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Directors' Duty of Care in China: Empirical and Comparative Perspective

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Abstract: The adoption of director's duty of care in the 2005 revision of the PRC Company Law made significant progress in holding directors accountable for their wrongdoings. However, certain defects still exist, most importantly the lack of a specific standard for the duty of care in the legislation. Therefore, this article adopts an empirical and comparative approach in reviewing Chinese duty of care cases in comparison with major jurisdictions such as the United Kingdom and the United States. The 86 sample cases hand-collected from the ten-year period from 2011 to 2020 reveal that the number of duty of care litigation in China is still far lower than other types of company disputes, despite an increasing trend. This article finds a divergence in judicial practice concerning at least two different standards of the duty of care, with an array of non-uniform factors considered in the judgments. Accordingly, this article adopts a selective approach concerning best practices in major jurisdictions globally and proposes several solutions specifically catered to China's legal and commercial context, including the unified adoption of the objective reasonable person standard, the suggestion that a wholesale transplant of the business judgment rule is undesirable while some of its elements could be borrowed for reference, the shifting of evidentiary burden to the defendants and the promotion of director's liability insurance. By incorporating these changes, China's company law stands to benefit from striking an appropriate balance between director's authority to manage the companies and shareholder's right to hold them accountable.

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Keywords: duty of care, director duties, empirical studies, ordinary person standard, business judgment rule, burden of proof, China

1. Introduction

It has been long recognized that directors are at the center of attention in corporate governance and their role is becoming increasingly significant following the financial crisis in 2008. As such, director's duties are adopted in many countries in order to make them accountable for breach of duties. However, the dilemma for legislating director's duties is that the potential liability may also deter talented and diligent people from taking directorships. This is particularly true when it comes to the duty of care, as there is a clear gap between the stringent standards of conduct (*i.e.*, conduct rules) and the more lenient standards of review (*i.e.*, decision rules) in laws and regulations.[1] In this article, we focus on director's duty of care (*qin mian yi wu,* 勤勉义务) in the context of corporate law, where the director or officer of a company is required to manage the company with a certain standard of care so as to safeguard and promote the best interest of the company. The duty of care, together with the duty of loyalty, are generally recognized as two key components of the fiduciary duties owed by directors to their company. The duty of loyalty and the duty of care correspond broadly to two types of major risks imposed on shareholders when they delegate management to directors. While the duty of loyalty concerns conflict of interest situations where directors pursue their self-interests, the duty of care addresses situations where the directors are not pursuing self-interests but are nevertheless slack or incompetent with their actions, leading to losses to the company.[2] Such a notion of the duty of care is the most developed in common law countries, while civil law countries like China, Japan and Germany have introduced similar concepts.

In the United Kingdom, director's duties were codified for the first time under section 172(1) of the UK Companies Act 2006, which requires a director to "*act in good faith… to promote the success of the company*".[3] The goal of section 172(1) was to adopt an "enlightened self-interest" approach to UK corporate Law.[4] Although this approach is

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[1] Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984); Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437–468 (1993); D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CINCINNATI L. REV. 1201 (1999).

[2] PAUL L. DAVIES ET AL., GOWER'S PRINCIPLES OF MODERN COMPANY LAW paras. [16–15] (10th ed. 2016).

[3] Companies Act 2006, c. 46, § 172(1) (UK).

[4] Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's*

regarded as an aspirational standard, it has been criticized by some commentators as "British Folly".[5] It remains to be seen whether such legislation will achieve its goal.[6] More specifically, section 174 further provides an objective reasonably diligent person standard for the duty of care, requiring a director to exercise "reasonable skill, care and diligence" that can be expected of a reasonably diligent person in his position.[7] Therefore, section 174 represents a departure from the relatively relaxed subjective standard that UK courts historically subscribed to.[8]

In the United States, although the duty of care appears to be a relatively strict requirement for directors, it is adjudicated in a generous way by the courts.[9] The probable reason behind this is the effect of the court's combined application of both the objective standard and the business judgment rule.[10] This means that while the US courts follow an objective reasonable person standard, a favorable presumption would shield the directors from liability if he or she made an unwise decision but nevertheless met the requirements of 1) absence of self-interest, 2) appropriate information gathered and 3) rational belief that the decision was in the best interest of the company.[11] As such, instances entailing liability for the breach of the duty of care are relatively rare in the US and this trend is likely to continue.[12]
Recent Australian case law exhibits a greater fluidity compared with the US. Meanwhile, it is more stringent from a liability perspective, as the primary tool of enforcing breach of director's duties is by way of Australian Securities and Investments Commission, rather than private litigation.[13]

"Enlightened Shareholder Value Approach", 29 SYDNEY L. REV. 577 (2007).
[5] John Green, *Should the Corporations Act Require Directors to Consider Non-Shareholder "Stakeholders"? Two Perspectives*, *in* COMPANY DIRECTORS AND CORPORATE SOCIAL RESPONSIBILITY: UK AND AUSTRALIAN PERSPECTIVES 44, 49–50 (Robert P. Austin ed., 2007).
[6] Jennifer G. Hill, *Evolving Directors' Duties in the Common Law World*, *in* RESEARCH HANDBOOK ON DIRECTORS' DUTIES 3 (Adolfo Paolini ed., 2014).
[7] Companies Act 2006, c. 46, § 174 (UK).
[8] DAVIES ET AL., *supra* note 2.
[9] Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 W. & M. L. REV. 519 (2012).
[10] David Rosenberg, *Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule*, 6 BERKELEY BUS. L.J. 216 (2009); STEVEN L. EMANUEL, EMANUEL LAW OUTLINES: CORPORATIONS AND OTHER BUSINESS ENTITIES 169 (7th ed. 2013).
[11] *See* for illustration, AM. L. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (1994) [hereinafter *ALI Principles*].
[12] Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009); *In re* The Dow Chemical Company Derivative Litigation, C.A. No. 4349-CC, 2010 WL 66769 (Del. Ch. Jan. 11, 2010).
[13] *See* Renee Jones & Michelle Welsh, *Towards a Public Enforcement Model for Directors' Duty of Oversight*, 45 VANDERBILT J. TRANSNAT'L L. 343 (2012).

In Germany, section 43(1) of the Limited Private Companies Act ("GmbHG")[14] and section 93(1) of the Stock Corporations Act ("AktG")[15] require that a director must employ the diligence of a prudent businessman in all matters concerning the company. Since 2005, section 93(1) of the AktG further includes the business judgment rule with respect to entrepreneurial decisions, which, as acknowledged by the courts, applies to limited private companies as well.[16]

Similarly, in Japan, section 330 of the Companies Act states that "the relationship between a stock company and its directors shall be governed by the provisions on *mandate*"[17]. In addition, the Civil Code provides that "a *mandatary* is obligated to manage the entrusted affairs with *the care of a good manager* in accordance with the tenor of the mandate".[18] The Japanese court has also applied the business judgment rule with slight variations.[19]

In China, the duty of care was introduced under Article 148 of the 2005 Revision of the PRC Company Law.[20] In 2018, the Company Law was revised again, following which the duty of care is stipulated in Article 147.[21] It provides that "directors, supervisors and senior officers of a company shall observe laws, administrative regulations and the company's article of association, and shall assume the duty of loyalty and *duty of care*

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[14] Gesetz betreffend die Gesellschaften mit beschränkter Haftung [Limited Private Companies Act], BGBI I S at 477, Apr. 20, 1892, § 43(1) (Ger.).
[15] Aktiengesetz [Stock Corporations Act], Sept. 6, 1965, BGBI I S at 1089, § 93(1) (Ger.).
[16] *See e.g.*, Bundesgerichtshof [BGH] [Federal Court of Justice], Neue Juristische Wochenschrift [NJW] 453 (2006) (Ger.). *See* further KARIN MADISSON, DUTIES AND LIABILITIES OF COMPANY DIRECTORS UNDER GERMAN AND ESTONIAN LAW: A COMPARATIVE ANALYSIS 35 (RGSL Rsch. Papers No.7, 2012) for a general discussion.
[17] Kaisha-ho [Companies Act], Act No. 86 of 2005, art. 330, as last amended by Act No. 90 of 2014, similar expression was originally present in § 254(3) of Shoho [Commercial Code], Act No. 48 of 1899 but was subsequently deleted.
[18] MINPO [CIV. C.] art. 644 (Japan).
[19] *See* Osaka Dist. Ct., Sept. 20, 2000, 1721 HANREI JIHO 3 (Japan). *See* also Bruce E. Aronson, *Learning from Comparative Law in Teaching U.S. Corporate Law: Director's Liability in Japan and the U.S.*, 22 PENN ST. INT'L L. REV. 213, 222–33 (2003).
[20] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, rev'd Oct 27, 2005, effective Jan. 1, 2006), art. 148 (China) [hereinafter *Company Law 2005*].
[21] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, rev'd and effective Oct 26, 2018), art. 147 (China) [hereinafter *Company Law 2018*].

to the company".[22] Moreover, "directors, supervisors and senior officers of a company shall not take advantage of their functions and powers to accept bribes or collect other illicit earnings, and shall not take illegal possession of the property of the companies".[23] Furthermore, Article 149 of the 2018 Revision stipulates that where a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association in performance of his duties, and thus causes losses to the company, *he shall be liable for compensation*.[24] Lastly, Article 151 allows shareholders to bring derivative actions against wrongful directors if the company itself has failed to do so.[25]

Although such provisions have made much progress from a historical perspective, certain defects still exist. Most importantly, there is an imbalance between the duty of loyalty and the duty of care. While the content of the duty of loyalty is stipulated in detail in Article 148,[26] none of the articles in the Company Law, nor in any other laws, provide a general standard for the duty of care. While some regulations do provide further details, they are nevertheless soft law that is non-binding on the Chinese courts.[27] For example, Articles 4 and 21 through 26 of the Code of Corporate Governance for Listed Companies issued by the China Securities Regulatory Commission ("CSRC")[28] indicate that director's duty of care means that directors should invest sufficient time and energy in performing their duties;[29] possess necessary knowledge, competence and qualities to perform their duties;[30] and also ensure that the company complies with laws, regulations and its articles of association.[31]

[22] *Id.* The authors note that although the literal translation of the Chinese expression "勤勉义务 (*qin mian yi wu*)" is "duty of diligence", this article uses the phrase "duty of care" as it is the substantive understanding the Chinese courts and scholars have ascribed to this phrase, in line with jurisprudence in other countries discussed above.
[23] *Id.*
[24] *Id.* art. 149.
[25] *Id.* art. 151.
[26] *Id.* art. 148.
[27] *See e.g.*, Lin Lin, *Code of Corporate Governance: Lessons from Singapore to China*, 40 COMPANY LAWYER 227, 230–32 (2019) (where the author argued that such Guidance should be interpreted as soft law instruments).
[28] Zhongguo Shangshi Gongsi Zhili Zhunze (中国上市公司治理准则) [Code of Corporate Governance for Listed Companies in China] (promulgated by China Sec. Regul. Comm'n, Jan. 1, 2002, rev'd and effective Sep. 30, 2018) (China).
[29] *Id.* art. 22.
[30] *Id.* art. 25.
[31] *Id.* art. 26.

Similarly, in the Guidelines for Articles of Association of Listed Companies issued by CSRC,[32] Article 98 stipulates that the duty of care requires directors to "1) ensure that the commercial activities of the company comply with laws and administrative regulations and the requirements of various economic policies of the State, and that the commercial activities do not exceed the scope of business stipulated in the business license; 2) treat all shareholders equally; 3) get a timely grasp of the company's business and management; 4) issue a written confirmation opinion for the company's regular reports, and ensure the veracity, accuracy and integrity of information disclosure by the company; 5) provide the relevant information and materials to the board of supervisors truthfully, and refrain from hindering the exercise of official powers by the board of supervisors or the supervisors; 6) and observe any other diligence obligations stipulated by laws, administrative regulations, ministry rules and these Guidelines." In addition, "Companies can provide further requirements regarding the duty of care in the articles of association pursuant to specific needs".

In addition to the above regulations, the Guidance on Appointment and Activities of Directors of Listed Companies of the Shanghai Stock Exchange[33] and the Guidance on the Shenzhen Stock Exchange Small and Medium Enterprise Director Conduct[34] also mention directors' duty of care without providing a specific standard. Although these soft law instruments help in delineating the specific actions directors should undertake to ensure their fulfillment of the duty, they still fall short of providing a general standard that would enable judges to adjudicate cases with factual scenarios that do not fall squarely within these provisions. Additionally, these provisions themselves contain a certain level of vagueness in expressions such as "timely report".[35]

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[32] Shangshi Gongsi Zhangcheng Zhiyin (上市公司章程指引) [Guidelines for Articles of Associations of Listed Companies] (promulgated by China Sec. Regul. Comm'n, Dec. 16, 1997, rev'd and effective April 17, 2019) (China).

[33] Shanghai Zhengquan Jiaoyi Suo Shangshi Gongsi Dongshi Xuanren yu Xingwei Zhiyin (上海证券交易所上市公司董事选任与行为指引) [SHSE Guidelines on Appointment and Conduct of Directors of Listed Companies] (promulgated by Shanghai Stock Exchange, Aug. 25, 2009, rev'd and effective June 13, 2013), c. 4 (China) [hereinafter *SHSE Guidelines*].

[34] Shenzhen Zhengquan Jiaoyi Suo Zhongxiao Qiye Bankuai Shangshi Gongsi Dongshi Xingwei Zhiyin (深圳证券交易所中小企业板块上市公司董事行为指引) [SZSE Guidelines on Conduct of Directors of SME Board Listed Companies] [(promulgated by Shenzhen Stock Exchange, Mar. 1, 2005, effective Mar. 1, 2005, abolished Sept. 1, 2010), art. 4 (China) [hereinafter *SZSE Guidelines*].

