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Corporate Governance and the Business Judgment Rule: Fiduciary Duties of Directors in Canada and the People's Republic of China

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Abstract

This paper will examine the fiduciary duties of directors expressed in statutory instruments in Canada and China. Analyses herein incorporate statutes and corporate law, secondary literature, newspaper commentary, and select jurisprudence, to help elucidate the similarities and differences between the two countries' regulatory frameworks, from the perspective of corporate governance and responsible business decision-making.

Keywords: Corporate Governance; Business Judgment Rule; Fiduciary Duties; Republic of China

Introduction and Overview

Much can be learned from a comparative analysis of the different corporate governance practices of Canada and the People's Republic of China (hereafter "PRC" or "China"), specifically with respect to the duties of directors in overseeing registered corporations. This paper examines the fiduciary duties of directors expressed in statutory instruments in Canada and China. Analyses herein incorporate statutes and corporate law, secondary literature, newspaper commentary, and select jurisprudence, to help elucidate the similarities and differences between the two countries' regulatory frameworks, from the perspective of corporate governance and responsible business decision-making.

For instance, *Peoples* [1] is employed as the leading Supreme Court of Canada case that interprets fiduciary duties of directors prescribed in section 122(1) of the *Canada Business Corporations Act* (CBCA) [2] as well as the "duty of care of directors and officers" in section 122(1)(b). *Peoples* affirmed and upheld Canada's *business judgment rule* (BJR), which relies on directors' expertise to make responsible and informed decisions regarding reasonable business matters.

Next, in comparison to Canada, China's corporate law decision-making fiduciary obligations are examined, including detailed analyses of the *Company Law of the People's Republic of China* [3]. The author outlines how the PRC could benefit from applying the principles of *Peoples* and the BJR to circumvent problems associated with China's legal culture, including a lack of judiciary independence [4], and corrupt behaviors more generally. The approach herein is not intended to attribute blame toward China compared to Canada. Instead, the short paper identifies several ways China can derive corporate governance lessons through Canada's BJR, while recognizing Canada has much to learn from China as well.

Ultimately, the author argues strengths and weaknesses are derived from both countries' systems, and that China must not lose sight of its unique cultural milieu. Chinese corporations must properly balance strong adherence to corporate governance standards, while retaining independent oversight of company operations in a culturally distinct, yet globally connected—and competitive—business environment.

Relevant and Select Provisions of the *Canada Business Corporations Act* (CBCA)

Duties of directors of Canadian companies are articulated within the CBCA and select jurisprudence interpreting provisions of the Act. Pursuant to "Part X, Directors and Officers," Section 102 outlines directors' duties to manage or supervise management of a corporation. Similar to China's regime, to be discussed shortly, a minimum of three directors is required where there remains an outstanding securities issuance, held by more than one person (s 102(2)). Director terms must not exceed three years from the initially held annual shareholders meeting (s 106(3)), depending on an expressly stated term of office (s 106(5)).

Section 122 of the CBCA outlines the duty of care of directors and officers, codifying a principle of Canadian common law.

Duty of care of directors and officers

122(1) every director and officer of a corporation in exercising their powers and discharging their duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances

No exculpation

Subject to subsection 146(5), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves them from liability for a breach thereof.

Prior to *Peoples*, there was debate as to whether fiduciary duties, an instrument to protect corporate wealth belonging to shareholders, extended to other stakeholders, such as employees and suppliers, when assessing loyalty, care, and good faith of corporate directors. In Canada, the elements of fiduciary duty comprise loyalty (to act in the interests of the corporation), care (exercise reasonable care), and good faith (act with honesty) [5]. Indeed, a more expansive scope of fiduciary duty is now understood. Corporate interests include those of numerous

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stakeholders (e.g., employees, suppliers, and the environment, in addition to shareholders).

It is important to consider the historical intent and justification for codified fiduciary duties within the CBCA, which includes economic rationales to encourage shareholder investment and ethical considerations as a means to provide checks-and-balances for wrongdoing by corporate insiders. The duty of honesty and good faith (s 122(1)(a)) is relatively straightforward and prohibits acting fraudulently. However, understanding "acting in the best interests of the corporation" is often problematic, particularly in instances where decisions disproportionately benefit one or some groups, but harm others [6].

