists of shareholder representatives and an employee representative in a listed company in China.[66] Theoretically, the supervisory board has significant power to supervise directors, examine financial documents, and convene shareholder meetings.[67] However, in practice the supervisory board has not functioned effectively because it does not have genuine power to select or discipline directors and managers.[68] Furthermore, there is some overlap between the function of the supervisory board and the board of directors.[69]

For various reasons, the China Securities Regulatory Commission in 2001 issued the landmark guiding opinion establishing the independent director institution in China, under which a minimum of one-third of each listed company's board members must be independent by June 30, 2003.[70] In some sense, the introduction of the independent director institution implies the ineffectiveness of the supervisory board in those listed

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> meeting has become controlling shareholders' meeting; board meeting has become executive board meeting of controlling shareholders; and supervisory meeting has become supervisory meeting of the board. The meetings exist in form only. Such governance structure has further evolved into dominance of one share, which is unique in China.

Jipeng Liu, *Independent Directors System in Modern Corporate Governance Structure*, ¶ 4, *available at* http://www.cipe.org/regional/asia/china/independent.htm (last visited Feb. 24, 2010); *see also,* Jie Yuan, *Formal Convergence or Substantial Divergence?: Evidence from Adoption of the Independent Director System in China*, 9 ASIAN-PAC. L. & POL'Y J. 71 (2007); Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125 (2006).

66. *See, e.g.,* Yuwa Wei, *Seeking A Practicable Chinese Model of Corporate Governance*, 10 MSU-DCL J. INT'L L. 393, 400–02 (2001); Jiong Deng, *Building an Investor-Friendly Shareholder Derivative Lawsuit System in China*, 46 HARV. INT'L L.J. 347 (2005); Hui Huang, *China's Takeover Law: A Comparative Analysis and Proposals for Reform*, 30 DEL. J. CORP. L. 145 (2005); Zhongfei Zhou & Jingwei Li, *In Search of Approaches to Improving Corporate Governance in China's State-Owned Commercial Banks*, 36 INT'L L. 215 (2002).

67. The Company Law (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), *available at* http://www.asianlii.org/cn/legis/cen/laws/tclotproc/2005496/.

68. *See, e.g.,* Yuan, *supra* note 65; Yuwa Wei, *Volatility of China's Securities Markets and Corporate Governance*, 29 SUFFOLK TRANSNAT'L L. REV. 207 (2006).

69. *See* Thomas W. Lin, *Corporate Governance in China: Recent Developments, Key Problems, and Solutions*, 1 J. ACCT. & CORP. GOVERNANCE 1 (2004); ON KIT TAM, THE DEVELOPMENT OF CORPORATE GOVERNANCE IN CHINA 59 (1999) [hereinafter ON KIT TAM].

70. *See* Sibao Shen & Jing Jia, *Will the Independent Director Institution Work in China*, 27 LOY. L. A. INT'L & COMP. L. REV. 223, 223 (2005). One of the reasons for establishing independent directors is to solve the problem caused by controlling shareholders. *Id.* at 224–25.

companies.[71] Actually, the previous circulars on independent directors were only recommendations; thus it was optional for the companies themselves to decide whether or not to adopt them.[72] However, since the 2001 guiding opinion, these requirements become mandatory for the listed companies.[73]

Consistent with the motivation of establishing mandatory requirements on independent directors, they are expected to effectively monitor management, conduct conflict checking, and safeguard the interests of minority shareholders.[74]

Although it is acknowledged that independent directors could be an efficient institution for reducing the likelihood of opportunistic behaviors, under China's current corporate law regime, there are some inherent problems related to it. Generally speaking, these problems can be categorized into two types. The first type of problem is deals with the relationship between independent directors and the supervisory board. ("Incompatibility" problem). The second type of problem is the intrinsic defects of the independent director institution as a supervising body ("Intrinsic" problem).

Although some commentators argue that the monitoring role of independent directors is different from the supervisory board,[75] and hence there is no conflict between the two bodies,[76] as a matter of fact, there are overlaps between the functions of the two bodies. This certainly increases transaction costs. As suggested by Professor Eric Kades, if there are inherent conflicting interests between a supervisory board and independent directors, the efforts of creating incentives to encourage cooperation between the two bodies are likely to be futile. Therefore, there are at least two possible options. The first option is to dispense with the supervisory board in a corporation. This could thoroughly eliminate the inherent conflicts between the two bodies. The second option is for laws and regulations to allocate and separate clearly the powers of supervisors and directors.[77] If the second option is adopted, there would be more inherent

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71. If the supervisory board could effectively monitor management, it seems that there should be no strong reasons for creating another supervisory body.

