Interpretation Path of Shadow Directors in Article 192 of China's New Company Law

——Based on the Comparison of Chinese and English Companies Law

Kunlin Li*

[1] School of Law, Guangdong University of Foreign Studies, Guangzhou, 510000, China

*Corresponding author. Email: 1832629126@qq.com

Abstract. With the implementation of China's new Company Law in 2024, Article 192 specifically targets the institutional design for regulating the abuse of control by controlling shareholders and actual controllers. However, there remain deficiencies in the current identification of actual controllers and the regulation of behaviors that harm the interests of the company. Given the similarity between Article 192 and the shadow director system in the UK, this article compares this new provision with the traditional shadow director system, which also aims to regulate those who "manipulate" behind the directors. By analyzing the similarities and differences in their regulatory functions, this article suggests improving Article 192 of China's Company Law by drawing on the extraterritorial shadow director system. The specific improvement paths include: specifying the criteria for identifying actual controllers, clarifying the acts that constitute "instructions," and determining the criteria for dividing the internal liability shares among jointly and severally liable parties.

Keywords: shadow directors, UK Company Law, 2024 Company Law, actual controllers, instructing behaviors

1 Introduction

In 2019, Shan Chuan and Wu Qiong became the actual controllers of Aowei Communication through equity acquisition. Subsequently, the couple of Shan Chuan and Wu Qiong abused their actual control over the company and forced through certain resolutions despite the opposition of other directors, resulting in discord with the company's management and constant internal disputes. In 2021, Owei Communication announced that the actual controller of the company, Shan Chuan, was sentenced for a crime, but because he did not participate in the company's operations, his criminal punishment would not have a significant impact on the company.[1] In fact, even if the actual controller "does not participate in business decision-making" on the surface, the actual controller can still use its control position

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to grasp the direction of the company's resolution, which has a significant impact on the company or minority shareholders. Thus, it can be seen that in China's judicial practice, the actual controller abuses its control in the "shadow". Article 192 of the new Company Law investigates the responsibility of the controlling shareholders and actual controllers who instruct directors and senior executives, which is an important measure to investigate the people who are really responsible in the field of company law, and is conducive to regulating the behavior of the actual controllers and controlling shareholders. However, this article only has a general framework at present, and if it is not refined, it will certainly encounter various problems in practice, such as: What is the identification standard of the actual controller stipulated in Article 192 of the Company Law of China? What level of conduct constitutes an "instruction"? What is the standard for dividing the internal liability share of the jointly liable person? Many problems need to be further studied and discussed.

2 The Legal Implication of Shadow Director and the Necessity of Regulation

2.1 Definition of Shadow Director Concept

The definition of shadow director in the UK Company law is that "shadow director refers to a person who is accustomed to acting in accordance with his instructions or instructions."[2] In addition, some countries, such as Japan, have not passed legislation to regulate shadow directors, but have recognized the existence of shadow directors through jurisprudence. Even if the director is not registered in the register, the actual operator who has the power to decide important matters has the same responsibility as the director.[3] The definition of shadow director in Chinese academic circles can be summarized as follows: a shadow director is a natural person who does not have the status of a formal director of the company, and this natural person can manipulate some directors and even the board of directors of the company, so as to control the company to make resolutions that meet its expectations.[4]

2.2 Necessity of Shadow Director Regulation

In judicial practice, shadow directors infringe on the interests of the company, including related party transactions, related party guarantees and embezzlement of company profits. Related party transaction refers to the behavior that an enterprise and related parties reach a transaction that violates the principle of fairness and carries out improper interest transmission, which may damage the interests of related subjects such as the company and shareholders, and is one of the main means for controlling shareholders to gain benefits from the company.[5] Related guarantee refers to the behavior that a company provides guarantee for its shareholders or actual controllers, which is also called "internal guarantee of the company" by some scholars.[6] Major shareholders take advantage of the profits of the company by appointing a majority of directors on the board of directors and thereby manipulating the board of directors.

Large shareholders can use the control generated by holding shares to improperly gain more profits by increasing their shares at low prices. In fact, the actual controller system regulates the operation of corporate control. If the actual controller is allowed to abuse the control power, the market economy will be disturbed to some extent. Under the dual role of the current situation of corporate equity concentration and the capital majority decision mechanism, the controlling shareholders and actual controllers who hold a considerable amount of equity have a decisive influence on the appointment and removal of directors and the content of corporate resolutions. Some boards of directors of companies may be controlled by shareholders or managers. Therefore, it is necessary to use the shadow director system to regulate the abuse of control power by controlling shareholders and actual controllers.

