LIMITED LIABILITY IN CHINA: A PARTIAL READING OF CHINA'S COMPANY LAW OF 1994

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I. INTRODUCTION

Since China reopened its doors to the Western world in the late 1970's, the country has seen tremendous economic growth, as well as problems associated with an ambitious, but ill-equipped, developing economy. To provide the necessary legal framework for sustained economic growth while still adhering to the traditional Confucian rule of neutrality, China has successfully carved out a route toward the so-called "socialism with Chinese characteristics,"[1] evidenced by numerous newly enacted local and national laws and regulations in the economic arena.[2] The new Company Law, effective since July 1, 1994, is not only another example of innovative legislation, but also a further step toward identifying with Western market economies.

This Note, by reviewing the concept of limited liability in Chinese corporate law and using the U.S. system as a reference, argues that although China has begun to embrace the concept of limited liability as a

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1. Since 1979, China has been moving toward a "market economy with Chinese characteristics" under a top-down approach distinct from the paths followed in the Eastern European bloc. Measures under the Chinese approach include privatizing production in the countryside, opening the domestic markets to the rest of the world, and establishing special economic zones in coastal regions. The "Chinese characteristics" seem to be those associated with the top-down approach, such as the motivation of increasing productivity without releasing state control and the limited scope of privatization. *See* Matthew Bersani, *Privatization and the Creation of Stock Companies in China*, 1993 COLUM. BUS. L. REV. 301, 303-306 (1993).

2. *E.g.* Zhonghua Renmin Gongheguo Zhongwai Hezi Jinyingqiye Fa [Law of the People's Republic of China (hereinafter "PRC") on Sino-Foreign Joint Equity Enterprises] (1979); Zhonghua Renmin Gongheguo Shewai Jinjihetong Fa [Foreign Economic Contract Law] (1985); Zhonghua Renmin Gongheguo Siying Qiye Zhanxing Tiaoli [Provisional Regulations of the PRC on Private Enterprises] (1988); Zhonghua Renmin Gongheguo Zhongwai Hezuo Jinyingqiye Fa [Law of the PRC on Sino-Foreign Co-Operative Enterprises] (1988); Zhonghua Renmin Gongheguo Waiziqiye Fa [Law of the PRC on Wholly Foreign-Owned Enterprises] (1986); Shenzhen Gupiao Faxing Yu Jiaoyi Guanli Zhanxing Banfa [Regional Securities Exchange Regulations of Shenzhen] (1991); Shanghai Zhenjuan Jiaoyi Guanli Banfa [Regional Securities Exchange Regulations of Shanghai] (1990); Guowuyuan Guanyu Gupiao Faxing Yu Jiaoyi Guanli Zhanxing Tiaoli [State Council's Provisional Regulations on Securities Issuing and Trading] (1993); Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of 1994], *in* FAGUI HUIBIAN, *translated in* 2 CHINA L. & PRAC. 7 (1994) [hereinafter Company Law].

fundamental quality of the corporate form, its understanding and treatment of the concept still fall short of what it is accorded in Western market economies. Part I provides, as a background, the historical development of China's understanding of the relationship between the individual and the economic entity prior to the enactment of the Company Law in 1994. Part II examines the concept of limited liability under the Company Law using prevalent American views as a reference. Part III provides rationales for the differences between the Chinese and American understanding of limited liability and describes problems and possible solutions to the Chinese treatment of the issue.

II. HISTORICAL BACKGROUND

Limited liability in Western and American corporate law has two prongs: ownership or shareholder limited liability and officer limited liability.[3] In China, state-owned enterprises, supplemented by collectively-owned and private enterprises,[4] still dominate the Chinese economy.[5] Before the emergence of corporatization or privatization in the late 1970's, state-owned enterprises were considered to be "owned by the whole people" and every Chinese citizen was "the owner or 'master' of each state-owned enterprise."[6] Theoretically, the issue of shareholder limited liability in this type of economy appears moot since everybody is an owner of the enterprise with a presumably equal share of interest and liability in the enterprise.[7] At least in dealings among state-owned enterprises, the entire state-owned economy can be viewed as a single large enterprise and all liabilities become internal or intra-enterprise.

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3. *See* WILLIAM CARY & MELVIN EISENBERG, CASES AND MATERIALS ON CORPORATIONS 117 (7th Ed. 1995).

4. *See generally* SHIZHONG DONG ET AL., TRADE AND INVESTMENT OPPORTUNITIES IN CHINA - THE CURRENT COMMERCIAL AND LEGAL FRAMEWORK 25 (1992). Private enterprises employed about 180,000 people in 1978 and about 3.67 million in 1987. *See also* Alison Conner, *To Get Rich is Precarious: Regulations of Private Enterprises in the People's Republic of China*, 5 J. CHINESE L. 1, 5 (1991).

5. In 1993, state-owned enterprises accounted for 53% of the country's total industrial output and 67% of state revenues. *See* Robert Art & Minkang Gu, *China Incorporated: The First Corporation Law of the People's Republic of China*, 20 YALE J. INT'L L. 273, 276 (1995).