72. *See* Shen & Jia, *supra* note 70, at 230–31.

73. For a detailed discussion about the evolution of the requirements on independent directors, see Liu Junhai, *Woguo Gongsifa Yizhi Duli Dongshi Zhidu de Sikao* [*Some Thoughts on Transplanting the Independent Director System into China's Company Law*], 21 ZHENGFA LUNTAN [TRIB. POL. SC. & L.] 41, 44–46 (2003) (P.R.C.).

74. *See* Moses Mo-Chi Cheng, *Role of Independent Non-Executive Directors*, *available at* http://www.cipe.org/regional/asia/china/role.htm (last visited Feb. 24, 2010).

75. Shen & Jia, *supra* note 70, at 246.

76. It is true that generally speaking, the functions of independent directors are more operable and direct. *See* Danhan Huang, *Problems Concerning Independent Directors System and its Legal Environment*, *available at* http://www.cipe.org/china/p3_danhan.htm (last visited Feb. 24, 2010).

77. Shen & Jia, *supra* note 70, at 246.

"incompatibility" problems. First, who is going to supervise whom?[78] Second, how will possible collusion between the two bodies be effectively prevented?[79] Given the path-dependent concerns, although the first option seems more direct, the second option is more reasonable because there are considerable advantages in maintaining the supervisory body through which the employee may participate in management. Some scholars argue that employees' participation in the corporate governance may reduce the information asymmetry that threatens a trade-off between their commitment (to make firm-specific human capital investment) and adaptability (to meet technological changes and organization restructure).[80] Furthermore, the Chinese government might still rely on those listed companies (restructured state owned enterprises) to provide social security and welfare to the workers.[81]

Additionally, independent directors as a supervisory body have various intrinsic defects as well. There is always a tradeoff between the insiders' knowledge and the outsiders' independence. Usually the outside directors are from academia and normally they have other employment obligations. Hence, many independent directors neither have sufficient information nor the incentive to provide substantial supervision. The lack of a reasonable process of selection is another intrinsic problem.[82]

C. Suggestions on Reform

Many people who are about to make suggestions on changes might find themselves in a dilemma of being too "idealistic" or too "realistic." This dilemma is vividly elaborated by Professor Radin: on one hand, if one compromises too much, one may reinforce the status quo instead of making any progress; on the other hand, if one is too utopian about the ideals, one

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78. *See* Anna M. Han, *China's Company Law: Practicing Capitalism in a Transitional Economy*, 5 PAC. RIM L. & POL'Y J. 457 (1996).

79. The possible collusion would be similar collusion between the manager and the auditor as elaborated in Fred Kofman & Jacques Lawarree, *Collusion in Hierarchical Agency*, 61 ECONOMETRICA 629 (1993); *see also* ERIC RASMUSEN, *supra* note 20, at 159–290.

80. *See* Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 343–44 (1996).

81. *See* ON KIT TAM, *supra* note 69, at 59. However, the present Author tends to agree with the proposition that "the current formal corporate governance structures and the prevailing ideology have mandated a corporate governance role for the employees . . . ." *Id.* at 97.

82. For instance, a survey demonstrates that the focus of selecting independent directors is their technology background, rather than knowledge in corporate governance. *See generally* Tong Lu, *Development of a System of Independent Directors and the Chinese Experience*, *in* CORPORATE GOVERNANCE REFORM: CHINA AND WORLD (2002); *see also* Mingkang Gu, *Will an Independent Director Perform Better than a Supervisor?: Comments on the Newly Created Independent Director System in the People's Republic of China*, 6 J. CHINESE & COMP. L. 59, 75 (2003).

may make no progress either.[83] A middle way might be a sensible compromise. Generally speaking, in terms of developing a suitable corporate governance model for China, both the long-term objectives and short-term goals shall be considered. In addition, a combination of regulatory measures and market forces should participate in the reform. Accordingly, the reform shall have both top-down and bottom-up elements.