[35] For example, Article 38 of the *SHSE Guidelines* stipulates that a director should timely report to the

This absence of a general standard for the duty of care in the Company Law deprives judges of proper guidance in judicial practice, resulting in inconsistency and confusion as judges apply different standards to fill the lacuna. The existing literature either has a disproportionate focus on the duty of loyalty under PRC law and relatively thin discussion on the duty of care, or conflated the two duties.[36] Moreover, most of the empirical studies are outdated and therefore do not reflect the most current trend of judgments in this topic. This is particularly so since it is only in recent years that duty of care related litigation has been increasing.[37] It is against this backdrop that we have written this article to fill the literature gap in examining the duty of care in China from empirical and comparative perspectives, and to discuss the enforcement of the duty of care in practice by empirical research, with a view to obtaining a theoretical reflection on the potential institutional disadvantages and problems and offering corresponding solutions.

In this article, we surveyed the duty of care cases from 2011 to 2020. It is only about a decade ago that PRC courts at various levels started to gradually make their judgments accessible online, pursuant to the Six Regulations on Transparency of the Judiciary, effective from December 12, 2009.[38] All of the relevant cases dating from the issuance

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relevant regulatory bodies if he or she discovers that a listed company or its directors, supervisors or senior managers are suspected of violating laws and regulations. Article 19 and Article 20 of the *SZSE Guidelines* also use "timely report".

[36] *See e.g.*, Marcos Jaramillo, *Directors' Duties in China*, *in* RESEARCH HANDBOOK ON DIRECTORS' DUTIES 154 (2014). Also, in terms of the relevant articles in journals, the authors searched CNKI and found more than 80 articles in the name of the duty of loyalty and only 53 articles in the name of the duty of care. *See e.g.* Xu Guangdong et. al., *Directors' Duties in China*, 14 EUR. BUS. ORG. L. REV. 57 (2013) (only focused on duty of loyalty cases); Wang Jun, *On Cases Against Corporate Managers for Breaching Their Duty of Loyalty and/or Duty of Diligence in China*, 10 FRONTIERS OF LAW IN CHINA 77 (2015) (conflated the duty of loyalty and the duty of care, and analysis was based on cases before 2011). *See also* Kevin M. Hubacher, *A Statutory Business Judgment Rule for China's Company Law: Theoretical and Comparative Considerations,* 13 TSINGHUA CHINA L. REV. 1 (2020) (as a positive example where the author discussed both the duty of care and the duty of loyalty, and the possibility of transplanting the business judgment rule to China).

[37] *See e.g.*, Wang Jiangyu, *Enforcing Fiduciary Duties as Tort Liability in Chinese Courts*, *in* ENFORCEMENT OF CORPORATE AND SECURITIES LAW: CHINA AND THE WORLD 185–206 (Robin Hui Huang & Nicholas C. Howson eds., 2017) (did not examine cases from an empirical perspective); Nicholas C. Howson, *Twenty-Five Years On — The Establishment and Application of Corporate Fiduciary Duties in PRC Law*, 10 L. & ECON. WORKING PAPERS 146 (2017) (only pre-2006 cases were considered in analysis of duty of care).

[38] Guanyu Sifa Gongkai de Liuxiang Guiding (关于司法公开的六项规定) [Six Provisions of the Supreme People's Court on Judicial Openness, Judicial Document No. 58 [2009]] (promulgated by the Sup. People's Ct., Dec. 8, 2009, effective Dec. 8, 2009) (China).

of the Regulation to December 31, 2020 have been collected and examined in this paper, constituting the most updated set of cases under this topic. The judgment database used is China Judgments Online,[39] which is the most comprehensive database on Chinese judgments and has archived 73,419,189 civil cases adjudicated by various levels of courts at the end of our search period. We used "duty of care (*qin mian yi wu*)" as the keyword in the database, selected "judgment" for the type of documents, "civil cases" for the type of cases and narrowed down the areas to disputes related to "companies", "securities, bonds, insurance, bills, etc", or "liability arising from damaging company's interests" and litigated under Article 147 of the PRC Company Law. We excluded the cases that are irrelevant to the duty of care, the cases that do not involve directors or senior executives, as well as the administrative cases and repeated ones. A total of 86 cases were found on the duty of care of directors and senior executives.[40] They are examined in detail in this article.

This article is thus structured as follows. The second part performs quantitative and qualitative analysis on the 86 hand-collected cases in order to examine the collective trends in terms of their chronological and geographical spread, the characteristics of the plaintiffs and defendants, including factors such as the shareholding of the plaintiffs and the types of wrongdoings. The third part reviews the reasoning in these cases and focuses on a theoretical discussion about the standards Chinese judges use in deciding duty of care cases and their underlying rationales, while engaging in a comparative analysis with the standards used in UK and US courts. The fourth part offers several recommendations that the authors believe would help to improve and clarify the duty of care in China. Most importantly, the authors recommend that the objective reasonable person standard should be uniformly applied by Chinese judges in adjudicating duty of care cases, whereas a wholesale transplant of the business judgment rule is undesirable. It is also suggested that the burden of proof should be shifted to the defendant directors once the plaintiff could establish a *prima facie* case.

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[39] Zhongguo Caipan Wenshu Wang (中国裁判文书网) [China Judgments Online], https://wenshu.court.gov.cn/. The China Judgements Online is selected as the ideal database because it is the only authoritative standardized online database for publishing judgments by PRC courts of all levels. Courts of all levels are required to maintain a link to China Judgments Online in their internal administrative website and public information sharing page. The accuracy and comprehensiveness of the judgments maintained by this database is therefore guaranteed.

[40] As supervisors usually do not participate in the daily operation of a company, there is no case on supervisors breaching the duty of care in the selected samples.

The last part concludes.

2. Quantitative and Qualitative Review of Duty of Care Cases in China

In this section, the 86 cases gathered are analyzed to reveal common trends exhibited by these cases and explain the underlying rationales. The temporal and geographical spread of the cases is examined, together with the characteristics of the plaintiffs, such as their shareholding in the company, and the characteristics of the defendants, such as whether they hold other positions or multiple directorships and the type of their wrongdoings.

Before this paper delves into the main arguments concerning a unified standard for the duty of care, among other recommendations, this section provides a helpful empirical perspective in understanding the real-life application of the duty of care in China. The empirical analysis demonstrates the importance of an improved duty of care given the rising number of cases over the years. It is also important to bear in mind that China's legal system is not a monolithic piece, but rather a complicated web of varying practices due to geographical and economic differences. Therefore, any recommendation should account for such complexities and the difficulty of implementation. The empirical findings in this section provides the practical background for the recommendations in the following sections.

At the same time, it is admitted that this empirical study is bound by some limitations. Most importantly, given that most of the 86 cases concern Limited Liability Companies, the conclusions drawn in this section therefore finds greater application in this organizational type.

2.1 Temporal Spread

The sample cases demonstrate an increasing trend in the number of cases since 2011 (see Fig. 1 below), peaking in 2019, with 21 cases. While there is a dip in the data for 2020, possibly due to the COVID-19 situation, the general increasing trend since 2011 is nevertheless largely intact.

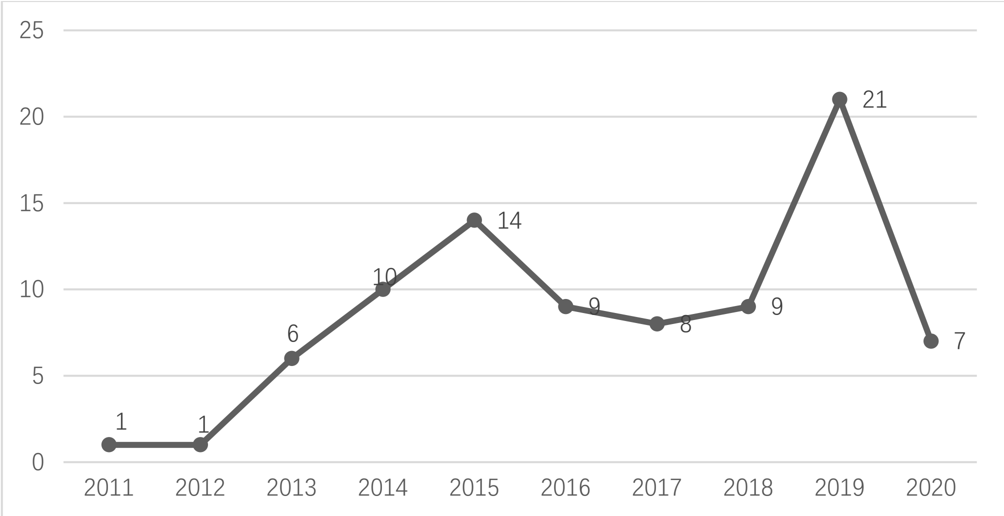

Fig. 1. Temporal Spread of the Number of Cases each year

There was a substantial revision of capital requirements in 2013 in the PRC Company Law, which removed the minimum capital requirement for registration of companies.[41] This might be one of the reasons for the significant rise of cases in 2014. Compared with the old rules, the revision provides for a new capital subscription registration system, which loosened the restrictions on the minimum registered capital and removed the mandatory requirement on the initial contribution ratio of registration capital. It also abolished the requirements for providing the certificate of capital verification and the restrictions on the monetary contribution ratio and lowered the capital threshold for establishment of company, thereby significantly motivating the entrepreneurial enthusiasm of the investors. According to the National Bureau of Statistics, there are 10,617,154 enterprise legal persons registered in 2014 and the number in 2013 is 8,208,273, showing a year-on-year increase of 2,408,881 and a growth rate of 19.36%.[42] The rapid increase in the number of registered companies has led to a rise in lawsuits and disputes, as well as cases concerning the breach of the duty of care.

2.2 Geographical Spread

An earlier empirical study shows that derivative actions usually take place in the

[41] Guowuyuan Guanyu Yinfa Zhuce Ziben Dengji Zhidu Gaige Fangan de Tongzhi (国务院关于印发注册资本登记制度改革方案的通知) [Notice of the State Council on Issuing the Scheme for the Registration System Reform of Registered Capital] (promulgated by the State Council, Feb. 7, 2014, effective Feb. 7, 2014) (China).

[42] For the detail of this, please visit the official website of the National Bureau of Statistics of PRC: http://data.stats.gov.cn/easyquery.htm?cn=C01 (last visited June 5, 2021).

economically developed areas, and most of the cases concerning shareholder derivative actions occur in such places as Beijing and Shanghai.[43] Our empirical data shows that the same geographical spread applies to duty of care cases.

As shown in Fig. 2, the cases occurred mainly in more economically developed areas such as Beijing, Guangdong, Shanghai, Jiangsu and Zhejiang, with the number of cases in these five places accounting for 59.3% of the total number. The occurrence rate in less developed inland provinces such as Qinghai, Sichuan, Liaoning, Gansu and Ningxia is far lower than that in the more developed eastern regions. According to the National Bureau of Statistics, in 2015, the total GDP of Beijing is RMB 2,301.459 billion and that of Shanghai RMB 2,512.345 billion, while Qinghai has only RMB 241.705 billion and Gansu only RMB 679.032 billion.[44] One may conclude that the development of the economy, on most occasions, is proportional to the occurrence rate of cases, as rapid development of economy triggers more disputes. Consequently, judges and lawyers gain more experience and learn to handle these cases with higher proficiency.

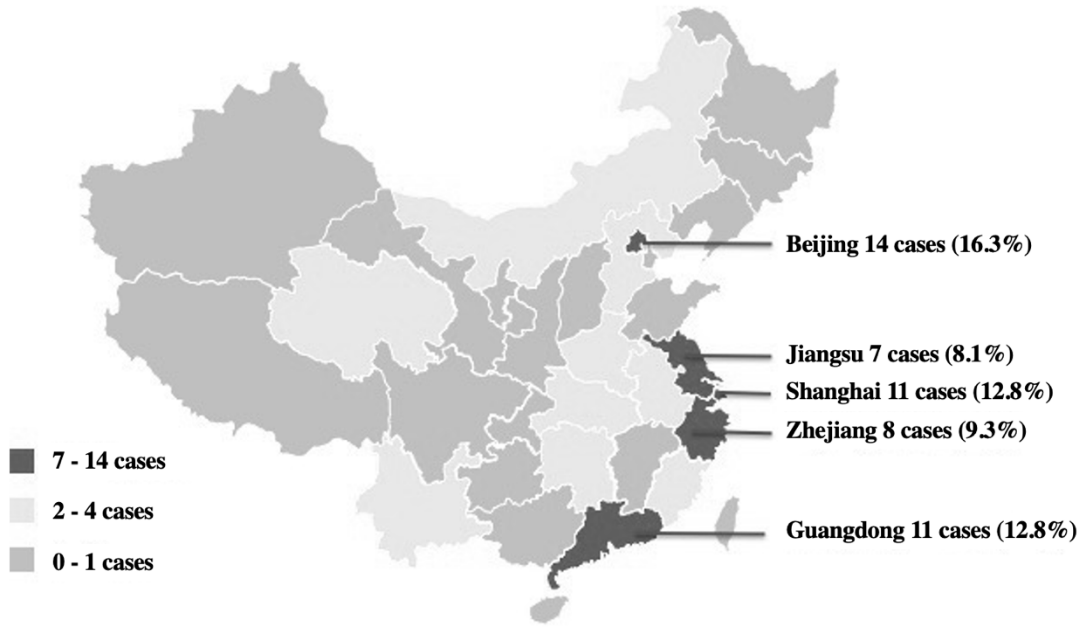

Fig. 2 Geographical Spread of Number of Cases each Province

[43] Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, 27 BANKING AND FIN. L. REV. 619 (2012).
[44] *Supra* note 42.