6. *See* DONG, *supra* note 4. However, in reality, the government manages state-owned enterprises as surrogates of the people. In fact, conflicts constantly arise between the local governments where the enterprises are located and the central government, usually the ministry with jurisdiction over a specific industry. *Id.*

7. *Id.*

The issue of limited liability does arise when the other two sectors of the economy, namely collectively-owned and private enterprises, are involved. Both of these secondary sectors differ from state-owned enterprises in that they are of local ownership, i.e. not owned by "the whole people" but by a fraction of the whole population.[8] Limited liability, as understood in U.S. corporate law, means that a shareholder's personal liability as an owner is limited to her/his investment or share of interest in the enterprise.[9] Because, in theory, the owners of collectively-owned enterprises are those who are "private investors in their own business" and who collectively own all assets of the business (except for land),[10] liability incurred by the business should be borne only by them as owners. However, after 1956, collective enterprises assimilated into the large scheme of the planned economy and have essentially become state enterprises owned by local governments.[11] Since in the traditional Chinese economy, local economic plans are subordinate components of the national plan, ownership and control of collective enterprises are virtually indistinguishable from those of state-owned enterprises. The only noticeable difference is that collective enterprises generally belong to the less important industries and, therefore, have fewer employee benefits and less scrutiny and control from the national government.[12] Thus, the issue of limited liability also seems insignificant for collectively-owned enterprises.

Since 1978, China has seen a boom of legislation in the economic arena to accommodate the rapid economic growth unprecedented in China's modern history. Some of these new laws focus primarily on encouraging direct foreign investment in China. Several forms of investment are available, including wholly foreign-owned enterprises, equity joint ventures and contractual joint ventures.[13] Limited liability is

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8. *See* DONG, *supra* note 4, at 25-31. "This category of collective enterprises was administered by local governments, and assigned production targets were incorporated into the state plan... Local governments have now established bureaus of light industry with supervisory authority over the business activities of the collectively-owned enterprises." *Id.* at 28.

9. *See* CARY & EISENBERG, *supra* note 3, at 164.

10. DONG, *supra* note 4, at 28.

11. *See id.*; CARY & EISENBERG, *supra* note 3, at 164.

12. DONG, *supra* note 4, at 28-29.

13. *See* Daniel Brink & Xiao Lin Li, *A Legal and Practical Overview of Direct Investment and Joint Ventures in the "New" China*, 28 J. MARSHALL L. REV. 567, 568 (1995). *See generally* Lin, *New Forms and Organizational Structures of Foreign Investment in China under the Company Law of the PRC*, 7 TRANSNAT'L LAW 327 (1994).

generally available to foreign investors in all three forms.[14] It is unclear whether a Chinese enterprise partner in a Sino-foreign joint venture enjoys the same limited liability as its foreign partner does, but as described above, for the vast majority of state enterprises in non-joint venture situations, it is clear that the issue of ownership limited liability remains moot.

Somewhat surprisingly, limited liability has been available to purely private enterprises in China since 1951.[15] Moreover, the Regulations of Private Enterprises of 1988 reiterated the availability of the limited liability company, as a business form, to private businesses.[16] However, because private enterprises previously represented a small sector of the economy, the impact of limited liability as a fundamental characteristic of the corporate form in China remains insignificant.[17] The insignificance of limited liability in the private sector is evidenced by the inadequacy of the relevant regulations and the uncertainty of whether a private limited liability company can enter into an equity joint venture like other domestic legal persons.[18]

A second aspect of limited liability in U.S. corporate law is that corporate managers are generally not responsible for corporate obligations.[19] In China, as well, this concept has arguably existed since the

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14. *See* Stephen Curley & Darren Fortunato, *Tax Considerations for Investors in China*, 20 N.C. J. INT'L L. & COM. REG. 531, 540 (1995) (cautioning that the interpretation of the governing laws and regulations is uncertainty). By definition, an equity joint venture is a limited liability entity formed between foreign and Chinese entities. Understandably, the liabilities of a contractual joint venture are limited to the amount of capital supplied under the contract. Also, the liability of a wholly foreign-owned enterprise (hereinafter "WFOE") is generally limited to the registered capital of the WFOE. See the laws of the PRC on equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises, and the regulations promulgated thereunder.

15. Conner, *supra* note 4, at 21:

> Most significant was the power granted to private enterprise owners to conduct business as a limited liability company. . . . [The private limited liability company] nearly resembled a close corporation, with its limited number of owner-investors and restricted offering and transfer of shares. . . . [T]his modified corporate form still provided Chinese entrepreneurs with real advantages (and potential for greater growth) over other business forms: capital could be pooled from more than two or three investors, who could also limit their liability.

See also Provisional Regulations on Private Enterprises (promulgated Dec. 30, 1950); Provisional Regulations of the PRC Concerning Private Enterprises *translated in* E. ASIAN EXEC. REP., Oct. 15, 1988, at 24.

16. *Id.*

17. *See* DONG, *supra* note 4.

18. *See* Conner, *supra* note 4, at 22; DONG, *supra* note 4, at 31. *See also* GENERAL PRINCIPLES OF CIVIL LAW OF THE PRC (Whitmore Gray & Henry Ruheng Zheng eds.1986).