Lastly, the "exercise [of] care, diligence and skill that a reasonably prudent person [objective standard] would exercise in comparable circumstances [subjective standard]" expressed in Section 122(1)(b) modifies the more subjective common law rule concerned with honesty and diligence, rather than competence. The "reasonably prudent person" standard in the CBCA sets a higher bar for directors and officers, akin to professionals such as engineers and accountants. Drafters intended to make the standard more objective. An applicable degree of care also depends on personal knowledge, experience, and positions of individual directors (e.g., audit committee members must have some knowledge of finance and accounting and are held to higher standards of care) [7]. Full-time directors, relative to part-time, have also been held to higher standards [8].

The Business Judgment Rule articulated in *Peoples Department Stores Inc*

Peoples [1] is a frequently cited case from the Supreme Court of Canada regarding the scope of fiduciary duties imposed on directors and officers. As background, three Wise brothers were the primary holders of shares in Wise Stores Incorporated, which was a retail chain. In 1994, they acquired Peoples Department Store Incorporated, acting as sole directors of the company. Wise and Peoples eventually declared bankruptcy and a petition was filed against the Wise brothers from the Peoples' trustee, claiming the Wise brothers weighed the interests of Wise Stores Inc. favorably compared to Peoples, having direct impact on Peoples' creditors. The question before the Supreme Court was whether the Wise brothers, as sole directors of Peoples, breached their duties as prescribed by Section 122(1) of the CBCA. The high court held the Wise brothers did not. Moreover, they did not owe duty of care to creditors in implementing business restructuring that exposed creditors to risk – they only owed a duty to the corporation.

The court noted a multitude of factors that are important for determining directors' liabilities and duties, and possible breaches arising from those duties, including consideration of the socioeconomic conditions of the companies involved. Engaging the *business judgment rule* (distinct from the *business judgment test* used for assessing decisions related to Section 192 of the CBCA), and citing *Maple Leaf Foods* as authority, Major and Deschamps JJ noted the court considers whether the directors have acted "reasonably and fairly" and assess the presence of a "*reasonable* decision *not a perfect* decision [9]." Further, today, the court generally refrains from substituting its decision for that of the Board's, so long as directors have acted within a *range of reasonableness* [1]. In other words, deference is afforded to the Board of Directors unless alternatively beneficial or favorable transaction options are easily identifiable. The case illustrates a fairly low-threshold interpretation of Section 122(1)(a) of the CBCA, where the Wise brothers were understood to "act honestly and in good faith with a view to the best interests of the corporation" with the care and diligence of a reasonably prudent person in similar circumstances.

Nonetheless, in accordance with a trend which began in the late 1990s, *Peoples* is consistent with Canadian courts' historical tendency to afford deference to directors in fulfillment of their duties as accountable to the companies' shareholders. In determining what is in the best interests of the corporation, in 2008, the case of *BCE Inc v 1976 Debentureholders* [6] emphasized a plethora of ancillary interests informing directors' decisions, including but not limited to "shareholders, employees, creditors, consumers, governments, and the environment" to inform their decisions. At the time, there was a particular focus on benefits for shareholders. In that case, a decision of the directors favorably benefitted the shareholders compared to the debentureholders [*sic*]. The court noted the BJR applies equally to stakeholders' interests as well as directorial decision-making. Ultimately, the court in BCE found directors did not commit breach of their duty of care in recommending a leveraged buy-out to shareholders. *BCE* expanded *Peoples*, elucidating the Supreme Court's broad inclusion of the environment, community, partners, employees, and suppliers, in addition to shareholders, in determining the best interest of the corporation.

Relevant and Select Provisions of the *Company Law of the PRC*

In its current form, the *Company Law of the People's Republic of China* contains several provisions pertaining to the responsibilities and duties of directors, notably Chapter 2, Section 2, which outlines the organizational structure of the corporation and limited liability companies (LLCs). Wholly state-owned companies are not the focus of this analysis. As stipulated under Article 44 [3], a LLC is required to have a Board of Directors consisting of 3-13 members. Similar to Canada's approach, each Director has a three-year term with the possibility to serve consecutive terms following reelection (art 45).