2.3 Characteristics of the Companies

There are two major types of companies in China, namely the Limited Liability Company (LLC) and the Joint Stock Company (JSC). While LLC refers to companies where the liability of a shareholder is limited to the extent of the subscribed *capital contribution*, JSC refers to companies where the liability of a shareholder is limited to the extent of the *shares* it subscribes.[45]

Out of the cases we have gathered, 85 occurred in LLCs while only one case happened in a JSC. Several reasons may account for this. To begin with, there are more LLCs in China than JSCs. Furthermore, in LLCs, given the smaller number of shareholders, their competing and overlapping interests can be intensified in a more intimate and compact setting, and therefore it is more likely for conflicts to occur.[46] In addition, the board is normally controlled by the majority shareholder, who could potentially abuse his concentrated power and damage the interests of minority shareholders directly through the directors under his influence. It is also more difficult for shareholders in JSCs to demonstrate the causal relationship between the loss suffered by the company and the director's breach of duty. Article 151 of the Company Law further requires a minimum 1% shareholding in a JSC for at least 180 days before a shareholder could bring a derivative action,[47] which is in practice difficult for minority shareholders to acquire given the generally significant size of the JSCs. Lastly, shareholders in JSCs who are dissatisfied with its management could easily exit by selling their shares while this option is not available for shareholders in LLCs.

Our analysis further revealed a negative correlation between the frequency of duty of care cases and the number of shareholders in a company. As shown in Fig. 3 below, in 86 sample cases, there are 47 cases in which the company has less than 2 shareholders, accounting for 55% of the overall cases, 21 cases with 3 or 4 shareholders, accounting for 24%, 10 cases with 5 or 6 shareholders, accounting for 12%, and only 8 cases with 7 or more shareholders, accounting for 9%. Thus, it seems that the violations of the

[45] *Company Law 2018*, art. 3.

[46] Zhou Yini (周旖旎), Wanshan Woguo Youxian Zeren Gongsi Zhili Jiegou de Shexiang (完善我国有限责任公司治理结构的设想) [Ideas for Improving Corporate Governance of Limited Liability Companies in China] 8–9 (Oct. 31, 2008) (LL.M. thesis, East China University of Political Science and Law) (CNKI).

[47] *Company Law 2018*, art. 151.

duty of care are more likely to occur in companies with less shareholders. The reason therefore may be that, in LLCs, shareholders often simultaneously serve the significant roles of directors, managers and others, causing a high overlap of these roles.[48] As shareholders are short in number and hold several positions simultaneously, their powers are difficult to check on and can easily be abused, resulting in more frequent violations of the duty of care by company directors.

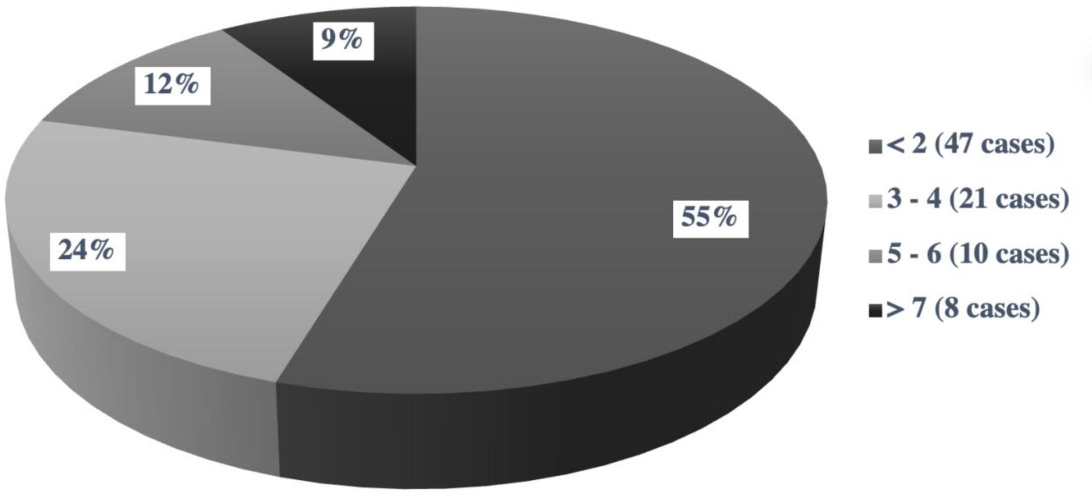

Fig. 3. Percentage of Cases in terms of Number of Shareholders

2.4 Characteristics of the Plaintiffs

2.4.1 Types of Plaintiffs

There are two types of litigation in enforcing director's duties in China: direct actions and derivative actions. If the plaintiff is the shareholder, the litigation will be conducted as a derivative action. On the contrary, if the plaintiff is the company itself, the litigation will be initiated as a direct action. The legal process and regulations are completely different depending on the type of litigation. As shown in Fig. 4, in all 86 cases, there are 67 cases in which the company initiated action directly, accounting for 78% of the total number, and 19 cases in which derivative actions were raised, accounting for 22%.

[48] Zhou, *supra* note 46, at 9.

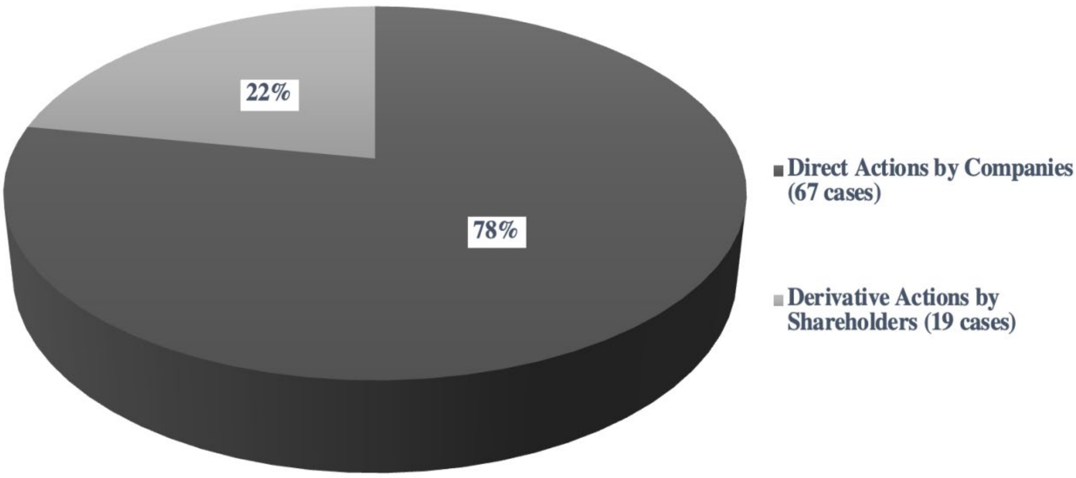

Fig. 4. Percentage of Cases in terms of Direct Actions vs Derivative Actions

In fact, after the derivative action was formally established under the Company Law in 2005, there had only been a total of 103 cases brought over a period spanning nearly eight years.[49] This figure seems encouraging when compared with Japan, in which the mechanism laid dormant for the first 35 years,[50] but given the severe double agency costs and the ineffectiveness of other shareholder protection mechanisms in China, the number is not as encouraging as might be expected. There are reasons why the number of derivative actions is relatively low. Indeed, shareholders would not be willing to initiate derivative actions unless left with no choice.[51] Unfortunately, the high standing requirement (*e.g.*, 1% shareholding in a JSC for at least 180 days) for initiating such cases and the procedural requirement of a failure by the company to bring an action upon request can also create barriers for shareholders.[52]

Furthermore, the plaintiff shareholder will have to pay the lawyer fees and/or the legal cost of the defendant if the lawsuit is unsuccessful, while any recovery accrued by litigation goes to the company if it is successful.[53] This obviously has a substantial negative impact on a shareholder's decision to initiate a derivative action. Although the

[49] Shaowei Lin, *Derivative Actions in China: Case Analysis*, 44 HONG KONG L.J. 621 (2014).
[50] Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NORTHWESTERN U. L. REV. 1436 (1994).
[51] Under the current derivative actions in Chinese Company Law, shareholders do not have enough incentives to raise such proceedings. For the details of China's derivative actions, *see* SHAOWEI LIN, DERIVATIVE ACTIONS IN CHINESE COMPANY LAW 175 (2015).
[52] *Company Law 2018*, art. 151.
[53] Susong Feiyong Jiaona Banfa (诉讼费用交纳办法) [Measures for the Payment of Litigation Fees], (promulgated by the State Council, Dec. 19, 2006, effective Apr. 1, 2007) (China).

Fourth Interpretation of Company Law made by the Supreme People's Court stipulates that the legal cost of derivative actions may be undertaken by the company instead of the plaintiff shareholders, two conditions must be met: the lawsuit is successful and the legal cost is reasonable.[54] Otherwise, the plaintiff shareholders will still have to bear the costs. As such, it is not surprising to see that the number of the cases initiated by shareholders involving violation of the duty of care is rather limited in China.

2.4.2 Shareholdings of the plaintiff shareholders

In the 19 derivative actions, 13 instances (68%) are cases in which the plaintiffs held less than 50% of the voting shares (see Fig. 5). This means minority shareholders are more likely to initiate lawsuits to protect the interests of the companies and of themselves. Indeed, considering the vulnerable situation of their positions in the companies, breach of director's duty of care is more likely to undermine their interests. Nevertheless, it is also interesting to see that some plaintiffs are controlling shareholders.

There are 3 cases with shareholders holding over 50% of the shares, accounting for 16% of the total 19 cases as shown in Fig 5. This also implies that the controlling shareholders may have to bring derivative actions against the directors when the latter have violated the duty of care. This is particularly true when some directors are not appointed by the controlling shareholders. In addition, in 3 of the 19 cases, the company had only two shareholders with each holding 50% of the voting shares. In such a situation, it is highly likely to have a deadlock between the two shareholders. Therefore, it is common for each individual shareholder to bring a lawsuit against the directors if the conflict is not settled between the two of them.

[54] Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Gongsifa Ruogan Wenti de Guiding (Si) (最高人民法院关于适用《中华人民共和国公司法》若干问题的规定(四)) [Provisions of Supreme People's Court on Several Issues Relating to Application of the Company Law of the People's Republic of China (IV)] (promulgated by the Sup. People's Ct., Aug. 25, 2017, rev'd Dec 29, 2020, effective Jan. 1, 2021), art. 26 (China).

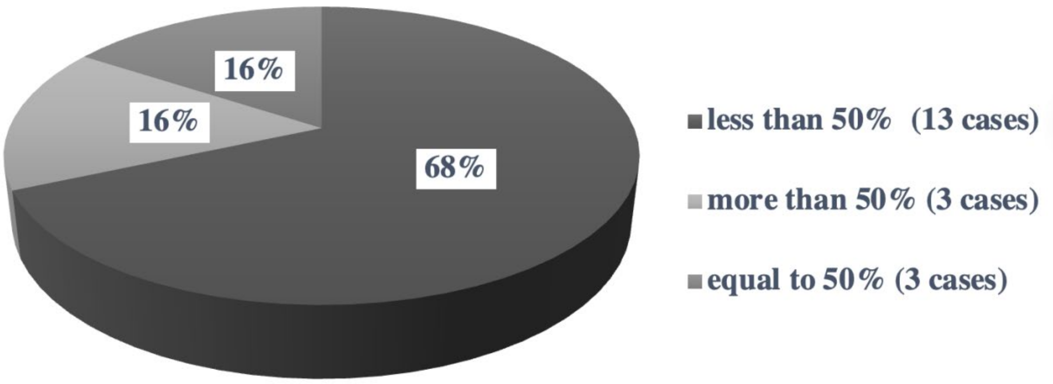

Fig. 5. Percentage of Cases in terms of Shareholdings of the Plaintiff

2.5 Characteristics of the Defendants

As a preliminary point, it is important to note that the duty of care in China covers not only directors, but also supervisors and senior officers of the company,[55] in contrast with the UK and the US, where duty of care is primarily concerned with directors.

2.5.1 Defendants as Shareholder-Directors or Holders of Multiple Directorships

We explored whether the defendant directors are also shareholders in the companies or hold directorships in other companies. In the 86 sample cases, there are 52 cases involving directors who are also shareholders, accounting for 61% of the total number. There are 34 cases in which the defendants only serve as directors of the companies, accounting for 40%. Normally, the ownership and management would not be separate in small and medium-sized LLCs,[56] and the data lends preliminary support to such a theory.

In terms of whether defendants are taking directorships in other companies, there are 41 cases in which the defendant assumed director or senior manager positions in other companies, accounting for 48% of the total number. Presumably, if directors hold positions in other companies, they are more likely to breach the duty of care for a variety of reasons.[57] For example, they might not be afraid of losing the job in one company. Also, since they hold multiple directorships, they may lose focus on the management

[55] *Company Law 2018*, art 151.

[56] The agency cost split between shareholders and managers normally occurs in large public companies. *See* PAUL REDMOND, COMPANIES AND SECURITIES LAW: COMMENTARY AND MATERIALS 181 (3d ed. 2000).

[57] John K. Wells, *Multiple Directorships: The Fiduciary Duties and Conflicts of Interest that Arise when One Individual Serves More than One Corporation*, 33 JOHN MARSHALL L. Rev. 561 (2000).

of one company, which makes them more likely to breach their duty. Nevertheless, the present set of data does not provide strong support for this positive correlation, given that nearly half (17 cases) of the 41 cases were held in favor of the defendant directors. Overall, it is possible that directors can still perform decently even if they hold multiple directorships. This could be particularly true for professional directors hired by multiple companies for their expertise.