19. CARY & EISENBERG, *supra* note 3, at 164.

beginning of China's socialist regime. However, this principle has developed into one of the major drawbacks of public ownership and planned economy, i.e. inefficiency of management due to a lack of incentive, or the so-called "iron rice bowl."[20] The established judicial standard of review of management in most enterprises has been something more deferential than the business judgment rule used in the United States. China's efforts to combat inefficiency and establish incentive systems have intensified throughout the reform era, with the start of the "director (manager) responsibility system" in 1979 and the "operational responsibility contract system" in 1987.[21] While there may be instances of overdoing the responsibility system and imposing personal liability on managers for an enterprise's profit payment to the government,[22] the responsibility system is generally recognized as a means to give management incentives on the upside and no personal risk on the downside.[23]

Since the late 1970's, China has enacted numerous pieces of reform era legislation to fuel its economic growth and to increase the confidence and motivation of foreign investment in the Chinese market. However, legislation touching on the fundamentals of corporate law have been best characterized as fragmented, task-oriented and not representative enough to offer a more formalized theory of the corporate entity. This is what makes the Company Law of 1994 a significant piece of legislation.

III. THE COMPANY LAW OF 1994

A. *Embracing Limited Liability*

Probably the most important feature of the Company Law's concept of limited liability is that it expressly stipulates that entities formed under the Company Law "shall be enterprise legal persons." Shareholders of a

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20. The term refers to the style of production where a Chinese enterprise functions as a government workshop with little economic autonomy and incentive due to central planning at all stages of production and management. This inefficient style is generally associated with poor product quality, slow production process, excessive cost, and lack of after-sale service. *See* Dong, *supra* note 4, at 12.

21. *Id.* at 38. *See also* Xiaoping Yang, *Progress and Problems in the Development of a New Income Tax System for State-Owned Enterprises in China*, 3 J. CHINESE L. 95, 113 (1989); Bersani, *supra* note 1, at 306; DONG, *supra* note 4, at 32-34.

22. Yang, *supra* note 21.

23. Bersani, *supra* note 1.

limited liability company or of a company limited by shares shall be "liable toward the company" to the extent of their "capital contributions" or "shareholdings," respectively.[24] This represents a significant alignment of Chinese corporate law with the prevalent American corporate law in terms of shareholder limited liability.[25] Given the failure to address such a concept in the historic development of enterprise law in China, this step indicates China's recognition that, in balancing the benefits of encouraging commerce and entrepreneurship with the evils of the society bearing the costs of externalities created by individuals, the former outweighs the latter.[26] This recognition is also reflected in the law's conferring "legal person" status on all entities formed under it, thus making the enterprise an entity with "full rights" in its property and all civil rights and liabilities "according to law," as distinct from those rights and liabilities of the individual shareholders.[27] Compared with historic practice before the Company Law, the inclusiveness of the law in conferring "legal person" status and limited liability protection has a twofold effect in the standardization of treatment of enterprises.

The first equalizing effect is that the Company Law does not distinguish between purely domestic enterprises and those receiving foreign investment (hereinafter "foreign-invested companies"). Previously,

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24. Company Law, *supra* note 2, art. 3:

> Limited liability companies and companies limited by shares shall be enterprise legal persons.
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> In the case of a limited liability company, shareholders shall be liable toward the company to the extent of their respective capital contributions, and the company shall be liable for its debts to the extent of all its assets.
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> In the case of a company limited by shares, all of the company's capital shall be divided into equal shares, shareholders shall be liable toward the company to the extent of their respective shareholdings, and the company shall be liable for its debts to the extent of all its assets.

The distinction between a "limited liability company" and a "company limited by shares" is similar to that between a close corporation and a corporation in U.S. terms. The Chinese term of "limited liability company" should be distinguished from the same term used in American law, which describes unincorporated entities with specific governance structures. Art & Gu, *supra* note 5, at 291.

25. *Id.* at 293-294. Although limited liability has arguably been available to certain purely private enterprises since 1951, its impact on the economic system was negligible. Under the new Company Law, all eligible entities, including private enterprises, are afforded limited liability protection, but various requirements, such as capitalization, tend to exclude most private enterprises.

26. *Id.*

27. Company Law, article 4, states in part: ". . . Companies shall possess full rights in the legal person property formed by the investments of their shareholders, and shall possess civil rights and bear civil liability according to law." Company Law, *supra* note 2, art. 4. *See also* Art & Gu, *supra* note 5, at 293; DONG, *supra* note 4, at 34 (citing from the General Principles of Chinese Civil Law, arts. 22-34, the definition of "legal person," which includes the quality of being "able to assume civil obligations independently").

foreign investors generally had the advantage of electing to be a limited liability company.[28] This difference seems motivated by the government's desire to attract foreign investment and at the same time to keep tight control over domestic enterprises.[29] While the protection of limited liability is available to foreign investors, the specific entity form of "foreign enterprise" offers an extra layer of protection if investors are uncomfortable with the uncertainty in the interpretation of Chinese foreign investment laws. A "foreign enterprise" may elect to incorporate under a foreign jurisdiction (e.g. Delaware, Hong Kong, or the Cayman Islands) and be controlled by the laws of the foreign jurisdiction instead of by Chinese law.[30] However, although the Company Law does not make a distinction between foreign and domestic enterprises, the actual effectiveness of such equal treatment remains to be seen. The Chinese government generally takes a permissive view of existing laws, in the sense that existing laws are controlling if not overruled expressly by new laws.[31] Therefore, in the areas not covered expressly in the Company Law, unequal treatment of domestic and foreign enterprises may still prevail.