3 Different Paths of Chinese and English Regulation

3.1 Regulation of Shadow Directors in Article 192 of the Company Law of China

Behavioral Requirement. According to Article 192 of the Company Law of China, the acts directed by the actual controller and controlling shareholder must be acts that harm the interests of the company or shareholders. By comparing with the rules of directors' duty of loyalty in the Company Law, it can be found that the behavior of "harming the interests of the company" required by Article 192 is in fact very consistent with the situation of directors' breach of duty of loyalty. For example, the acts of misappropriation of company property and misappropriation of company funds listed in Article 181 of the Company Law, related party transactions listed in Article 182, seeking business opportunities belonging to the Company by taking advantage of power and convenience stipulated in article 183, illegal self-operation or operation of similar business for others in competition with the Company stipulated in Article 184, The above actions are violations of the duty of loyalty, and the result of the actions does damage the interests of the company. Therefore, the act requirements of the actual controller or controlling shareholder damaging the interests of the company stipulated in Article 192 of the Company Law of China can also be regarded as the act requirements of shadow directors damaging the interests of the company by violating the duty of loyalty.

Behavioral Requirement. Article 192 of the Company Law of China stipulates that shadow directors and directors and senior managers who accept their instructions shall bear joint and several liability. As a general liability type, the core of joint liability, as stipulated in Article 178 of China's Civil Code, is that the right holder can request any party of joint liability to bear all the responsibilities.[7] In this way, on the one hand, the controlling shareholders and actual controllers can be better regulated to form a deterrent and reduce their motivation to instruct directors to engage in illegal acts behind the scenes; Second, it can achieve the civil compensation effect of making up for the loss of the company and other shareholders. Due to restrictive regulations on directors' compensation and limits on directors' liability insurance payouts, it may sometimes be difficult to fully recover the losses of the company or shareholders. Compared with directors, the controlling shareholders or actual controllers of a company often have stronger economic strength, requiring them to bear joint and several liability is helpful to realize the civil compensation effect of making up for the losses of the company and shareholders in essence.

3.2 Regulation of Shadow Directors under the UK Companies Act

Obligations of Shadow Directors under the UK Companies Act. Under current British law, shadow directors bear the same obligations as directors, including duty of care and duty of loyalty. The duty of care refers to the duty of directors to perform their duties according to the articles of association and laws, to take their due knowledge and skills as certain actions or not to take certain actions to ensure that the company avoids unnecessary losses. The duty of loyalty means that directors should avoid the conflict between their personal interests and the interests of the company and put the interests of the company above their personal interests.[8] In judicial practice, British courts tried to provide theoretical basis for shadow directors to undertake fiduciary duties by analogy. Holland v. Revenue & Customs Commissioners case of British Supreme Court[9], The judge held that a person in fact assumed the role of director not because they considered themselves to be a director or were appointed to be a director, but because they performed a management function of the company. Therefore, scholars believe that the fiduciary duty of directors should also apply to shadow directors.[10] This kind of fiduciary duty actually starts from the fiduciary relationship between the company and the director, and considers the fiduciary relationship to be the legal relationship in which the trustee exercises discretion over the significant actual interests of the other beneficiary. According to this fiduciary power theory, company directors are typical trustees, and shadow directors gain the power to handle company affairs by manipulating directors, so shadow directors are also trustees. Then the determination of fiduciary duty can be considered from the following three factors: first, the trustee has the scope to exercise some discretion; Second, the trustee can unilaterally exercise the power to affect the legal or practical interests of the beneficiary; Third, the beneficiary is easily dominated by the trustee.

Liability of Shadow Directors under the UK Companies Act. The purpose of requiring shadow directors to perform their obligations is to regulate their behavior. Generally speaking, the liability basis of legal liability is "non-performance of obligations". The law only confirms complex rights and obligations at first, and then stipulates various responsibilities based on the non-performance of obligations.[11] The legal liability of the shadow director refers to the legal liability that the shadow director should bear for the damage caused by the breach of the corresponding obligations due to major mistakes in the performance of his duties.

In essence, the shadow director breaches his obligation, that is, he breaches the appointment contract between him and the company. Therefore, the shadow director should be liable to the company for his non-performance of the obligation. Shadow directors must take responsibility for the company after they do acts that harm the company, such as director non-competition, related party transactions or commercial bribery, and they should compensate the company for losses. If they obtain improper benefits, they must return the benefits to the company.