2.5.2 Type of Wrongdoings — Positive Actions vs Omissions

It is possible for a director to damage a company's interests either by positive actions or by omissions. Our data shows that the number of cases on the ground of positive actions is 51, accounting for 59%, and the number of cases brought on the ground of omissions is 35, accounting for 41%. Comparing with violation by omission, it is much easier to identify a breach of duty by positive actions, as the only thing to be decided is whether the director concerned has committed such an act. However, for the violation by omissions, the boundaries of director's responsibilities should also be identified and determined. If the director has performed his responsibilities, then omission under such circumstances shall not lead to a breach of his duty. However, companies usually lack specific provisions concerning director's responsibilities and job scope, making it difficult to determine whether a director has performed his responsibilities and whether to require such a director to assume corresponding liabilities.

As shown in Table. 1 and Table. 2, in cases involving violation by positive actions, directors often make arbitrary decisions without a shareholder resolution, sign contracts with a third party beyond their authorities, use company properties to offset personal debts, or cause the company to be subject to punishments for the violation of laws and regulations, among other things. In cases involving violation by omissions, directors often fail to hand over documents (such as debt certificate and contracts) after resignation, to pay social security for employees, to implement board resolutions, or are otherwise negligent in exercising their rights.

Table. 1: Positive Actions Resulting in Breach of Duty

Specific types of actions	No. of

		cases
Improper exercise of rights	Providing security or loan without conducting proper due diligence[58]	29
	Causing the company to be subject to punishments for violation of law[59]	
Act beyond authority	Determining the operation plan of company arbitrarily[60]	22
	Disposing company properties arbitrarily[61]	

Table. 2: Types of Omissions Resulting in Breach of Duty

Specific types of omission		No. of cases
Being negligent in exercising	Failure to implement the resolutions of the board in time[62]	21

[58] *See e.g.*, Xia Chen, Zhu Aiguo Sunhai Gongsi Liyi Zeren Jiufen Ershen Minshi Panjueshu (夏晨、朱爱国损害公司利益责任纠纷二审民事判决书) [Second Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company by Xia Chen and Zhu Aiguo], (2018)皖 01 民终 2601 号 (Interm. People's Ct. of Hefei City, Anhui Prov., Sept. 18, 2018) (China).

[59] *See e.g.*, Bengbu Lituo Cheyong Nengyuan Youxian Gongsi, Lϋbo Sunhai Gongsi Liyi Zeren Jiufen Ershen Minshi Panjueshu (蚌埠利拓车用能源有限公司、吕博损害公司利益责任纠纷二审民事判决书) [Bengbu Lituo Car Energy Co., Ltd v. Lübo (Second Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2018)皖 03 民终 1942 号 (Interm. People's Ct. of Bengbu City, Dec. 13, 2018) (China).

[60] *See e.g.*, Shanghai Pufeier Jinshu Diaoding Youxian Gongsi yu Shanghai Kelamei Kongtiao Youxian Gongsi, Gerald Kirk, Shanghai Pufeier Jinshu Zhipin Youxian Gongsi Sunhai Gongsi Liyi Zeren Jiufen Shenpan Jiandu Minshi Panjueshu (上海浦飞尔金属吊顶有限公司与上海克拉美空调有限公司、基拉德·柯克、上海浦飞尔金属制品有限公司损害公司利益责任纠纷审判监督民事判决书) [Shanghai Pufeier Metal Ceiling Co., Ltd v. Shanghai Kelamei Air-Conditioning Co., Ltd, Gerald Kirk, Shanghai Pufeier Metal Products Co., Ltd (Trial Supervision Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2017)沪民再 2 号 (Higher People's Ct. of Shanghai Mun., June 30, 2017) (China) (the director caused the plaintiff company to enter into arbitrary agreements with a second related company, which unduly benefited the second company at the expense of the plaintiff company's own interests).

[61] *See e.g.*, Li Tongsheng, Li Qiang, Hu Diange Sunhai Gongsi Liyi Zeren Jiufen Yishen Minshi Panjueshu (李同生与李强、胡殿阁损害公司利益责任纠纷一审民事判决书) [First Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company by Li Tongsheng, Li Qiang and Hu Diange], (2017)豫 0782 民初 554 号 (People's Ct. of Huixian City, Henan Prov., Jan. 10, 2018) (China).

[62] *See e.g.*, Xuanwei Shi Huilun Hengye Fazhan Youxian Gongsi yu Yunnan Huilun Fangji Touzi Youxian Gongsi Gongsi Jueyi Jiufen An（宣威市会伦恒业发展有限公司与云南会伦方基投资有限公司公司决议纠纷一审民事判决书） [Xuanwei Huilun Hengye Development Co., Ltd v. Yunnan Huilun Fangji Investment Co., Ltd (First Trial Civil Judgement on Dispute over Company's Resolution)],

rights of director	Being negligent in investigating the liability of the debtors[63]	
	Being negligent in rectifying internal violations[64]	
Failure to properly hand over documents (such as debt certificates and contracts) when resigning from the office[65]		5
Failure to effectively identify basic risks of the company[66]		9

3. Duty of Care and Related Issues — China, the UK and the US

As the provision concerning the duty of care in the PRC Company Law is too vague and lacks explicit standards, it is necessary to analyze how this rule has been applied in judicial practice. For this purpose, this article discusses the underlying logic of judicial decisions by studying the 86 duty of care cases, suggesting a potentially universal standard. To provide a few points of reference, this section begins by reviewing the

(2019)云 0111 民初 2083 号 (People's Ct. of Guandu District, Kunming City, Yunnan Prov., Aug. 13, 2019) (China) (shareholder meeting pursuant to the request of the 45% shareholder who was entitled for such a request).

63 *See e.g.*, Simantewei Xianshi Keji (Shenzhen) Youxian Gongsi yu Hu Qiusheng deng Sunhai Gongsi Liyi Zeren Jiufen Zaishen Minshi Panjueshu (斯曼特微显示科技（深圳）有限公司与胡秋生等损害公司利益责任纠纷再审民事判决书) [Simantewei Technology (Shenzhen) Co. Ltd v. Hu Qiusheng (Retrial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2018) 最高法民再 366 号 (Sup. People's Ct., Sept. 28, 2019) (China).

64 *See e.g.*, Liu Zijian, Huang Zhijiang Sunhai Gongsi Liyi Zeren Jiufen Ershen Minshi Panjueshu (刘子健、黄志江损害公司利益责任纠纷二审民事判决书) [Second Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company by Liu Zijian and Huang Zhijiang], (2019)粤 06 民终 490 号 (Interm. People's Ct. of Foshan City, Guangdong Prov., Apr. 8, 2019) (China).

65 *See e.g.*, Liu Jing deng yu Zhang Pei deng Gudong Sunhai Gongsi Zhaiquanren Liyi Zeren Jiufen Ershen Minshi Panjueshu (柳靖等与张沛等股东损害公司债权人利益责任纠纷二审民事判决书) [Second Trial Civil Judgment on the Dispute over Liability for Shareholder's Damage to the Interests of Company's Creditor], (2019)京 01 民终 503 号 (1st Interm. People's Ct. of Beijing Mun., Mar. 14, 2019) (China). Zou Hongzheng, Zhuhai Baoshuiqu Minsheng Gongye Cangchu Youxian Gongsi Gudong Sunhai Gongsi Zhaiquanren Liyi Zeren Jiufen Ershen Minshi Panjueshu (邹鸿政、珠海保税区民生工业仓储有限公司股东损害公司债权人利益责任纠纷二审民事判决书) [Zou Hongzheng v. Zhuhai Free Trade Zone Minsheng Industrial Storage Co., Ltd (Second Trial Civil Judgment on the Dispute over Liability for Shareholder's Damage to the Interests of Company's Creditor)], (2017)粤 04 民终 2429 号 (Interm. People's Ct. of Zhuhai City, Guangdong Prov., Dec. 12, 2017) (China).

66 *See e.g.*, Beijing Dongfang Wangxin Keji Gufen Youxian Gongsi Shangsu He Yongze Sunhai Gongsi Liyi Zeren Jiufen Ershen Minshi Panjueshu (北京东方网信科技股份有限公司与何咏泽损害公司利益责任纠纷二审民事判决书) [Beijing Dongfang Wangxin Technology Co. Ltd. v. He Yongze (Second Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2016)京 01 民终 5551 号 (1st Interm. People's Ct. of Beijing Mun., Sept. 26, 2016) (China) (the directors failed to effectively identify third party fraud).

present practices in the UK and the US for comparison.

3.1 Comparative Analysis of Duty of Care in the UK and the US

3.1.1 United Kingdom

The standard for director's duty of care in the UK initially started with a subjective standard and gradually moved to an objective reasonable person standard.[67] The historical subjective standard was best represented in the case of *Re City Equitable Fire Insurance Co*,[68] where Romer J at first instance famously posited that "a director needs *not* exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of *his* knowledge and experience". This test is predominantly a subjective test given that the director is not required to achieve a standard higher than his personal capabilities, while there is also an objective benchmark of what a person of his caliber is *reasonably* capable of doing. Influenced by the development of a more stringent and objective statutory standard in section 214 of the 1986 Insolvency Act,[69] a series of UK judgments, most notably by Hoffmann J, started to shift towards an objective standard.[70] Eventually, this change in the common law was adopted by the Law Commissions and codified in section 174 of the 2006 Companies Act as follows, tracking very closely the expression of the 1984 Insolvency Act.[71]

> "This means the care, skill and diligence that would be exercised by a *reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function by the director in relation to the company* and (b) the general knowledge, skill and experience that he has."

While the second limb of the provision does introduce a subjective element, the UK test embodied in this provision is generally understood to be a predominantly objective one.[72] This is because the director's own knowledge and skill only serves to raise the

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[67] DAVIES ET AL., *supra* note 2.
[68] *In re* City Equitable Fire Ins. Co., Ltd. [1925] Ch. 407 (UK).
[69] Insolvency Act 1986, c. 45, § 214 (UK).
[70] Norman v. Theodore Goddard [1991] BCLC 1027 (UK) (Hoffmann J was willing to assume that § 214 of the Insolvency Act represented the common law); Re D'Jan of London Ltd [1994] 1 BCLC 561 (UK) (where an objective test was applied); Cohen v. Selby [2001] 1 BCLC 176 (UK).
[71] Companies Act 2006, c. 46, § 174 (UK).
[72] DAVIES ET AL., *supra* note 2.

bar to a higher standard, particularly so if he is a trained professional such as a lawyer or an accountant, but not to lower the bar below the objective standard. In addition, directors are allowed to rely on delegation of management functions to other employees or division of functions among themselves, as long as they put in place adequate internal control systems to guide and monitor the business.[73] The UK Law Commissions once considered but thought it unnecessary to introduce the business judgment rule. This is because they trusted that the judges would be cautious not to substitute their hindsight for the directors' foresight, and wanted to avoid the risk that cases which failed procedural requirements would be regarded as presumptively negligent under the rule.[74]

Concerning the burden of proof, the claimants have to first make a *prima facie* case by proving that a fiduciary duty existed, and that the company suffered loss.[75] Once this is done, the burden shifts to the director to show he has not breached his fiduciary duties and explain the circumstances. This shifting of the burden is well stated in a number of cases such as *Gillman & Soame Ltd v Young*,[76] *United Pan-Europe Communications v Deutsche Bank*,[77] and *Re Idessa (UK) Ltd (in liq), Burke v Morrison*.[78]

Before we leave the discussion of the UK practices, it is noteworthy to point out that the use of director's and officer's insurance ("D&O insurance") has gained much traction in the UK.[79] Major insurance companies offer D&O insurance services to company directors.[80] In the event that the director fails to perform his duty and the court awards damages to the claimant, the insurance will pay for the damages and legal fees incurred by the director if the claim is covered. Such an arrangement significantly takes away the stress and paranoia of directors and allows them to focus on their work. We

[73] *Id.* quoting *In re* Barings Plc (No.5) [2000] 1 BCLC 523 (UK). *See also* UK FIN. REP. COUNCIL, CORPORATE GOVERNANCE CODE (2018) (although the code is non-binding on the courts).
[74] THE L. COMM'N & THE SCOTTISH L. COMM'N, COMPANY DIRECTORS: REGULATING CONFLICTS OF INTEREST AND FORMULATING A STATEMENT OF DUTIES 5 (1999).
[75] CHRISTOPHER BROCKMAN, DIRECTORS, FIDUCIARY DUTIES AND THE BURDEN OF PROOF (2017).
[76] Gillman & Soame Ltd v. Young, [2007] EWCA 1245 (UK).
[77] United Pan-Europe Communications N.V. v. Deutsche Bank AG, [2000] 2 BCLC 461 (UK).
[78] *In re* Idessa (UK) Ltd (in liq) (sub nom Burke v. Morrison), [2011] EWHC 804 (Ch.) (UK).
[79] Robert Lewis, *What is Directors' and Officers' Liability Insurance and Do You Need It,* ENTREPRENEUR HANDBOOK (Mar. 27, 2021), https://entrepreneurhandbook.co.uk/directors-and-officers-liability-insurance/.
[80] *D&O Insurance Explained*, ALLIANZ, https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/d-o-insurance-explained.html (last visited: July 13, 2021).

will return to this point of D&O insurance when making recommendations in Section 4.