The second equalizing effect of the Company Law is that among domestic enterprises, no distinction is drawn among enterprises of different ownership structures, i.e. state-owned, collectively-owned, and private or individual enterprises.[32] The significance of this effect is not so much the equality between private and public enterprises (state-owned and collectively-owned) but rather the equality among private enterprises themselves. Because the issue of limited liability appears moot in public enterprises, it is difficult to evaluate the implications of limited liability between public and private enterprises. However, it is clear that before the Company Law, only a portion of China's private enterprises enjoyed the

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28. Brink & Li, *supra* note 13, at 587 (stating that "until the legislature enacted the new Company Law, China's legislators had always differentiated between 'foreign invested enterprises' and 'domestic companies.' For example, 'foreign invested enterprises' received more preferential treatment and tax advantages than 'domestic companies.'").

29. *Id.*

30. *See* Curley & Fortunato, *supra* note 14, at 544.

31. Brink & Li, *supra* note 13, at 587. *See also* Yuen, *Editor's Notes*, 2 CHINA L. & PRAC. 50 (1994) (stating that "the practice in China has been to retain and apply local regulations in so far as they do not conflict with national laws"); Company Law, *supra* note 2, art. 18 (Article 18 provides: "This law shall apply to limited liability companies with foreign investment. Where laws concerning Sino-foreign equity joint ventures, Sino-foreign co-operative joint ventures and foreign investment enterprises have different provisions, such provisions shall apply.").

32. *See supra* notes 24, 27.

status of a "legal person" and the protection of limited liability.[33] The effort not to distinguish between the different types of domestic enterprises in the Company Law essentially means that the protection of limited liability is now available to all domestic enterprises, including all domestic private enterprises.

B. Limitations on Limited Liability

Notwithstanding the broad recognition of limited liability in the Company Law, the law imposes a number of limitations on the limited liability doctrine. These limitations substantially offset the protection offered by limited liability to companies, shareholders, and officers, thereby effectively reducing the step toward virtual alignment with Western and U.S. corporate law to a half-step. One significant limitation is the consistent application of the concept of "legal representative" throughout the Company Law.[34] Although the enterprise is a distinctive "legal person" with independent rights and liabilities in all corporate affairs and transactions, under the Company Law, as well as traditional practice in China, at least some essential aspects of the legal person are condensed and attached to a "legal representative," who is a natural person representing and acting on behalf of the enterprise.[35] No comparable concept exists in American corporate law; the closest similarity is found in the concept of "agency."[36] Under U.S. law, the agent of a corporation is generally an officer of the corporation, authorized to represent the corporation in transactions and affairs, and afforded greater protection under agency principles than that afforded to a director of the corporation. The "legal representative" in a Chinese enterprise is usually the chairperson of the board.[37] The scope of duty and liabilities of the legal

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33. *See* CARY & EISENBERG, *supra* note 3; Conner, *supra* note 4, at 21-22; DONG, *supra* note 4, at 31; Provisional Regulations of the PRC Concerning Private Enterprises, *supra* note 2.

34. *See* Art & Gu, *supra* note 5, at 293-294; Company Law, *supra* note 2, art. 45 (chairperson of the board shall be the legal representative of a limited liability company); *id.* art. 51 ("If a limited liability company does not have a board of directors, the executive director shall be the legal representative of the company"); *id.* art. 68 (chairperson of the board shall be the legal representative of a wholly state-owned limited liability company); *id.* art. 94 (application for registration of establishment shall include "the name and domicile of the legal representative"); *id.* art. 96 (the legal representative has the duty to apply for registration for a branch of a company limited by shares); *id.* art. 113 (chairperson of the board shall be the legal representative of a company limited by shares).

35. Art & Gu, *supra* note 5, at 294.

36. *Id.*

37. *Id. See* Company Law, *supra* note 2; *supra* note 34.

representative are not delineated in the Company Law, but are found in the Civil Law of the PRC. This law provides that a legal representative is subject to various types of administrative sanctions, including "warning, minor and severe reprimands, probation, demotion, dismissal, and discharge."[38] Although the law excludes personal liability for enterprise debt, the enumerated liabilities of the legal representative are generally severe and disproportionate to her/his shareholdings in the enterprise.[39] Although sanctions are administrative in nature, the whole concept of a "legal representative" singularly bearing the consequences of enterprise conduct is not only a serious limitation to the limited liability doctrine, but a virtual disregard of the "legal person" delineation under the Company Law.

Apart from the sharp restrictions on the limited liability doctrine caused by the concept of the legal representative, the Liability section of the Company Law also imposes stringent personal liability imposed on officers and directors of the enterprise.[40] While U.S. corporate law generally describes duties of corporate directors and officers broadly as the "duty of care"[41] and allows substantial discretion under the rubric of the "business judgment rule,"[42] the Company Law takes a different approach. In the Liability section, the law specifically lists various types of prohibited conduct and the available sanctions attached to each.[43] There are four types of sanctions: fines levied on the enterprise, fines levied on individuals, administrative sanctions and criminal liability. While fines are levied mostly when finances are involved and administrative sanctions are only imposed on state employees, criminal sanctions are attached to almost every article in this section as the most severe alternative to imposing

38. *See* Art & Gu, *supra* note 5, at 294.