In order to eliminate the inherent conflicting interest between the supervisory board and independent directors, the most direct way is to consolidate the two supervising bodies into one. However, path-dependence theory predicts that this is very unlikely to happen. An additional cost would be the sacrifice of the employees' participation in the management. Therefore, we have to turn to more realistic alternatives.

One option is to establish the hierarchical model between independent directors and the supervisory board,[84] although in the two-level supervising arrangement, the cost of supervising might be higher vis-à-vis consolidating two supervising bodies into one. With the development of a capital market, China might gradually be able to rely more on the market to reach the optimal corporate governance. Under this hypothesis, the legislature may amend the company law, making the current mandatory requirements on independent directors optional. If the institution of independent directors can help the listed companies improve performance, it is expected that those corporations will opt to increase the percentage of independent directors on the board of directors.

VI. An Inconclusive Conclusion

As supported by the path dependence theory, different nations use different ways (such as the German dual-board mechanism and the U.S. independent director requirement)[85] to separate management functions from supervisory functions to better serve a nation's goals for corporate law.

Different development paths might lead to different outcomes.[86] China has introduced the institution of independent directors with the hope of enhancing its corporate governance. However, the independent director institution is by no means a sufficient condition for the development of corporate governance.[87] Therefore, it is both unreasonable and unrealistic to

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83. *See* Margaret J. Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849 (1987).

84. For example, some scholars suggest that the supervisory board should be given the power to nominate independent directors, and to sue directors or management upon exhaustion of internal remedies. Shen & Jia, *supra* note 70, at 246.

85. *See* discussion, *supra* Parts I, II.

86. *See, e.g.,* Brett H. McDonnell, *Lessons from the Rise and (Possible) Fall of Chinese Township-Village Enterprises*, 45 WM. & MARY L. REV. 953, 1002 (2004).

87. *See*, *e.g.*, Donald C. Clarke, *The Independent Director in Chinese Corporate Governance,* 31 DEL. J. CORP. L. 125 (2006); Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*, 22

pin all hopes on independent directors to solve all the problems. Rather, legal reform is like a comprehensive engineering project that has various dimensions, including both top-down reform and bottom-up development.[88] Its effectiveness also depends on a developed market and a fine corporate governance culture.[89] Moreover, legal reform is a process. Furthermore, as argued and expected by some scholars and practitioners, there would be sufficient incentive to push for the reform continuously.[90]

In light of the special concerns of an economy in a transition period, carrying out government imposed reform through regulatory bodies is more efficient than cultivating a sophisticated judiciary.[91] In some aspects of corporate governance, it is more efficient to have some mandatory rules to be enforced by a strong regulatory body than to adopt the Delaware laws and invest in training the judges. The introduction of independent directors is a reasonable try. Although enough time should be provided in order to test the worthiness of the introduction of the institution, if it is proved that the institution of independent directors has not played the role as expected and will not be capable of functioning well, or that it will be too costly to do so, other more efficient alternatives should be considered. However, other bottom-up reforms are also necessary. As reminded by Joseph E. Stiglitz, the foundations of a market economy, institutional and legal infrastructure, should not be underestimated.[92] Therefore, it is advisable to bear in mind that establishing an appropriate corporate governance arrangement is a comprehensive project.[93]

CONN. J. INT'L L. 1 (2006); Fang Liufang, *Duli Dongshi zai Zhongguo* [*Independent Directors in China: Hypothesis and Reality*], 26 TRIB. POL. SCI. & L. 1 (2008).

88. Randall Peerenboom, *What Have We Learned About Law and Development?: Describing, Predicting, and Assessing Legal Reforms in China*, 27 MICH. J. INT'L L. 823, 829 (2006).

89. *See, e.g.,* Jinlong Zhao, *How to Ensure the Independence of Independent Directors in Listed Company in China*, 1 INT'L J. BUS. & MGMT 113 (2006).

90. *See, e.g.,* Howson, *supra* note 65, at 248.

91. *See generally* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

92. *See* Stiglitz, *supra* note 62.

93. *See, e.g.,* Yingyi Qian, *Reforming Corporate Governance and Finance in China*, *in* CORPORATE GOVERNANCE IN TRANSITION ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS (Masahiko Aoki & Hyung-Ki Kim eds., 1995); Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1 (2002).