3.1.2 United States

The standard for director's duty of care in the US can be summarized as a combination of the underlying objective reasonable person standard and the added protection and favorable presumption for directors proffered by the business judgment rule.[81] The basic standard for duty of care is one of an objective reasonable person, similar to the UK. This standard is imposed by virtually all states on all officers and directors, such that they "must exercise that degree of skill, diligence and care that a *reasonably prudent person* would exercise in *similar circumstances*".[82] Section 8.30 (a) of the Model Business Corporations Act spells out the duty of care in a typical way:[83]

> "**Section 8.30 (a)** Each member of the board of directors, when discharging the duties of a director, shall act: 1) in good faith, and 2) in a manner the director *reasonably believes* to be *in the best interests of the corporation.*"

In the US, most successful claims against directors emerged in cases where the director simply failed to do the basic things required of a director, such as the requirements to attend meetings, understand the substance of the business, read reports, obtain professional advice or go through the standard motions of diligent behavior.[84] Additionally, many cases in which directors are held liable for breaching the duty of care are also disguised "self-dealing" cases, where the judges believed the directors acted for their own benefit, but the evidence was insufficient to fault them under the duty of loyalty.[85]

When it comes to passive negligence or acts by omission cases, the director is generally *not* liable for breach of duty if he fails to detect wrongdoings,[86] as long as he had put in place internal monitoring and information system, consciously monitored the

[81] EMANUEL, supra note 10, at 176.
[82] ROBERT CLARK, CORPORATE LAW 123 (2d ed. 1986).
[83] Model Business Corp. Act (2016 Revision), c. 8, § 8.30(a) (American Bar Ass'n).
[84] *See* Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) for a typical fact scenario.
[85] *Id.*
[86] Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963).

company's operation and was not actually put on notice of acts that would make a reasonable person suspicious of wrongdoing.[87] The seminal case of *Stone v Ritter* further requires proof that the directors had knowledge of the shortcoming, and gross negligence is not sufficient in the scenario of passive negligence.[88]

The business judgment rule functions to potentially save a director from liability even if his conduct may seem to lack due care from the objective ordinary person standard, provided that a few conditions are met. Section 4.01(c) of the American Legal Institute's Principles of Corporate Governance (ALI Principles) provides the clearest definition of the rule as follows (explanation in bracket added).

> "**Section 4.01(c)** A director or officer who makes a *business judgment in good faith* fulfills the duty [of care] if the director or officer
>
> > (1) is *not interested* in the subject of the business judgement (*i.e.*, there is no conflict of interest nor self-dealing);
> > (2) is *informed* with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be *appropriate* under the circumstances (*i.e.*, he or she must gather appropriate information to enable him or her to make an informed decision[89]); and
> > (3) *rationally believes* that the business judgment is *in the best interest of the corporation* (*i.e.*, his or her judgment was rational, not entirely out of bounds)"

The rationale of the business judgment rule was to recognize that a certain amount of risk-taking is inevitable in fulfilling director's roles, and that judges are poor adjudicators of business reality and should not second-guess the substance of a business decision with the benefit of hindsight.[90] The best example of the lenience of the rule would be the *Brehm v Eisner* case, also known as the Disney case.[91] There, the directors were found to have made an informed decision in good faith by relying on expert

[87] *In re* Caremark Int'l. Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996), *aff'd* in Stone v. Ritter, 911 A.2d 362 (Del. 2006).
[88] *Stone*, 911 A.2d 362.
[89] *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (an example of how the directors breached their duty when they failed to acquire appropriate information and merely relied on oral representation by the company's chairman/CEO in a significant sale of company's shares held by the chairman/CEO himself).
[90] Joy v. North, 692 F.2d 880 (2d Cir. 1982); Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
[91] *See Brehm*, 746 A.2d 244.

opinion, even though the expert himself was at best careless and failed to spot the problem with a lucrative severance package that actually incentivized Disney's president to end his employment as soon as possible. Taking the objective reasonable person standard together with the business judgment rule, one realizes that the American courts set a more stringent requirement for the *process* of decision-making by directors, while being more lenient on the *substance* of a decision.[92] As long as the director was not interested in the transaction and acquired appropriate information to make an informed decision which he honestly believed was in the best interest of the company, a favorable presumption arises under the business judgment rule to shield him from liability even if his decision turned out to be unwise.

It is alluded to in the preceding discussion that the burden of proof initially rests on the plaintiff to make out a *prima facie* case of a breach of duty of care by the directors, following which the burden shifts to the director to prove the three conditions under the business judgment rule.[93] Because the US law specifically incorporated the business judgment rule to function as a "safety net" for the directors, it is analogous to the shifting of burden under UK law to give the directors a chance to prove that he has carried out his duty properly.

Similar to the UK, D&O insurance is also an important way for directors in the US to acquire personal protection in the event of an unfavorable court decision. It is so popular that "nearly all large companies, and many small ones" purchase D&O insurance for their directors.[94] The insurance payout is either paid to the company to cover its losses, or to the director to enable him to pay the substantial damages. Generally, the D&O insurance would exclude circumstances where the director gained a personal profit or advantage, or engaged in active and deliberate dishonesty. Therefore, the D&O insurance is generally more applicable in cases of the duty of care than of the duty of loyalty.

3.2 Divergence in the PRC Judicial Practice

[92] *See Smith*, 488 A.2d 858, where the substance of the decision was arguably acceptable, yet the directors breached the duty by failing to fulfill procedural requirements, in contrast with *Brehm*, 746 A.2d 244, *Francis*, 432 A.2d 814, where an unwise decision was saved because proper procedures were followed.
[93] EMANUEL, *supra* note 10.
[94] *Id.* at 263.

Based on our empirical analysis of the 86 sample cases, we distilled two standards in judicial practice when Chinese judges adjudicate the duty of care cases. One is the ordinary person standard in which the directors are required to pay reasonable care in carrying out his duties as an ordinary person would under similar circumstances. This standard is close to the objective ordinary person standard used in the UK and US-Delaware, as explained above. The other one is the professional manager standard which places a higher demand on directors carrying out company affairs, as they are professional managers rather than ordinary people. The second standard bears some resemblance to the prudent businessman or good manager standard found in German and Japanese company laws.[95]

Before a detailed discussion of how Chinese judges adopt these two standards in specific judicial practice, it is noteworthy to point out how often Chinese judges actually rely on such standards to decide a case. Empirically, our study of the 86 cases show that in a predominant proportion of cases (over 80% of the instances), the judges did not discuss the standard for duty of care, but instead merely relied on evidential grounds and decided the cases on failure to present cogent evidence. In the remaining small portion of cases where the judges did discuss the standard for duty of care, an overwhelming majority of them adopted the ordinary person standard, while only a minority of cases utilized the professional manager standard.

3.2.1 Ordinary Person Standard

Similar to what the UK Companies Act phrases as the "reasonably diligent person" standard, or what the Delaware law and the ALI Principles term the "ordinarily careful and prudent men" standard,[96] the Chinese judges also utilize the objective reasonable person standard in their judgments.[97] For example, in the case of *Siyang Tahui Textile Co., Ltd v. Yu Jianfen*,[98] the Suqian Intermediate People's Court stated that:

"Duty of care means that directors shall perform their duties for the company

[95] *See supra* text accompanying notes 14–19.
[96] Companies Act 2006, c. 46, § 174 (UK).
[97] *See*, *e.g.*, *Graham*, 188 A.2d at 130; AM. L. INST., *supra* note 11, § 4.01(a).
[98] Siyang Xian Tahui Fangzhi Youxian Gongsi yu Yu Jianfen Sunhai Gongsi Liyi Zeren Jiufen Yishen Minshi Panjueshu (泗阳县塔汇纺织有限公司与虞剑芬损害公司利益责任纠纷一审民事判决书) [Siyang Tahui Textile Co., Ltd v. Yu Jianfen (First Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2013)宿中商初字第 0140 号 (Interm. People's Ct. of Suqian City, Jiangsu Prov., June 30, 2014), 12 (China).

faithfully and honestly, *pay reasonable care as ordinary people under similar circumstances* and within corresponding responsibilities would do, manage company affairs diligently and protect the company interests responsibly."

Accordingly, the court went on to find that the articles of association neither provided that transfer of company property should be subject to a board approval, nor established any restriction on the amount of property that could be transferred by the general manager, Yu Jianfen. Therefore, acting as the general manager and legal representative of the company, he was entitled to enter into a house sales contract with the management committee of *Tahui Textile* and did not exceed his authority in doing so.[99] In this case, the court held that the defendant did not breach his duty because he performed the duty as an ordinary person under similar circumstances and within corresponding responsibilities would do.

In the other case of *Shenyang 4th Rubber (Factory) Co., Ltd v. Yan Feng*,[100] the company suffered loss from mistakes made in the installation of certain equipment. The defendant was the director who monitored the installation. Accordingly, the plaintiff argued that the defendant made mistakes of common sense in not detecting the mistake made by the technicians. They further contended that such mistakes fell within the scope of serious breach of duty, and the defendant should assume compensation liability for the losses. Their claim was rejected by the Shenyang Intermediate People's Court in the judgment of second instance, with the following reasons:

> "The plaintiff has entrusted other professional installation companies to install its new equipment. If there is any quality issue in the installation, the company can seek solution through other means and shall not attribute such to the breach of duty by Yan Feng. The defendant is incapable of causing such quality issue concerned, since the configuration of relevant equipment can only be processed and

[99] *Id.* at 13.

[100] Shenyang Disi Xiangjiao Chang Youxian Gongsi yu Yan Feng Sunhai Gongsi Liyi Zeren Jiufen Ershen Minshi Panjueshu (沈阳第四橡胶（厂）有限公司与闫峰损害公司利益责任纠纷二审民事判决书) [Shenyang 4th Rubber (Factory) Co., Ltd v. Yan Feng (Second Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2015)沈中民三终字第 01487 号 (Interm. People's Ct. of Shenyang City, Liaoning Prov., Dec. 14, 2015) (China).

maintained by suppliers and senior technicians, while he is but a graduate majored in chemical machinery. The company, hiring the defendant, should be aware of his education background and capabilities, as well as the professional qualities of senior executives required by the company. Therefore, the company may not attribute such a quality issue to the breach of the duty of care by Yan Feng, even though the aforementioned quality issue of equipment indeed exists."[101]

In this case, the plaintiff asserted that the defendant should be subjected to a stricter duty of care than ordinary people and possess certain professional knowledge. However, this claim was rejected as the court stated clearly that the configuration and maintenance of equipment can only be accomplished by suppliers and professional technicians instead of the defendant. Arguably, the court is applying an objective standard here, as an ordinary person cannot be expected to have the skills only available to professional technicians. As such, it is improper to require the defendant to perform duties beyond the standard of ordinary people. Therefore, the court decided that the defendant did not violate his duty of care and rejected the plaintiff's claim.

In addition to the above cases, the majority of the cases in our empirical studies demonstrated that the courts embraced an ordinary person standard. Under this standard, as long as directors have the good intention to protect company interests and take a prudent attitude as an ordinary person would in managing daily affairs of the company, their behaviors shall be recognized as legitimate even if damages may be suffered by the company subsequently, and they shall not assume any liability for such losses. It cannot be denied that, in judicial review, the adoption of the ordinary person standard is a credible attempt with respect to its practical effects, since directors need to make quick decisions and keep up with the market in order to deal with complex business environment, fleeting opportunity and a mix of risks and returns. With the ordinary person standard in place, the directors are assured that they do not have to second guess themselves when making corporate decisions, and they would not be worried of being held to a standard higher than what an ordinary person can achieve. Under such background, efficient business decisions could be achieved to some extent by imposing such a standard.

[101] *Id.* at 5–6.

3.2.2 Professional Manager Standard

The professional manager standard resembles the prudent businessman standard in German law,[102] which requires the directors to carry out stricter care in managing company affairs.[103] This standard imposes that, in operating activities of the company, directors should implement self-discipline in accordance with the standards of a prudent and responsible company management personnel, instead of an ordinary person, and shall master necessary knowledge for performing their duties. Some scholars believe that such stricter duty of care imposes absolute requirements for directors and allows for no negligence, no matter how subtle it is. As long as such negligence may incur damage to the company, it will be firmly prohibited.[104] Once directors have committed negligence, violated their duty of care and caused damage to the company, they inevitably have to assume corresponding liability.[105] Therefore, directors face much stricter liability under the professional manager standard.

The professional manager standard was also found in the sample cases, even though to a lesser extent. In the case of *Zhou Jielin v. Liu Zhibiao*,[106] the plaintiff, the defendant and Li Bin established Hengzhi Company, and the defendant then served as the company's executive director and legal representative. On May 23, 2014, the defendant signed the Bidding Agreement with an auction company and the Contract for Assignment of State-owned Construction Land Use Right with the Land and Resource Bureau, impropriating the land use right of Shiwan Cinema as his personal property, which should have been acquired by the company through bidding. The plaintiff claimed that the defendant infringed upon his legitimate interest by taking advantage

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102 Liu Jingwei（刘敬伟）, *Dongshi Qinmian Yiwu Panduan Biaozhun Bijiao Yanjiu*（董事勤勉义务判断标准比较研究）[A Comparative Study on the Criteria of Directors' Duty of Care], 5 CONTEMP. LEGAL STUD. 150 (2007).

103 Ren Zili (任自力), *Gongsi Dongshi de Qinmian Yiwu Biaozhun Yanjiu* (公司董事的勤勉义务标准研究) [*A Study on Standards of Corporate Directors' Duty of Care*], 6 ZHONGGUO FAXUE (中国法学) [CHINA LEGAL SCI.] 83, 84–92 (2008).