39. *Id.* ("The Chinese legal representative . . . serves an expanded role bearing greater risks than an agent under American law. . . . [T]he Civil code subjects a legal representative to sanctions for the legal person's misconduct.").

40. Company Law, *supra* note 2, arts. 206-228 (each article typically includes: ". . . administrative sanctions shall be imposed according to law on the personnel in charge that are directly responsible and on other directly responsible personnel. If a criminal offence is constituted, criminal liability shall be pursued according to law.").

41. *See generally* N. Y. BUS. CORP. LAW §717 (McKinney 1995); DEL. CODE ANN. tit., §141; AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMENDATIONS §4.01 (1994).

42. *Id. See also* Aronson v. Lewis, 473 A.2d 805 (Del.1984).

43. *E.g.* Company Law, *supra* note 2, art. 211 (fine of 10,000 *yuan* to 100,000 *yuan* on the company for "establishing account books in addition to those required by law"); *id.* art. 212 (fine of 10,000 *yuan* to 100,000 *yuan* levied on "responsible personnel" for false information or concealment of major facts in financial and accounting reports); *id.* art. 213 (administrative sanction levied on "responsible personnel" for "converting state-owned assets into shares at a depressed value").

liability on enterprise personnel.[44] Two aspects of such liability provisions appear to be overly harsh and with no comparable counterparts in American corporate law. One is the imposition of additional sanctions outside of the governance structure of the enterprise, which usually happens to state personnel in a company partially or wholly-owned by the state. Aside from internal actions of the company, the state is free to apply additional sanctions. In such situations, the individuals involved completely lose the protection of limited liability. The other aspect is that sanctions are imposed on relatively medium or low-level personnel. Considering the basic lack of discretion and the follow-the-instructions nature of medium and low-level positions in the enterprise, such sanctions represent a severe infringement on the protection of limited liability through the agency theory. In the United States, due to the predominantly private nature of corporations, administrative sanctions are uncommon.[45] Also, corporate personnel not authorized for high-level decision-making are protected from liability except for criminal conduct.[46]

In addition, the Company Law imposes relaxed capitalization requirements, ranging from 100,000 *yuan* to 500,000 *yuan* for limited liability companies and 10 million *yuan* for companies limited by shares.[47] Such a capitalization requirement has been commonplace since the

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44. *See supra* note 40.

45. *See generally* Principles of Corporate Governance, *supra* note 41, §7.18 (limiting the remedy to damages suffered and, in certain circumstances, attorney's fees).

46. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (1968) (en banc) (Friendly, J., concurring); *cert. denied,* 394 U.S. 976 (1969).

47. Company Law, article 23 provides, in part:

> The registered capital of limited liability companies may not be less than the following minima:
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> (1) for companies involved mainly in production and business operations, 500,000 *yuan*;
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> (2) for companies involved mainly in wholesale of merchandise, 500,000 *yuan*;
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> (3) for companies involved mainly in commercial retailing, 300,000 *yuan*;
>
> (4) for scientific and technological development, consultancy and service companies, 100,000 *yuan*.
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> If the minima for registered capital of limited liability companies in special industries need to be higher than those set forth in the preceding paragraph, such higher minima shall be provided for separately in laws and administrative regulations.

Company Law, *supra* note 2, Art. 23.

Article 78 provides in part: "The minimum registered capital of a company limited by shares shall be 10 million *yuan*. If the minimum registered capital of a company limited by shares needs to be higher than the foregoing amount, such higher minimum shall be provided for separately in laws and administrative regulations." *Id.* art. 78.

beginning of China's open-door era economic legislation.[48] Though the minimum amount of registered capital varies with different laws, there seems to be a recognizable downward trend. The national level regulations on companies limited by shares promulgated by the PRC State Economic Commission required 10 million *yuan* for domestic incorporators and 30 million *yuan* for foreign-invested companies.[49] In the same year, the Shanghai municipality issued provisional regulations that required at least 5 million *yuan* for limited liability companies and 30 million *yuan* for foreign-invested companies.[50] So, the Company Law appears to have taken a considerable step forward in greatly reducing the capitalization requirement for limited liability companies and by disposing entirely of any such requirement for foreign-invested companies. Despite this, what remains is still a substantially higher standard than that under U.S. law. In the United States, virtually no capitalization is required for incorporation,[51] and the gap left by the absence of such requirement is arguably filled by the common-law doctrine of corporate-veil piercing.[52] Empirically, inadequate capitalization may well be the most important substantive factor that U.S. courts rely on in finding personal liability of shareholders.[53] To the extent that *post facto* veil-piercing in the United States has enabled shareholders to enjoy the protection of limited liability until the corporate veil is pierced, the Chinese approach effectively precludes shareholders from availing themselves of the protection of limited liability if they cannot meet the capitalization requirement. The Company Law's capitalization requirement is also restrictive since it has essentially placed limited liability protection beyond the reach of a large portion of the population, considering the generally low level of income in China.