4 Improvement of China's Legal Regulatory Framework

4.1 Concrete Criteria for Identifying Actual Controllers

Actual controllers often overlap significantly with shadow directors. Compared to directors, all actual controllers share a common characteristic: the separation of internal control rights from external representation rights. Unlike company directors, who are endowed with representation rights and preset as direct controllers, the term "actual" in "actual controller" restricts such individuals because they often do not possess legal external representation rights. Therefore, actual controllers either compensate for this lack of representation rights by becoming shadow directors or acquire them by becoming statutory directors. Becoming a shadow director allows for covert manipulation of the company and evasion of legal obligations and responsibilities. Consequently, actual controllers prefer to become shadow directors rather than statutory directors.[12] Given this, it is reasonable to determine the criteria for identifying actual controllers by referring to the identification methods for shadow directors. The "ability to actually control the company's actions" stipulated in China's "Company Law" can be further clarified as follows: an individual can be deemed an actual controller if they possess the decisive power to pass a resolution at the time of its adoption, particularly in matters or resolutions that are the focus of litigation. Thus, the definition of shadow directors under Section 251 of the UK's "Companies Act 2006" can serve as an auxiliary standard to determine whether the litigant party has actual control, i.e., whether the company's statutory directors are accustomed to following the party's instructions.

4.2 Clarification of Acts Constituting "Instructions"

In the UK case of Vivendi SA Centenary Holdings Iii Ltd v. Richards,[13] Richards emailed Bloch instructions on the terms to be proposed in contracts with third parties. Richards acknowledged that "Bloch would seek my support as a shareholder in almost everything." The judge in this case held that the court must objectively assess, based on all evidence, whether all words and actions emanating from the alleged shadow director should be classified as instructions or orders. In this regard, no evidence is required to prove the subjective understanding of the sender or recipient of the words and actions. In most cases, merely proving the content and consequences of such words and actions that can be considered instructions is sufficient, leading to Richards being deemed a shadow director in this case.

According to China's "Company Law," controlling shareholders and actual controllers refer to individuals with a certain degree of influence or control over the company's actions. Therefore, the "instructions" they issue should also possess a certain binding force.[14] The core feature of "instructions" lies in their dominance and control, which requires assessing whether statutory directors are psychologically dominated by shadow directors. Since Article 192 of China's "Company Law" inherently covers influential controlling shareholders and actual controllers, when identifying "instructions," it is not necessary for the instructions to cause the majority of directors to habitually follow them. Instructions can occur once or be directed to a single director or senior manager.

4.3 Determining the Allocation Criteria for Internal Liability Shares Among Jointly and Severally Liable Persons

The criteria for dividing joint and several liabilities should prioritize the objective degree of fault and causal force, followed by an analysis of the proportion of profits obtained, and finally, the adoption of equal sharing as a comprehensive fallback standard. The primary reason for considering the objective degree of fault and causal force as the primary standard for internal liability division is that they respectively represent the reprehensibility of the subjective psychology and objective behavior of jointly and severally liable persons.[15] In the context of Article 192, the imputability of the instructing party (i.e., controlling shareholders and actual controllers) manifests as the abuse of control rights, while the imputability of the instructed party (i.e., directors and senior executives) arises from their violation of the duty of care by abandoning their independent judgment as company managers and choosing to follow others' instructions, thereby harming the company's interests.[16] This approach, similar to UK jurisprudence that infers subjective intent from objective behavior, adopts an objective fault standard when assessing the fault of controlling shareholders and actual controllers. By determining whether they have fulfilled the duty of care expected of a prudent and wise rational person in society, this approach not only aligns with the requirements of commercial appearance doctrine for commercial acts and subjects but also solidifies risks through clear obligations, providing clear and concise guidance for actors.[17]

5 Conclusions

With the rapid development of China's capital market, the controlling shareholders and actual controllers have infringed on the interests of companies and shareholders with the help of their influence on corporate affairs. The dominant phenomenon of state-owned enterprises and family enterprises is a significant feature of our country's corporate structure, and the perfection of our country's corporate system should not be separated from the consideration of this situation. Some directors may be used by the controlling shareholders to carry out related party transactions, embezzlement of funds, violation of non-competition rules and other acts that cause damage to the company and shareholders. At present, the fiduciary duty of the Company Law is for the directors of the company, and the actual controller and controlling shareholder do not bear fiduciary duty of the company because they do not have a fiduciary relationship with the company. If the controlling shareholder and the actual controller violate the fiduciary duty as the way to interpret the source of responsibility of the controlling shareholder and the actual controller in article 192 of the Company Law, there will be a conflict with the fiduciary duty clause of the Company Law. However, the shadow director system in the United Kingdom can be used to explain the source of liability of controlling shareholders and actual controllers in Article 192 of the Company Law of China, and the subject of manipulating directors' behavior can be included in the scope of directors, and the director's obligations and responsibilities can be regulated, so that the controlling shareholders and actual controllers can bear legal liability for their abuse of the influence of directors. In this way, it is helpful for controlling shareholders and actual controllers to change the concept of "rule by man", respect the independence of the board of directors and the independent personality of the company, and properly handle the interest relationship with the company.

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