104 Ye Jinqiang (叶金强), *Dongshi Weifan Qinmian Yiwu Panduan Biaozhun de Jutihua* (董事违反勤勉义务判断标准的具体化) [*The Specification of the Criterion for Judging Directors' Breach of Duty of Care*], 6 BIJIAO FA YANJIU (比较法研究) [J. OF COMPAR. L.] 79, 79 (2018).

105 Vassil Breskovski, *Directors Duty of Care in Eastern Europe*, 29 THE INT'L LAWYER 77, 89 (1995).

106 Zhou Jielin yu Liu Zhibiao Sunhai Gongsi Liyi Zeren Jiufen Yishen Minshi Panjueshu (周洁琳与刘志彪损害公司利益责任纠纷一审民事判决书) [Zhou Jielin v. Liu Zhibiao (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2015)东民二初字第 54 号 (People's Ct. of Hengdong Cnty., Hunan Prov., Aug. 10, 2015), 16 (China).

of his position, and breached his duty as a professional manager. The court made the following statement in the final judgment:

> "[D]uty of care requires the directors to show the prudence as a good manager… as the decision made by the directors will significantly affect the interests of the company and shareholders, (they have to run the company as professional managers)."[107]

The part in parenthesis is inferred from the general tenet of the judgment. Here the court explicitly mentioned that the duty of care requires the directors to show the prudence of a good manager, echoing the argument of the plaintiff. Therefore, it can be inferred that the judges were of the opinion that the professional manager standard should be imposed on top of the ordinary person standard. By emphasizing how the decisions made by the directors have a significant impact on the interests of the company and its shareholders, the court again stressed that the directors should be held to a higher standard of a professional manager. While the facts of this case may also be categorized under the duty of loyalty, it is nevertheless an appropriate example here as the court went to some length to discuss the standard for the duty of care as well.

Similarly, in the case of *Tian Guisheng, Wei Chi and Zhou Tianrun v. Diao Jian*,[108] the three plaintiffs and one other person established the company. The defendant purchased accessories from an outside party, and failed to make corresponding payment as agreed. Subsequently, he arbitrarily used the equipment of the company to offset his personal debts without a shareholder resolution and relevant authorization. Therefore, the three plaintiffs initiated a lawsuit claiming for compensation. Although the plaintiffs in the case were not suing the defendant for a simple breach of the duty of care, the court made it clear in its ruling that "the defendant, as a director, has the power to dispose of

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[107] *Id.*

[108] Tian Guisheng, Wei Chi, Zhou Tianrun yu Diao Jian, Disanren Sichuan Guoshui Zuran Wufang Zhipin Youxian Gongsi Sunhai Gongsi Liyi Zeren Jiufen Minshi Panjueshu (田贵生、魏驰、周天润与刁建、第三人四川国水阻燃无纺制品有限公司损害公司利益责任纠纷一审民事判决书) [Tian Guisheng, Wei Chi and Zhou Tianrun v. Diao Jian, Third Party Sichuan Guoshui Anti-Inflamatory Non-Woven Products Co., Ltd. (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2014)简阳民初字第 1190 号 (People's Ct. of Jianyang City, Sichuan Prov., Oct. 9, 2014), 8 (China).

the company's property",[109] and thus, as was mentioned many times in its judgment, should fulfill the corresponding obligations as a manager. While the court did not clearly point out that directors should fulfill the duty of care as managers, it is inferred the court may adopt the professional manager standard in deciding whether the duty of care is violated.

In the two cases above, the judges focused more on whether the directors have paid due attention as a prudent senior executive and required them to perform the duty of care in a much stricter manner than that of ordinary people in order to protect the interests of the company. However, such an approach is rarely adopted in other cases. In fact, only 2 of the 86 sample cases adopted the professional manager standard, while most of the cases embraced the ordinary person standard. Considering the relative looseness of the latter standard, it can be inferred that the judges are friendly towards directors when they adjudicate cases. The reason behind this may be that Chinese directors have varying levels of management skills and knowledge structure, and thus it is difficult to require them to perform the duty as professional managers.[110] Otherwise, many talented persons, who are not yet directors but may assume the role, would be deterred from taking directorship in companies, and the economy as a whole would be undermined.

3.3 Burden of Proof

Under Chinese law, the general principle of the burden of proof in civil lawsuits is that the person who makes the claim should bear the burden of proof. Article 64 of the PRC Civil Procedure Law clearly stipulates that "the parties have the duty to provide evidence for their claims",[111] and that the party bearing the burden of proof should bear the adverse consequences.[112] This so-called principle of "he who asserts must prove" is widely used in most of the civil cases. However, if such a principle is applied in lawsuits concerning director's duty of care, the plaintiff shareholders would be trapped

[109] *Id.*
[110] *See e.g.*, Deloitte Rsch. Ctr., *2018 Deqin Zhongguo Shangshi Gongsi Duli Dongshi Diaoyan Baogao* (2018 德勤中国上市公司独立董事调研报告) [2018 Deloitte Research Report on Independent Directors of Listed Companies in China], https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/ined/deloitte-inde-2018-deloitte-inde-report-zh-180322.pdf.
[111] Minshi Susong Fa (民事诉讼法) [Civil Procedure Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 8, 1982, rev'd June 27, 2017, effective July 1, 2017), art. 64 (China).
[112] *Id.*

in a dilemma, as many of them do not serve as directors nor participate in the operation and management of the companies. From this perspective, it would be highly unlikely for them to provide evidence to prove the illegality of the actions or the breach of the duty of care. Even though there is regular disclosure by directors to shareholders and compulsory discovery in the process of a lawsuit, practical difficulties do exist in terms of non-disclosure, concealment or destruction of evidence, or the lack of evidence when informal decision-making is done. As shall be seen in the following discussion, most of the Chinese courts imposed the burden of proof on the plaintiff, whereas a small minority of cases allowed a shifting of the burden of proof to the defendant and required the defendant to raise evidence to prove he discharged his duty.

3.2.1 Burden of Proof on the Plaintiff

Although placing the burden of proof on the plaintiff brings significant disadvantages to them, most of the judges still follow this general principle. In the case of *Qinghai Chijiu Oil Shale Development Co., Ltd v. Li Hongduo*,[113] the plaintiff claimed that the defendant failed to change the well location in accordance with certain standards, therefore causing huge losses to the company. As such, the plaintiff initiated the lawsuit arguing that the defendant breached his duty as a director and should be held liable for the loss. Pingan District People's Court held that:

> "[T]he plaintiff failed to provide any relevant evidence to prove the defendant's serious violation of the duty of care and the articles of association or the losses caused thereby. Hence, the plaintiff's claim is rejected due to the lack of evidence."[114]

In this case, the court held that the plaintiff shall bear the burden of proof to prove the defendant's breach of duty. Unfortunately, the plaintiff failed to provide the evidence, and thus the court rejected the claim. Similarly, in the case of *Beijing Heguiyouxin*

[113] Qinghai Chijiu Youyeyan Kaifa Youxian Gongsi yu Li Hongduo Sunhai Gongsi Liyi Zeren Jiufen An Yishen Panjueshu (青海驰九油页岩开发有限公司与李洪铎损害公司利益责任纠纷案一审民事判决书) [Qinghai Chijiu Oil Shale Development Co., Ltd. v. Li Hongduo (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2015)平民初字第 738 号 (People's Ct. of Ping'an Cty., Qinghua Prov., Jan. 8, 2016) (China).

[114] *Id.* at 5.

Investment Co., Ltd v. Shang Sijun,[115] the plaintiff company claimed that the defendant director provided inaccurate credit advice and risk analysis without carrying out comprehensive due diligence investigation on the target project and thus breached his duty of care, rendering the security of the project unrealizable and loans irrecoverable. Accordingly, the plaintiff requested the defendant to compensate for the losses caused. Chaoyang District People's Court held that:

> "*The burden of proof to show that the defendant breached his duty of care lies with the plaintiff.* With regard to the submitted evidence, the plaintiff failed to provide valid and sufficient evidence to prove the existence of the accused actions. In addition, the risk and responsibility arising from the external contract with the outside party should not be assumed by the defendant simply because he is the director of risk control in the company. To the contrary, the defendant has formulated credit procedure for the company while taking such a post, indicating that he has properly performed his job responsibilities and duties… There is no evidence to support the plaintiff's petition, and thus the court rejects such a claim."[116]

In this case, the court has also rejected the plaintiff's claim because of the absence of valid evidence. In addition to the above two cases, this article found that there are 35 more cases in which the courts adopted this approach. Indeed, as the general principle is explicitly stipulated in the PRC Civil Procedure Law, it is not surprising that judges followed this principle. However, this does not necessarily mean such an approach is naturally right, because it is in certain circumstances difficult and unfair for plaintiffs to bear such a burden, particularly when many plaintiffs do not participate in the daily operation of the companies. As such, it is no surprise that the number of cases in which directors are held liable is significantly less than other corporate dispute cases.[117]

[115] Beijing Hegui Youxin Touzi Youxian Gongsi yu Shang Sijun Sunhai Gongsi Liyi Zeren Jiufen Yishen Minshi Panjueshu (北京和贵有信投资有限公司与尚思俊损害公司利益责任纠纷一审民事判决书) [Beijing Hegui Youxin Investment Co., Ltd. v. Shang Sijun (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2016)京 0105 民初 3764 号 (People's Ct. of Chaoyang Dist., Beijing Mun., Apr. 13, 2016).

[116] *Id.* at 5.

[117] As shown in our empirical studies, the number of duty of care cases over a period of 10 years is only 86, and there were even less reported cases before this study period. However, from 2013 to 2019, the number of company-related disputes in China has increased from more than 1,000 to nearly 60,000 per

Professor Bishop once aptly observed that the search for cases in which directors have been held liable is a search for a very small number of needles in a very large haystack.[118] This vivid description truly reflects the judicial practice concerning the duty of care in China.

3.3.2 Shifting of Burden to the Defendant

As discussed above, it is hard for plaintiffs to demonstrate that directors have violated the duty of care when they do not participate in the management of the companies. Indeed, many shareholders are *de facto* outsiders who do not know much about the companies and rely heavily on the information provided by the directors. Furthermore, it is apparently against the director's own interests to disclose details of their own wrongdoings. Instead, they are more likely to cover up these mistakes or provide irrelevant or even misleading information. Therefore, requiring the plaintiffs to bear the whole burden of proof in effect imposes a higher requirement on the plaintiffs and tolerates the misbehavior of directors. Chinese courts recognize this and allow the shifting of the burden in some cases. This means the burden of proof is shifted to the defendants to provide sufficient evidence to demonstrate that they did not violate the duty of care, otherwise they would be held accountable. This shifting of the burden of proof undoubtedly benefits the plaintiffs. In the case of *Chen Jia v. Huang Xiaogang*,[119] the plaintiff claimed that the defendant, as executive director of the company, has withdrawn RMB 200,000 from the company account without approval by other shareholders and thus breached his duty. The defendant was also accused of misappropriating cloth manufactured by the company. However, the defendant argued that the money was used to repay the company's loan to outsiders, and that the cloth was disposed as a normal operation of the company. The court held that:

"The defendant, as the executive director of the company, is responsible for its

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year. *See* Zhao Xudong (赵旭东), *Zhongguo Gongsi Zhili Zhidu de Kunjing yu Chulu* (中国公司治理制度的困境与出路) [*The Dilemma and Outlet of China's Corporate Governance System*], 2 XIANDAI FAXUE (现代法学) [MOD. L. SCI.] 89 (2021).

118 Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

119 Chen Jia yu Huang Xiaogang Sunhai Gongsi Liyi Zeren Jiufen Minshi Yishen Panjueshu (陈佳与黄晓刚损害公司利益责任纠纷民事一审判决书) [Chen Jia v. Huang Xiaogang (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2013)绍商初字第 278 号 (People's Ct. of Shaoxing Cty., Zhejiang Prov. July 2, 2013) (China).

daily operation and decision-making. During his term of office in Zhongbo Company, the defendant has handled corporate funds of RMB 200,000 and misappropriated cloth manufactured by the company. According to the defendant, the funds were used to repay the outside party while the disposal of the cloth was a normal operation, *but he has not provided any valid and sufficient evidence to prove it.* Therefore, the court held that the defendant failed to perform his duty of care in good faith and shall assume the liability of compensation for the total loss of RMB 225,000 suffered by Zhongbo Company."[120]

In this case, the court held that the defendant was obliged to give reasonable explanation for the misappropriation of company property and provide corresponding evidence. However, the defendant failed to provide valid evidence to prove that the company properties he had misappropriated were used in normal operation, and thus he was held responsible. Here, the court shifted the burden to the defendant to prove he had properly discharged his duty. Since the defendant failed at the proof, the court found him to be liable for the loss.