A final, and perhaps more fundamental, limitation on the availability of limited liability is not expressly associated with such concepts as personal liability or capitalization, but is embedded in the spirit of the

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48. *See* James Fang & David Tang, *The Wholly Foreign-Owned Enterprise Law: Defining the Legislative History and Interpreting the Statute*, 2 J. CHINESE L. 153, 169, n.71 (1988); Bersani, *supra* note 1, at 314; PROVISIONAL REGULATIONS OF SHANGHAI MUNICIPALITY ON LIMITED LIABILITY COMPANIES (1992).

49. *Supra* note 48.

50. *Supra* note 48.

51. *See* Bersani, *supra* note 1, at 314. *See generally* N. Y. BUS. CORP. LAW, *supra* note 41, §402; DEL. CODE ANN., *supra* note 41, §§101-102.

52. Minton v. Cavaney, 56 Cal.2d 576 (1961).

53. *See* William Hackney & Tracey Benson, *Shareholder Liability for Inadequate Capital*, 43 U.PITT.L.REV. 837 (1982); CARY & EISENBERG, *supra* note 3, at 200 (stating that "undercapitalization is actually one of the most significant factors in piercing").

entire statute. This is the great power of state control over incorporation.[54] This essentially deems incorporation, and the rights and benefits thereof, privileges subject to state approval. The broad language of Article 8 of the Company Law makes an individual's right to incorporate contingent upon the amorphous content and interpretation of existing laws and regulations.[55] According to the Company Law, while the power to "examine and approve" the establishment of limited liability companies is entrusted to "relevant authorities," that concerning the establishment of companies limited by shares can be ultimately traced to the PRC State Council or the "People's Government at the provincial level."[56] What is not detailed in the Company Law, but in the Administrative Regulations of PRC Concerning the Registration of Corporations, is a list of the more specific and demanding requirements necessary to obtain such approval.[57] Prevalent U.S. law, on the other hand, makes incorporation a right rather than a privilege,[58] and grants the protection of limited liability and other

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54. According to the Company Law, the state retains control over various corporate issues, including registration, amendment to the certificate of incorporation, public stock offering, etc. *See* Art & Gu, *supra* note 5, at 288 (stating that the Company Law "tightly regulates incorporation, maintaining state control over this form and its attendant privilege of limited liability . . . The process of incorporation, operation, and capitalization of a business are thus plainly matters of government control and permission, not of right"); Company Law, *supra* note 2, art. 8 (registration is subject to examination and approval under prior laws or administrative regulations); *id.* art. 11 (amendment of the company registry to change the scope of business requires approval by both the approval and registration authority); *id.* art. 27 (requiring capital contribution to be verified by a statutory investment verification organization and approved by the registration authority and relevant authorities via examination and approval if provided by other laws and regulations); *id.* art. 77 (establishment of company limited by shares msut be approved by the State Council or a provincial government).

55. *See* Company Law, *supra* note 2, art. 8; *supra* note 54.

56. Company Law, *supra* note 2, arts. 27, 77.

57. Articles 19 and 73 of the Company Law provide general requirements for establishing a limited liability company and a company limited by shares, respectively. The Administrative Regulations of the PRC Governing the Registration of Legal Corporations (promulgated by the State Council, 1988) and the Administrative Regulations of the PRC Concerning the Registration of Corporations (promulgated by the State Council, 1994) provide a more detailed list of requirements: 1) Own name, organizational structure, and articles of association; 2) fixed place of business and physical facilities; 3) funds and personnel conforming with state regulations and proportionate with the scale of production and services; 4) ability to bear civil liability independently; and 5) scope of business conforming with state laws, statutory regulations, and policies. *See* Art & Gu, *supra* note 5, at 96.

58. The Delaware General Corporations Law § 101 provides: "Any person, partnership, association or corporation, singly or jointly with others . . . may incorporate or organize a corporation under this chapter by filing with the Secretary of State a certificate of incorporation which shall be executed, acknowledged, filed and recorded in accordance with section 103 of this title." § 103 merely provides certain requirements clerical or formal in nature. DEL. CODE ANN., *supra* note 41, §§101,103.

incidental benefits of incorporation upon completion of minimal formalities.[59] Hence, the limited availability of limited liability to individuals in China is just another indication of a centralized government experimenting with a uniquely Chinese model of a market economy without relinquishing control from the top.

IV. CONFLICTING INTERESTS AND PROBLEMS

Just as the self-conflicting term "socialist market economy" suggests, all economic legislation of the open-door era has to contend with conflicting interests of the state. These conflicting interests eventually converge into two general ones: at one end, socialist public ownership and state control; at the other end, economic efficiency. While to some people these two ends would seem constantly at odds, they would not appear so to China's top policy makers. Increased economic efficiency at the expense of the erosion of public ownership may well be characterized as innovative policy making without compromising socialist ideology and state control.[60] The introduction of market mechanisms, from securities exchanges to limited liability companies, is merely viewed as making use of neutral resources for the benefit of the existing socialist regime. Thus, limited privatization, or granting the right to create private companies under the restraining power of the state can similarly be characterized as harnessing private capital under the state's control.[61] Article 1 of the Company Law echoes such a self-serving characterization, although it arguably downplays socialist ideology by emphasizing a "modern enterprise system."[62]