Article 46 outlines Director *responsibilities*, *functions*, and *powers*, which include: convening shareholders' meetings and presenting reports (art 46(1)); implementing resolutions' of the shareholders' meetings (art 46(2)); determining business and investment plans of the company (art 46(3)); formulating the annual financial budget plan and final account plans (art 46(4)); formulating plans for profit distribution or making up losses of the company (art 46(5)); formulating plans for increasing or reducing registered capital (art 46(6)); formulating plans in the case of merger, division, transformation, or dissolution of the company (art 46(7)); decisions related to establishing the company's internal management departments (art 46(8)); the appointment or dismissal of the company's manager or deputy manager(s), including decisions related to their remuneration (art 46(9)); directors' responsibilities for formulating the company's basic management system (art 46(10)); and, finally, other functions as specified in the bylaw (art 46(11)).

The *duties of directors* are outlined in Articles 147-152. China's *Company Law* outlines specific ethical and legal obligations of company Directors. Below, Article 147 is reproduced in full, as I will return to its text later to illustrate the corporate cultural differences between China and Canada with respect to corruption, money laundering, and financial bribes.

Article 147

"The directors, supervisors and senior management personnel of a company shall abide by laws, administrative regulations and the company's articles of association. They shall be faithful and diligent to the company.

No director, supervisor or senior management personnel may, by abusing their powers, take any bribe or other illegal gains, or encroach on the property of the company."

Article 147 is the sole provision relating to the duty of care. Article 148 accounts for profits made resulting from the breach of fiduciary duties. Specifically, Articles 148(1)(2) prohibit the misappropriation of company funds, including the impropriety of lending company money to others, or the deposit of company assets into personal bank accounts belonging to directors or others. Article 148(3) states directors are not allowed to lend company money to others or provide corporate security to others without approval. Article 148(4) prohibits directors' self-dealings. Article 148(5) disallows directors from operating for themselves or others the same category of business as operated by the company they are serving, including engaging in activities contrary to the company's interests. Article 148(7) bans disclosure of company secrets except as required by law. Article 149 highlights director's liability to compensate the company if an individual, in the performance of their duties, violates laws, administrative regulations, or the articles of association, causing damage to the company. Finally, Article 152 allows for civil liabilities for damages to shareholders for violations of law, regulation, and/or articles. This is a select, non-exhaustive catalogue of provisions used to illustrate some of the statutory language related to directors' duties while managing Chinese corporations.

Judicial Interference Impairing Businesses and Economic Growth in the PRC

Interestingly, the word "bribe" is contained nowhere in the CBCA yet there is explicit mention of the term in China's *Company Law*. The different use of language within the two statutes is simple yet speaks to the distinct cultural concerns and business climates of the regions. In addition to Article 147, Article 146 [3] disallows a person from becoming director of a company, if he/she "has been sentenced to criminal punishments due to corruption, bribery, embezzlement of property, misappropriation of property, or disrupting the order of the socialist market economy." Five years must have elapsed since the punishments were executed. The State's repetition of bribery and other financial misconduct for a reason was highlighted. It illustrates China's concern of directors' risk-taking and cronyism [10], yet these behaviors also persist within the Chinese judiciary and government itself [11].

Beyond concerns of corrupt corporate practices, as a means to mitigate Chinese judges' disputable decision-making, Weng recommends transplanting the modified BJR as a way to: (1) alleviate the current scarcity and vagueness of directors' fiduciary duties and (2) respond to various "legislative and judicial training issues," which makes it difficult for judges to make decisions in the shoes of directors [10]. Challenges for China also include inadequate standards for judicial appointment, minimal expertise in corporate law, and poor judicial impartiality [12]. Significantly, the BJR "prevents the judiciary from meddling in managerial decisions." Instead, attention and scrutiny is directed toward *how* the decision was made, rather than the decision itself. Further, moving away from the decisions directors make prevents judges' reliance on hindsight and innate biases.