In the case of *Dongguan Xiongyi Mould Company v. Li Yubin*,[121] the plaintiff company claimed that Li Yubin, the defendant, while taking charge of the daily management of the company as a legal representative, failed to manage the company in an organized manner and disobeyed the distribution procedures of the company, and hence breached the duty of care as a manager. Additionally, he failed to sign sales contracts with clients, delivered products in an arbitrary manner, filed no invoice upon delivery, made no request to the clients for filing and returning of receipts, and prepared no statement of account, and hence breached the duty of care as a director. The court held that:

"The Statement of Account provided by the defendant showed that Zeng was the one in charge of the financial affairs and account checking. Appendix I of Contracts Signed by Shareholders (List of Outstanding Payments) showed that Zeng, who

[120] *Id*. at 6.
[121] Dongguan Shi Xiongyi Muju Youxian Gongsi yu Li Yubin Sunhai Gongsi Liyi Zeren Jiufen Minshi Yishen Panjueshu (东莞市雄意模具有限公司与李榆斌损害公司利益责任纠纷民事一审判决书) [Dongguan Xiongyi Mould Co., Ltd. v. Li Yubin (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2014)东二法民二初字第 101 号 (Second People's Ct. of Dongguan City, Guangdong Prov., Mar. 11, 2014) (China).

was also a shareholder of the company, had been working in Xiongyi Company since January 31, 2012. The evidence provided by Li Yubin demonstrated that Zeng was responsible for the financial affairs and account checking of the company. Xiongyi Company blamed Li Yubin for the company's failure to collect the money, which could not be supported as Li Yubin demonstrated that he was not responsible for this. Therefore, the plaintiff's claim of violation of the duty of care by the defendant is rejected by the court."[122]

The result of this case is different from the previous case while the rationale is the same. The court supported the defendant in this case as he successfully proved that he was not responsible for the wrongdoings claimed by the plaintiff. These two cases are typical examples where the courts shifted the burden and required the defendant to prove that no breach of duty had occurred. However, the precondition for the shifting of the burden of proof is that the plaintiff must provide preliminary evidence. The burden of proof shall only be shifted when such preconditions are satisfied. This resembles the *prima facie* evidence in common law. The statement in *Speas v. Merchants' Bank & Trust Co*[123] may be the most illustrative of *prima facie* evidence, in which the judge indicates that when the actor has gone forward and made a *prima facie* case, the other party is compelled in turn to go forward, otherwise he would lose his case; in this sense the burden is shifted to him.[124]

3.4 Additional Factor of the Proper Development of the Company

Normally the outcome of the cases would be determined by the four elements of fault, action or omission, damage and causation.[125] However, it is interesting to find out that the courts would consider the additional factor of the proper development of the company in some cases on top of the traditional elements. This factor is obviously not stipulated in any legislation while it is used by the courts. To some extent, this probably reflects the fact that Chinese judges intend to balance interests in specific cases, rather

[122] *Id.* at 4.
[123] Speas v. Merchants' Bank & Trust Co., 125 S.E. 398 (N.C. 1924).
[124] *Id.*
[125] *See, e.g.*, Minfa Dian (民法典) [Civil Code] (promulgated by the Nat'l People's Cong., May 28, 2020, effective Jan. 1, 2021), art. 1165 (China).

than relying strictly on the law.[126] Although China is a civil law country, and thus the judges must adjudicate in accordance with the codified laws, the legal provisions on director's duty of care are too vague, resulting in judicial discretion in applying the rule. In the case of *Inner Mongolia Zhongrong Cashmere Company v. Zhang Xilun*[127] tried by the Ulanhot People's Court, the defendant served as the chairman of the board. The plaintiff argued that the defendant had, during his term of office, taken the wrong decision to enter into the contracts with Henan Hua'an Construction Company and caused significant economic losses to the company. The plaintiff therefore claimed the breach of duty and compensation for such losses. The court held that:

> "Pursuant to the articles of association, the defendant has the right to manage the daily production and operation of the company and sign relevant contracts. Even if the defendant made errors in decision-making and judgment or other negligence in performing his duties, he should not be simply held liable for damaging the interests of the company, otherwise all losses incurred by the company will be borne by the directors. *This is not conducive to the proper development of the company, and also contrary to the spirit of relevant legislation.*"[128]

As can be seen from this case, the court deems it inappropriate for directors to bear the liability for compensation too easily. Instead, in order not to discourage the enthusiasm of directors in managing companies, the courts tolerated certain misdeeds by directors in the process of management. Otherwise, the normal development of the company will be affected because directors may be too timid to act actively.

4. Ways Ahead

Before delving into the recommendations, it is imperative to examine whether director's duty of care should be strengthened. On the one hand, if the law demands too

[126] For more discussion, *see* KWAI HANG NG & XIN HE, EMBEDDED COURTS: JUDICIAL DECISION-MAKING IN CHINA (2017).
[127] Neimenggu Zhongrong Rongye Youxian Gongsi yu Zhang Xilun Sunhai Gongsi Liyi Zeren Jiufen Minshi Yishen Panjueshu (内蒙古中绒绒业有限公司与张希伦损害公司利益责任纠纷民事一审判决书) [Inner Mongolia Zhongrong Cashmere Co., Ltd. v. Zhang Xilun (First Trial Civil Judgment on the Dispute over the Liability for Damage to the Interests of Company], (2016)内 2201 民初 3737 号 (People's Ct. of Hohhot City, Inner Mongolia Autonomous Region, Nov. 24, 2016) (China).
[128] *Id.* at 4.

much of directors, it may reduce the appeal of directorships. Since there is a general correlation between risk and return,[129] directors would also be discouraged from taking high-risk and high-return business decisions which could eventually undermine the financial growth of the company. On the other hand, if director's duties are not emphasized and strengthened, it may be tantamount to a regulatory acquiescence for directors to run the company poorly at the cost of the company and the shareholders as a whole. Therefore, the core issue is how to strike a balance between these two extremes.

This article argues that given China's current stage of development and the fact that 99.8% of the enterprises are small and medium-sized enterprises in China,[130] the law should be relatively more favorable towards the directors. As will be explained below, the reasons for ensuring that the law is favorable to directors include the uneven knowledge distribution between directors, the need to attract more talented individuals to become directors and to continue to encourage them to take calculated risks to further the business. Although the internal control problem is severe in China, particularly in state-owned enterprises (SOEs),[131] directors should not be saddled with unduly excessive responsibility because China's sustained economic development is inseparable from company directors or executives. Also, this article suggests that the standard for the judicial application of the duty of care should be unified in order to overcome the difficulties posed by divergence in judicial views.[132] As such, this article

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[129] Manuel Nunez Nickel & Manuel Cano Rodriguez, *A Review of Research on the Negative Accounting Relationship Between Risk and Return: Bowman's Paradox*, 30 OMEGA 1 (2002) (It is recognized that this is not without controversy. Some literature suggests that there is a positive relationship between them while others have found that the relationship is negative.).

[130] *Zhong Xiao Wei Qiye Chengwei Tuidong Jingji Fazhan de Zhongyao Liliang — Di Si Ci Quanguo Jingji Pucha Xilie Baogao zhi Shi'er* (中小微企业成为推动经济发展的重要力量——第四次全国经济普查系列报告之十二) [Small, Medium and Micro Enterprises Become an Important Force to Promote Economic Development — The Twelfth Report of the Fourth National Economic Census], NATIONAL BUREAU OF STATISTIC (Dec. 18, 2019), http://www.stats.gov.cn/tjsj/zxfb/201912/t20191218_1718313.html.

[131] Keun Lee & Donghoon Hahn, *From Insider-Outsider Collusion to Insider Control in China's SOEs*, 40 ISSUES & STUDS. 1 (2004); Young-Sam Kang & Byung-Yeon Kim, *Ownership Structure and Firm Performance: Evidence from the Chinese Corporate Reform*, 23 CHINA ECON. REV. 471 (2012).

[132] Zuigao Renmin Fayuan Guanyu Luoshi Sifa Zeren Zhi Wanshan Shenpan Jiandu Guanli Jizhi de Yijian (Shixing) (最高人民法院关于落实司法责任制完善审判监督管理机制的意见(试行)) [Opinions of the Supreme People's Court on Implementing the Judicial Accountability System and Improving the Trial Supervision and Administration Mechanism (For Trial Implementation)] (promulgated by Sup. People's Ct., Apr. 12, 2017, effective May 1, 2017) (China) (In the latest round of judicial reform of Chinese courts (from 2014 to 2017), China's Supreme People's Court (SPC) has been promoting the system of "similar judgments for similar cases" in order to ensure the effective supervision of trial activities. The so-called "Compulsory Similar Cases Search and Reporting Mechanism" has been established in order to implement this judicial reform. The unified application standard of the duty of care would make contribution in this regard.).

promotes some possible solutions to address the problems arising from the empirical studies of director's duty of care.

4.1 Universal Application of the Objective Reasonable Person Standard

Different jurisdictions have undergone different development in their application standards for the duty of care. It is imperative that China should adopt a standard specific to its legal and commercial context. As the empirical studies above showed, Chinese courts have been adopting two standards in practice: ordinary person standard and professional manager standard. Nevertheless, it is recommended that the ordinary person standard should prevail for the following reasons.

First, the knowledge structure of directors is uneven, so it is not feasible to demand all of them to manage the companies in a professional way. Second, the relatively low standard of the ordinary person may attract more talented individuals to become directors, which in turn will improve the overall quality of management. Third, Chinese directors should be encouraged to take calculated risks when taking up projects amid the current development situation.[133] Without the establishment of the ordinary person standard, directors might be deterred from making high-risk, high-return decisions. Instead, they are likely to run the company with the mindset that they would rather not do it than do it wrong. Finally, the ordinary person standard has already been adopted in most of the cases, which means most judges have accepted this standard. As such, establishing this standard as the only unified one in the application of director's duty of care will not encounter much difficulties. Given that the ordinary person standard is already used in major economies like the US and the UK, the adoption of it is in line with the international trend. It is suggested that such a standard can be implemented either by legislative amendment to Article 147 of the PRC Company Law or by judicial interpretation issued by the Supreme People's Court, with the latter being faster and the former being more permanent.

4.2 No Wholesale Adoption of the Business Judgment Rule

As previously discussed, the business judgment rule was established more than 190

[133] Bernard S. Sharfman, *The Importance of the Business Judgment Rule,* 14 J. OF L. & BUSI. 4, 8 (2017).

years ago,[134] and protects directors from personal liability for business decisions made in their capacity, as long as certain conditions are met.[135] The business judgment rule aims to prevent courts from second-guessing business decisions that were made in good faith because even the learned and experienced judges cannot assert that they understand the market and business environment better than the directors. As such, it is wiser for the courts to scrutinize the decision process rather than meddle in managerial decisions.

As the business judgment rule is beneficial for businesses, it could potentially be transplanted to China and help the Chinese judiciary tackle issues raised by the increasing professionalization and independence of directors.[136] Indeed, with the protection provided by the business judgment rule, Chinese directors could concentrate on the management and make business decisions without worrying about their personal liability. However, this article suggests that a wholesale adoption of the business judgment rule may be inadequate for China due to its inherent difficulties, as well as inconsistency with other aspects of the duty of care in China.

The business judgment rule has been called "one of the least understood concepts in the entire corporate field"[137] and its application standards remain poorly understood. Several factors may account for this problem. First, the courts still hold divergent views in the nature and the detailed application of the standard, for example, with respect to whether the court should ever review the substance of the decision and if yes, under what circumstances is such review warranted,[138] and a lack of consensus could deepen the misunderstanding of this concept. Second, the increasingly complex and ever-evolving commercial transactions are poorly understood by many people, including the judges. Without in-depth knowledge and understanding of these complicated business

[134] S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).
[135] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VANDERBILT L. REV. 83 (2004).
[136] Charlie Xiao-chuan Weng, *Assessing the Applicability of the Business Judgment Rule and the "Defensive" Business Judgement Rule in the Chinese Judiciary: A Perspective on Takeover Dispute Adjudication*, 34 FORDHAM INT'L L.J. 124 (2010).
[137] Lyman P. Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 THE BUSI. LAWYER 439 (2005).
[138] Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 WILLIAM & MARY BUSI. L. REV. 521 (2013).

practices, it is difficult to form uniformly applicable standards of the business judgment rule. Third, the business judgment rule exacerbates the tension inherent in balancing "between government regulation and free markets, between public interests and private autonomy."[139] Fourth, there is a tension between balancing the director's authority to manage the companies and a shareholder's right to hold them accountable, because the more powers a legal system gives to shareholders by increasing the ease in which they can appoint and remove directors or even launch a derivative action against the directors, the more restrictions the directors have with regards to making decisions for the company. Because of a lack of understanding of this tension, the business judgment rule, which in essence accords the directors with great discretion to make decisions as long as they act in good faith, can be misunderstood as undermining shareholder protection.

A wholesale adoption of the business judgment rule could also result in inconsistency with other aspects of the duty of care in China. For example, unlike the ALI formulation cited earlier,[140] the Delaware formulation of the business judgment rule specifically recognizes a presumption in favor of the directors, where the business judgment rule raises "a *presumption* that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the most honest belief that the action taken was in the best interests of the company".[141] The significance of the presumption is that it firmly fixes the burden of proof on the plaintiff. This is inconsistent with the shifting of the burden of proof as recommended below. As explained above, the shareholders bringing the action could be disadvantaged evidentially since they are not involved in the day-to-day operations of the company and would have difficulty proving the director's misdeeds. Therefore, China should not adopt the business judgment rule wholesale without modifications.

Other jurisdictions have also shunned from a wholesale adoption of the business judgment rule. English company law does not recognize the business judgment rule.[142]

[139] Lael Daniel Weinberger, *The Business Judgment Rule and Sphere Sovereignty*, 27 THOMAS M. COOLEY L. REV. 279 (2010).
[140] *ALI Principles*, § 3.1.3.2.
[141] Aronson v. Lewis, 473 A.2d 805 (Del. 1984).
[142] DAVID KERSHAW, COMPANY LAW IN CONTEXT 429 (2d ed. 2012).