The treatment of limited liability in the Company Law also manifests certain conflicting interests and considerations. On the one hand, the law expressly recognizes the principle of shareholder limited liability and the rights and obligations attendant to "enterprise legal person" status.[63] This is a recognition of the result of the balancing test applied by capitalist countries that the benefits society as a whole gains from the limited liability doctrine in encouraging commerce and entrepreneurship outweighs the burden put on society by those shielded by the doctrine.[64] Even without its own historic experience in utilizing the doctrine, China

59. Art & Gu, *supra* note 5, at 289; Bersani, *supra* note 1, at 320.
60. Bersani, *supra* note 1, at 305-306.
61. *Id.*
62. Company Law, *supra* note 2, art. 1.
63. *Id.* arts. 3, 4.
64. Art & Gu, *supra* note 5, at 293-294.

has come to realize the incentive created by limited liability in private enterprises. Since 1978, limited liability was first afforded to foreign investment by the joint venture laws,[65] then to private domestic capital through corporatization of state-owned companies[66] and now indiscriminately by the Company Law of 1994.

On the other hand, the severe limitations on the availibility of limited liability point to the public interest served by preventing certain individuals from abusing the benefits offered by limited liability.[67] Such limitations may be viewed as safeguards against the danger of misuse and abuse. In a developing unsophisticated market economy like China, such protective mechanisms as the human "legal representative," severe personal liability for corporate misconduct and high capitalization requirement are undoubtedly necessary.[68] At least in the case of capitalization, a numeric threshold requirement may be the best way to battle the disorderly and even fraudulent conduct of the undercapitalized, so-called "briefcase companies." Tight state control over registration may at least not contribute to the exacerbation of the decreasing public confidence in the legitimacy of transacting parties. Moreover, such a control mechanism is aligned with the state's desire to maintain the socialist system, or whatever is left of it. Some pieces of evidence of such desire are the special provisions for wholly state-owned companies in the Company Law and the state's tendency to retain majority control in large corporatized enterprises.[69] However, as with any legislation in China, the real-world effect of such stringent limitation depends largely on the effectiveness of enforcement. In fact, the question is not whether the protection against abuse of the limited liability privilege will be discounted for lack of enforcement, but to what extent it will be discounted.

As evidenced by the conflicting state interests behind the simultaneous promotion of limited liability and imposition of limits on

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65. *See* Brink & Li, *supra* note 13, at 587.

66. Bersani, *supra* note 1, at 305.

67. *See* CARY & EISENBERG, *supra* note 3, at 186 (stating that corporations benefit from the upside of the risks they have taken and society bears the downside and that managers of corporations tend to take undue risks that they would not have taken if all of the externalities had to be taken into account).

68. Art & Gu, *supra* note 5, at 299-300.

69. *See* Company Law, *supra* note 2, arts. 64-72 (e.g. Article 66 states that "a wholly state-owned company shall not have a shareholders' meeting" and the power to decide major matters of the company vests in an organization or department that is "authorized by the state"; article 68 states that the power to appoint and replace directors vests in an organization or department is "authorized by the state.") *See also* Bersani, *supra* note 1, at 305.

limited liability protection, existing problems concerning limited liability in China are hard to reconcile. On the one hand, facing the abuse of limited liability protection, law enforcement remains lacking and the goal of achieving "the rule of law" instead of "the rule of person" constantly reminds one of the possibility that "the rule of law" will remain a perpetual goal and never a reality. Since its founding, the Chinese government has relied on short-term, narrowly motivated "movements" to achieve a certain desired state of affairs in all sorts of fields, from crackdowns on garden variety criminal activities to crackdowns on bribery, embezzlement, and other white-collar crimes, and from the fight against immoral activities such as gambling and prostitution to the hasty enforcement of copyright and trademark laws. While "briefcase companies" mushroom to take advantage of limited liability, the enforcement of laws and regulations concerning enterprise responsibilities and liabilities has so far not achieved a sufficiently high priority on the government's agenda. The enactment of the Company Law, nevertheless, represents a positive move toward a uniform enterprise legal system that could serve as a foundation for enforcement when the need for such enforcement becomes necessary. Since the process of achieving "the rule of law" in China in any field is still a developing and constantly changing process, the enforcement of the Company Law will likewise be a long-term process which will keep challenging the state with new opportunities, as well as problems.

On the other hand, the beneficial effects of limited liability on entrepreneurship and the formation of capital remain unappreciated, and the concept of the corporate entity, as distinctly separate from the individuals who own or manage the entity, has yet to be fully accepted. The problem is exemplified by the long-time practice of holding an individual responsible for the behaviors of the corporation, which is kept intact by the role of the "legal representative" in the Company Law. The motivation behind the solidification of the "legal representative" system can be described at best as a deterrence of the abuse of limited liability protection and the promotion of responsible corporate behavior, and at worst, as a distrust of people and a perpetuation of state control of economic activities. Such treatment of limited liability inevitably fails to effectively educate the general population on the benefits of limited liability. During the reform era, the boom of economic activities under the open-door and market-oriented policies has exacerbated the traditional disregard for limited liability. Self-help has grown out of proportion, especially in economic disputes between private parties or local state-owned enterprises. Even courts sometimes surrender to such pressure and disregard the limited

liability protection provided in the Company Law.[70] Such disregard of the corporate entity and its independent capacity to bear civil liabilities necessarily deters domestic and foreign investors from risking investment in companies. Educating the public seems the only viable solution to such conceptual problems, as with any such problems concerning the "rule of law" in China. While it is almost always easier said than done, it will have to be done.