Excessive risk-taking must be the focus of judges' discretion rather than strategic business decisions arising from the careful assessment of facts and circumstances at a particular point in time. Further, Weng notes three issues of concern related to the Chinese legal system, specifically in the context of corporate takeovers: (i) inadequate judicial nomination processes, causing endemic injustice; (ii) judges' local protectionism, which erodes the judiciary's independence; and (iii) "the scarcity of legislation on duty of care." The first and third points raised will inform the discussion. First, judicial nominations have been described as a "*systemic deprivation* of independence." The qualifications of those appointed to the judiciary are also problematic and widely criticized. Notably, Chapter IV "Qualifications for a Judge," Article 9(6) [13], states a judge must simply possess two years of law-related experience for four-year non-law specialty graduates-the same length of law-related experience required by law graduates. Only one year of professional legal experience is required for those holding an LLM or doctorate in law-the same amount for those holding master's or doctoral degrees of non-law specialty.

In both circumstances, one additional year of legal experience is required for persons appointed judges of the Higher People's Court or the Supreme People's Court. There are also built-in discretionary powers to approve judges holding two-or-three year courses in law when assessing academic qualifications. In short, citizens aspiring to be a judge simply must meet the twenty-three year age requirement. They do not require a law degree. Consequently, a significant number of judges are below thirty-five with very little formal legal education [10]. Retired military personnel also receive judiciary appointments, and there is the ineffective rotation of judges as a means to combat corruption. There are many other judiciary challenges.

Second, the incorporation of the BJR into judicial decision-making [14] – which implies corporate directors are in the best position to make reasonable business decisions – may avoid problems associated with the interconnected relationship between government and the judiciary [15]. An annual evaluation of judges completed by the government interferes with judges' impartiality, particularly when adjudicating cases involving government interests. Additionally, in cases where the duty of care is assessed by the court, China's civil law model means legal decisions are not binding authority. Still, judges' involvement with substantive decision-making of corporations and directors is avoided through the BJR. Focus is redirected toward evaluating "whether the decision-making process fits the prerequisites" of the standard of review; for example, judicial decisions requiring assessing complex business information or knowledge. Social strain on the judicial system is also lessened, as directors are not burdened with preparing litigation or expert testimony. Instead, directors can fulfill their fiduciary duties, being "faithful and diligent to the company [3]," through collaborative consultation with external professionals, such as accountants and financial planners, as a means to inform responsible decision-making.

One final suggestion is the incorporation of more specific language into China's C*ompany Law* duty of care provision. Similar to Section 122(1)(b) of the CBCA, Article 147, in its current form, includes the concept of acting with diligence, including a duty of loyalty to the company (art 148(8)). However, Article 147 excludes the notion of acting "honestly," and could benefit from a "good faith" requirement in the context of the best interests of the corporation, akin to Section 122(1)(a) of the CBCA.

Conclusion and Future Directions

A close examination of Canadian and Chinese statutory regimes,

select jurisprudence, and secondary commentary, underlines directors' fiduciary duties is a complex area of the law, in part, because of the differing levels of engagement with the corporation. A general trend between both jurisdictions is that directors who are more engaged with corporations wield relatively low risk for breaching duties of care. There is also incomplete duty of care provisions within Chinese *Company Law*. The PRC may benefit from modifying the BJR affirmed in *Peoples* as a means to circumvent inadequate standards, a lack of independence with respect to judicial appointments, and given the courts' limited expertise to evaluate or second-guess certain business decisions.

Many legislative, judicial, and political reforms are necessary for China. Implementing some form of the BJR, as one "standard of review," will not curtail all of the challenges identified. However, the *status quo* is more detrimental. Judicial interference can dissuade executives from risk-taking, which is an essential component of successful business development and economic growth for the PRC. Although the BJR is less stringent, it is an effective tool in determining: (a) whether independent and disinterested directors considered the issue; (b) if directors were sufficiently informed throughout decision-making; and (c) the standards of integrity informing the decision [5]. Despite the non-binding nature of the Chinese civil law system, there is little precedent regarding the imposition of BJR principles in judicial decision-making. Incorporating the BJR into judicial decision-making in China prevents the stringent application of the "reasonableness standard" and eschews an otherwise risk-averse [10] system that is both economically unviable and detrimental to corporate realities and intricacies.

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