Australia transplanted the business judgment rule with substantive modifications.[143] In Brazil, the business judgment rule is not clearly stipulated, while Article 159 of the Corporations Act enacted in 1976 seems to implicitly recognize it.[144] Italy developed the doctrine of the immunity of business decision, which is a kind of 'soft' business judgment rule.[145] In Japan, the business judgment rule is not stipulated in the Company Law, but it is recognized by both courts and academics, particularly in the case of *Apamanshop*, which was decided by the Supreme Court of Japan on July 15, 2010.[146]

In China, the PRC Company Law does not mention the business judgment rule, while in practice it has been mentioned to some extent by some cases.[147] Unfortunately, when the courts refer to the business judgment rule in adjudicating cases, the specific elements mentioned are not always consistent. For example, in the case of *Shanghai Zhongmin Asset Mangement Company v. Zhu Zhenhua*, the court regards whether the decision falls within the management authority as a constituent element.[148] In the case of *Hubei Enshi Tielian Materials Trading Company v.Zhang Jie and Du Rongzhong*, the distinction between gross negligence and intentional wrongdoing is considered by the courts.[149] Therefore, until and unless the courts arrive at a more consistent application of the business judgment rule, this article believes that the business judgment rule is not suitable to be transplanted completely to China. In addition,

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[143] Douglas M. Branson & Chee Keong Low, *Balancing the Scales: A Statutory Business Judgment Rule for Hong Kong?*, 34 HONG KONG L. J. 303 (2004).
[144] Mariana Pargendler, *Responsabilidade Civil dos Administradores e Business judgment rule no Direito Brasileiro*, 953 REVISTA DO TRIBUNAIS 51 (2015).
[145] Danilo Semeghini, *Il Dibattito Statunitense Sulla Business judgment rule: Spunti per una Rivisitazione Del Tema*, 2 RIVISTA dI DIRITTO SOCIETARIO 206 (2013).
[146] Dan W. Puchniak & Masafumi Nakahigashi, *Corporate Law, Business Judgment Rule — Derivative Action — Supreme Court 15 July 2010 — 'Apamanshop' with Comment*, *in* BUSINESS LAW IN JAPAN: CASES AND COMMENTS 215 (Moritz Bälz et al. eds., 2012).
[147] There are 19 cases in which the judges mentioned business judgment rule or business judgment according to the research of this article (from 2006–2019).
[148] Shanghai Zhongmin Zichan Guanli Youxian Gongsi yu Zhu Zhenhua Gongsi Liyi Zeren Jiufen An (上海中民资产管理有限公司与朱震华公司利益责任纠纷案) [Shanghai Zhongmin Assets Mamagement Co., Ltd. v. Zhu Zhenhua (Dispute over the Liability for Damage to the Interests of Company)], (2014)黄浦民二(商)初字第 1058 号 (People's Ct. of Huangpu Dist., Shanghai Mun., Jan. 21, 2015) (China).
[149] Hubei Enshi Tielian Wuzi Maoyi Youxian Gongsi yu Zhang Jie, Du Ronggong deng Sunhai Gongsi Liyi Jiufen Ershen Minshi Panjueshu (湖北恩施铁连物资贸易有限公司与张杰、杜荣忠等损害公司利益纠纷二审民事判决书) [Hubei Enshi Tielian Material Trade Company Limited v. Zhangjie and Du Rongzhong (Second Trial Civil Judgment on the Dispute over Liability for Damage to the Interests of Company)], (2015)鄂恩施中民终字第 00457 号 (Interm. People's Ct. of Enshi City, Hubei Prov., Sept. 19, 2015) (China).

whether the adoption could be successful depends on many factors, such as the corporate ownership structure, the type of investors, the enforcement of the duty of care, the quality of courts and the primary role of a corporation, all of which add obstacles to the transplantation.[150]

However, it should not be inferred that the business judgment rule is meaningless for China. Some elements of it can be useful for Chinese courts to consider, such as informed decision, absence of conflicts of interests, rational basis and good faith. Although the precise meaning of these elements, particularly the term of good faith, is quite controversial,[151] they are at least useful for Chinese courts as a starting point in creating a set of uniformed elements to consider in adjudicating duty of care cases.

4.3 Shifting of the Burden of Proof to the Defendant

The traditional general principle of the burden of proof creates difficulties for the plaintiffs, and thus it is necessary to allow the shifting of the burden to the defendant for the cases involving the duty of care. However, two points need to be clarified. First, under the PRC Civil Procedure Law, the general principle in civil lawsuits is that the burden of proof is borne by the claimants unless otherwise specified. That means the shifting of the burden cannot be willingly applied unless otherwise permitted. There are two main types of reversion of burden of proof in civil litigation in China: one is in special tort litigation,[152] the other is in labor dispute litigation.[153] Cases concerning the breach of the duty of care is not included in the above two situations. As such, if the shifting of burden is to be set up in duty of care cases, then it should be clearly stipulated in the Interpretation of Civil Procedure Law made by the Supreme People's Court and

[150] Aurelio Gurrea-Martínez, *Re-examining the Law and Economics of the Business Judgment Rule: Notes for Its Implementation in Non-US Jurisdictions*, 18 J. CORP. L. STUD. 417 (2018).
[151] D. Gordon Smith, *The Modern Business Judgment Rule*, *in* RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS 83 (Claire A. Hill & Steven D. Solomon eds., 2016).
[152] *E.g.*, patent infringement lawsuits arising from the invention of a product manufacturing method, *see* Zhuanli Fa (专利法) [Patent Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 12, 1984, rev'd Oct. 17, 2020, effective June 1, 2021), art. 61 (China); tort actions arising from environmental pollution causing injury to a person, *see* Civil Code, art. 1230; tort actions for damages caused by high-rise littering where the liable party cannot be determined with certainty, *see* Civil Code, art. 1254.
[153] In case of labor disputes, if the dispute arises as a result of the employer's decision to fire or dismiss the employee, terminate the labor contract, reduce labor remuneration, or calculate the number of working years of the laborer, the employer shall bear the burden of proof. *See* Zuigao Renmin Fayuan Guanyu Shenli Laodong Zhengyi Anjian Shiyong Falü Ruogan Wenti de Jieshi (最高人民法院关于审理劳动争议案件适用法律若干问题的解释) [Interpretation of the Supreme People's Court on Several Issues Regarding the Application of Law to Employment Disputes] (promulgated by Sup. People's Ct. Apr. 16, 2001, effective Apr. 30, 2001, abolished Jan. 1, 2021) art. 13 (China).

Company Law.

Second, the shifting of the burden to the defendant does not necessarily mean that the plaintiffs do not need to provide any proof. Instead, the precondition is that the plaintiffs are capable of providing preliminary evidence to prove the breach of duty by the defendants. Only then will the burden be shifted to the defendants. This principle, which resembles the *prima facie* evidence in English common law, has two implications. On one hand, if the *prima facie* evidence provided by the plaintiff is accepted, the burden shifts to the defendant to show that he has properly exercised his duties. On the other hand, if such evidence is not accepted, the burden will not be shifted to the defendants, and the plaintiffs will lose the case. The above empirical studies have shown that the shifting of the burden have been adopted in some cases, while most of the cases still applied the general principle. If the shifting of the burden of proof is utilized in all cases, it will greatly benefit the plaintiffs.

4.4 Promotion of Directors Liability Insurance

Directors liability insurance, also known as D&O insurance, is a liability cover for directors to protect them from lawsuits which may arise from the business decisions and actions taken within the scope of their regular duties.[154] It has become a common part of company risk management in many jurisdictions, particularly in North American and Europe. D&O insurance could be used to protect the directors if they perform their duties faithfully, so that talented or professional people would be attracted to serve without fear of personal financial loss.[155] It would also protect companies from lawsuit costs and alleviate board conservatism. With such protection, the efficiency of the board would be enhanced, and shareholder wealth will be safeguarded.[156] However, there are opposing views arguing that D&O insurance may encourage directors to pursue their personal interests at the cost of the companies and shareholders. Scholars have been constantly exploring the connection between D&O insurance and the performance of

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[154] Jia Ning & Tang Xuesong, *Directors' and Officers' Liability Insurance, Independent Director Behavior and Governance Effect*, 85 J. RISK & INS. 1013 (2018).

[155] John E. Core, *On the Corporate Demand for Directors' and Officers' Insurance*, 64 J. RISK AND INS. 63 (1997).

[156] Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 55–87 (1991); Yaron Brook & Ramesh K. S. Rao, *Shareholder Wealth Effects of Directors' Liability Limitation Provisions*, 29 J. FIN. & QUANTITATIVE ANALYSIS 481 (1994); also Martin M. Boyer, *Directors' and Officers' Insurance and Shareholder Protection*, 2 J. FIN. PERSPS. 1 (2014).

companies, and have found certain evidence different from those backing the value of D&O insurance. For example, recent works show that there are hidden costs behind D&O insurance, and thus it is suggested that inadequate behaviors induced by moral hazard could ultimately erode the benefits of D&O insurance.[157]

Despite the ongoing debate about the merits and defects of D&O insurance, it is increasingly prevalent in many countries. However, D&O insurance is not widespread in China for several reasons. Private securities litigation was allowed only in 2002 and the Code of Corporate Governance for Listed Companies stipulated that general meetings of listed companies could decide whether to purchase liability insurance for the directors.[158] Under this background, *Vanke Company* bought the first D&O insurance for directors through *China Ping An Insurance Company* in conjunction with *Chubb Insurance Group*. Since then, D&O insurance has gradually attracted attention, while it is still not prevalent in listed companies. Some research has shown that the insurance rate of D&O insurance in Chinese domestic listed companies has been very low, hovering around 9%.[159] This is far lower than that of other developed counties. Towers-Watson company's statistics in 2014 showed that 95% of the listed corporations in the US have purchased D&O insurance, while this proportion in Canada was approximately 80%.[160]Additionally, 95% of the Fortune 500 companies maintain D&O insurance policy.

It is important to explore why the insurance rate in China is so low. Under the "cost-benefit" principle, when faced with a low level of lawsuit risk, directors are less likely to be charged, and thus the company would be less willing to buy D&O insurance on their behalf. Even if the director was charged with litigation, it would still make sense not to buy D&O insurance, since it would be likely to cost more than the litigation. Only when the litigation risks and the costs of the civil compensation far outweigh the costs of D&O insurance will the insurance rate increase. In fact, some scholars have strongly demonstrated that the higher the risk of litigation, the stronger the motivation

[157] Chia-Chung Chan et al., *Directors' liability insurance and investment-cash flow sensitivity*, 43 J. ECON.& FIN. 27 (2019).
[158] Code of Corporate Governance for Listed Companies in China.
[159] Wu Yong et al., *Directors' and Officers' Liability can Enhance the Corporate Value? Based on the Perspective of Corporate Governance*, 4 CHINESE J. MGMT. SCI. 188 (2018).
[160] Boyer, *supra* note 158.

for companies to buy D&O insurance.[161] Empirical studies suggest that directors face increasing litigation risk now. With the further improvement of the Company Law and the promotion of shareholder's awareness to protect themselves, directors will face greater litigation risks. This is particularly true if the shifting of the burden of proof is established. Shareholders should be made aware that the presence of a D&O insurance is also in their interests, as it would ensure that damages can be claimed against a wrongdoing director, making it less objectionable to hold a director liable, and promote faster and more cost-efficient dispute resolution.

Therefore, in order to promote D&O insurance, every listed company should be required to purchase it, but the specific premium can be decided by the companies themselves, so as not to increase their burden. Non-listed companies or LLCs should also be encouraged to purchase D&O insurance with some financial incentives, such as tax reduction.

5. Conclusion

By reviewing all the duty of care cases adjudicated by Chinese courts from 2011 to 2020, this article uncovered an increasing trend, with cases more concentrated in the economically more developed cities. This article also revealed the characteristics of the plaintiffs and the defendants and theoretically scrutinized the rationales behind the two different standards relied on by the courts. Against the current backdrop of an upcoming major revision of the PRC Company Law[162] and after conducting a comparative

[161] Zhao Yang et al., *Litigation Risk, Judicial Transparency and Directors' and Officers' Liability Insurance*, 5 J. FIN. RISK MGMT. 213 (2016).

[162] The revision of Company Law was formally incorporated into the Legislative Plan of the Standing Committee of the 13th National People's Congress on September 8, 2018 as a "second category project". *See Shisan Jie Quanguo Renda Changwei Hui Lifa Guihua* (十三届全国人大常委会立法规划) [*Legislative Plan of the 13th Standing Committee of the National People's Congress*], NPC NET, (Sept. 10, 2018), http://www.npc.gov.cn/npc/c30834/201809/f9bff485a57f498e8d5e22e0b56740f6.shtml; the legislative work plan for 2021 announced by the Standing Committee of the National People's Congress also reaffirmed the inclusion of the revision of the Company Law in the legislative agenda, *see Quanguo Renda Changwei Hui 2021 Niandu Lifa Gongzuo Jihua* (全国人大常委会 2021 年度立法工作计划) [*Legislative Work Plan of the Standing Committee of National People's Congress for 2021*], NPC NET (Apr. 21, 2021), http://www.npc.gov.cn/npc/c30834/202104/1968af4c85c246069ef3e8ab36f58d0c.shtml; in addition, scholars who participated in this legislation process also expected that this round of amendments to the Company Law will be the most substantive one since 2005. *see* Zhao Xudong et al. (赵旭东等), *Gongsi Fa Dajia Tan* (公司法大家谈) [*Seminar on Corporation Law Amendment*], 1 XIBEI GONGYE DAXUE XUEBAO (SHEHUI KEXUE BAN) (西北工业大学学报(社会科学版)) [J. NW. POLYTECHNICAL U. (SOC. SCI. EDTION)] 89 (2021).

analysis with other major jurisdictions such as the UK and the US, this article has made a few key recommendations for improving the duty of care regime in China. Such recommendations include the unified adoption of the objective reasonable person standard, the borrowing of elements of the business judgment rule for references without a wholesale adoption of the rule, the shifting of the burden of proof to the defendants and the promotion of D&O insurance. In conclusion, by incorporating these changes, China's company law stands to benefit from striking an appropriate balance between director's authority to manage the companies and shareholder's right to hold them accountable.