Moreover, before effective education can be carried out, a few theoretical questions need to be addressed to make the framework of limited liability "with Chinese characteristics" complete. One question is whether to adopt the U.S. approach of different treatment of tort creditor and contract creditor in deciding when limited liability protection should be extended to corporate defendants.[71] While in the abstract arguments supporting such a distinction are compelling and consistent with common sense, the question has practical implications within the Chinese socio-economic environment. In China, with no real separation of judicial and executive powers, courts are not likely, or able, to serve as a interpretive tool on overly generalized or inadequate laws and regulations. As such, the difficult process of defining and redefining the distinction between tort and contract creditors is not likely to be carried out effectively by the courts. That the concept of "piercing the corporate veil" is nowhere mentioned in the Company Law may be indicative of the fact that such a

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70. Marcus Brauchli, *Beijing Eases Up: China's Economic Changes Spur Legal-System Reform*, ASIAN WALL ST. J. June 21, 1995, at 1. Brauchli illustrates the disregard of limited liability with this story:

> [T]he gap between China's legal infrastructure and its commercial pace can present problems. Just ask Troy McBride. The 44-year-old Miami businessman has spent weeks trapped in hotel room in the dusty eastern city of Hefei, where a company with which he had a business dispute persuaded a local judge to seize his passport and forbid him to leave. Mr. McBride admits his company owed the Chinese company money, but notes that it was a corporate obligation, not a personal one — and certainly not one his relatives in the U.S. should be forced to settle, as the judge suggested. "They wanted to go after anything and everything," Mr. McBride says.
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> China's latest commercial law — which has incorporated many standard business rules — recognizes limited liability companies, such as Mr. McBride's, and doesn't extend liability to directors. But, says an annoyed Mr. McBride, "there was no fundamental, rudimentary knowledge of that distinction." A justice ministry spokesman says he is unsure what the court was thinking when it detained Mr. McBride.

71. U.S. court-made law makes a distinction among plaintiffs in deciding whether to extend the protection of limited liability to corporate defendants. A plaintiff is categorized as either a contract creditor, who voluntarily enters into contract with or extend credit to the defendant corporation, or a tort creditor, who is involuntarily involved with the corporation and harmed by its tortious or other wrongful acts. Courts tend to be more likely to extend limited liability protection in contract creditor cases than tort creditor cases. *See* CARY & EISENBERG, *supra* note 3, at 185.

fuzzy constraint on limited liability may be unnecessary to the still developing corporation law of China. The same may be said of even more advanced issues like proportionate liability versus joint and several liability in a tort creditor case. What adds to the unique situation in China, as compared to that in the United States, is the general population's propensity to litigate, although the trend in this area may be that the gap is narrowing.

A second question has to do with state ownership in the Chinese corporate system.[72] State ownership seems to be treated similarly to that of private ownership in companies with wholly state-owned limited liability companies afforded similar treatment as other limited liability companies.[73] But such facially equal treatment is deceptive since state ownership can ultimately be traced to the various branches of the local and the national governments. Theoretically, if limited liability protection is denied and the government — especially the central government — is found liable, there will be truly unlimited liability. The difference is vast between a private individual or even a private parent corporation and a state-owned parent corporation or the government itself.[74] Questions exist as to which level of government should be reached if liability is found and whether a self-dealing situation exists when the state participates in common commercial activities as a stakeholder. The Chinese government has always demonstrated its intent to retain state control in the economic system, even through the market-oriented reforms and its tolerance of private ownership of means of production.[75] This so-called "Chinese characteristic" has been played out in various circumstances throughout the entire reform era and its role in the reform of China's corporation law is just another instance of the unique Chinese approach toward economic prosperity without jeopardizing the traditional system of policy-making.

V. CONCLUSION

The Company Law represents an important step in the reform of economic relationships in China. Its broad adoption of the concept of limited liability indicates that the Chinese government has aligned itself

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72. *See* Company Law, *supra* note 2, art. 4 ("... [t]he ownership of state-owned assets in a company shall vest in the state...").

73. *See generally id.* Part 2, §3.

74. Consider also that U.S. courts are more likely to extend liability to a non-human parent entity than to an individual in like circumstances. *See* CARY & EISENBERG, *supra* note 3, at 190.

75. *See supra* notes 59, 60.

with the Western economies in recognizing that the benefits of limited liability in encouraging formation of capital and entrepreneurship far outweigh the harm of externalizing the costs of the corporation into the society. However, the Company Law also contains significant limitations on the availability of limited liability protection to participants of commercial activities, which include the inheritance of the human legal representative concept from long-standing practices, the severe financial, criminal and administrative punishments for corporate actors, excessive capitalization requirements for incorporation as a limited liability company or a company limited by shares and the omnipresent state control in the granting of corporate entity status. Problems exist in the enforcement of these economic laws and regulations and in the education of the general public about the corporate entity and the role of limited liability. Theoretical questions on the refinement of the limited liability doctrine and the role of state ownership also present challenges. While the positive effect of the adoption of limited liability in the Company Law is undeniable, what and how much real effect it will have on reforming and standardizing economic relationships in China are still difficult to predict. Only time and experience will tell.