Legal Transplant as a Device of Legal Change in Transitional Economies: The Case of Importing Common-Law-Style Corporate Fiduciary Duties into Contemporary China

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Abstract

The process of legal reform in transitional economies has entailed primarily legal transplantation from Europe or US legal resources. China is no exception. One typical example is the transplantation of the distinct common-law concept of fiduciary duty in its 2005 Chinese Company Law. As a core concept in Anglo-American corporate law for delineating directorial standards and duties, the fiduciary duty is deeply embedded in the equity jurisdiction and the case law tradition, both hallmarks of common-law systems. The transplantation of the fiduciary duty concept to China, as both a transitional economy and a civil-law jurisdiction, therefore, is widely considered to be challenging. This thesis examines and explains the efficacy of this transplantation case study so as to contribute to legal transplant scholarship and practice.

Drawing on legal transplant theories, major factors influencing the efficacy of legal transplantation include: the transferability of a legal rule across legal systems, the local adaptation made by law reformers and enforcers in the recipient system, the social demand for the legal rule, and the knowledge of the rule by various actors in the recipient country. In the legal transplant case study, the transferability of the fiduciary duty concept from common-law systems to China is inherently low in light of the great context differentiation. Consequently, the effectiveness of the transplantation depends more on the local adaptation in China. Local adaptation plays a critical role in legal transplants even across similar legal systems and leads to substantial divergence of law. The transplantation of corporate fiduciary duties from the English legal system to a US legal system in history ultimately resulted in a very different model of law.

This thesis evaluates the legal transplant case study in three dimensions: the convergence dimension, the operative dimension, and the instrumental dimension, and concludes that China's transplantation of common-law corporate fiduciary duties has been largely effective. What explains the effectiveness of this legal transplantation is that Chinese legislative and judicial institutions, rising to the great challenges brought about by contextual differentiation, have undergone effective local adaptation in the transplantation process. Particularly, the empirical research in this thesis reveals that Chinese courts take initiative to interpret and apply fiduciary duties in the 2005 Chinese Company Law in a similar manner as common-law courts do. This case study therefore casts light on the feasibility for a common-law concept being effectively transplanted in civil law jurisdictions and/or transitional economies. Moreover, the theoretical framework formulated in this thesis for evaluating and explaining the legal transplant case study can serve as a useful tool for analysing the potential effectiveness of legal transplants on a case-by-case basis.

Key words: legal transplant, fiduciary duty, comparative corporate law, Chinese legal system

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Author's Declaration

I declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

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Abbreviations

ADHGB	Allgemeines Deutsches Handelsgesetzbuch
AOA	articles of association
BPC	Basic People’s Court
CA2006	Companies Act 2006
CCL1993	1993 Chinese Company Law
CCL2005	2005 Chinese Company Law
CEO	chief executive officer
CSRC	China Securities Regulatory Commission
DGCL	Delaware General Corporation Law
ESV	enlightened shareholder value
GDP	gross domestic product
IPC	Intermediate People’s Court
LBO	leveraged buyout
NPC	National People’s Congress of the People’ Republic of China
PRC	People’s Republic of China
QC	Queen’s Counsel
RMB	renminbi
SAMR	State Administration for Market Regulation
SSE	Shanghai Stock Exchange
SOEs	state-owned enterprises
SPC	Supreme People’s Court of the People’s Republic of China
SZSE	Shenzhen Stock Exchange
UK	United Kingdom
US	United States

Introduction

The law and finance theory[1] claims that countries with legal systems rooted in the common law, such as the United Kingdom (UK) and the United States (US), offer minority shareholders meaningful protection from opportunistic exploitation by corporate managers and controlling shareholders. As a result, investors in common-law countries are more willing to adopt passive investment roles. This explains why strong capital markets are more likely to locate in common-law jurisdictions. Moreover, the concept of fiduciary duty is considered to be one of the most fundamental constructs to help achieve the superiority of the US and UK corporate law. This is because common-law judges are able to apply extremely flexible fiduciary duty principles in regulating *ex post* (or making costly *ex ante*) potentially opportunistic, oppressive, or fraudulent behaviour in the corporate scheme.

Though highly influential, the law and finance theory has been heavily contested since its inception, both in its statistical data analysis and as a valid explanation of financial development and economic growth. Nevertheless, the possibility that the success of UK and US companies stems from the superiority of their common-law origins raises the question whether the adoption of similar legal rules, in particular the concept of fiduciary duty, in other countries might produce similar economic benefits. This possibility also lies at the heart of a heated controversy among corporate-law scholars over whether different nations' corporate laws can be expected to converge over time toward a single uniform model or, alternatively, to diverge because some path-dependant factors specific to different nations' political, economic, and cultural circumstances have inhibited functional convergence.

The process of legal reform in transitional economies to date has entailed primarily the transplantation of statutory law from Europe or US legal resources. China is no exception. Legal transplant has been a main device for the Chinese government to construct a new legal system in light of its drastic economic reforms from a planned economy to a market economy starting from the late 1970s. One typical example is the transplant of the distinct common-law concept of fiduciary duty in the extensively amended Chinese Company Law in 2005 after a lengthy debate in the Chinese legislature. Article 148 of Chinese Company Law now provides

[1] A considerable body of research in this area has been produced, see: Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W Vishny, 'Law and Finance' (1998) 106 Journal of Political Economy 113; Rafael La Porta *et al*, 'Investor Protection and Corporate Governance' (2000) 58 Journal of Financial Economics 3; Edward L Glaeser & Andrei Shleifer, 'Legal Origins' (2002) 117 Quarterly Journal of Economics 1193.

that directors, supervisors, and senior officers owe a duty of loyalty to the company. Article 149 fleshes out the specifics of the duty of loyalty in statutory form, outlawing misappropriation of corporate property, unauthorised interested transactions, exploitation of corporate opportunity, competing with the company, and other classic conflict of interest situations. Furthermore, the China Securities Regulatory Commission ('CSRC'), the Chinese securities market regulator, has promulgated a number of regulations incorporating the same duty of loyalty and proscriptive rules as a basis for enforcing them in China's listed companies.

However, it is generally acknowledged that, despite its central role in the US and UK corporate law, the notion of fiduciary duty remains elusive. Given the nature of fiduciary duties as a default rule serving to 'fill the gap', neither statutory nor case law can provide clear guidance on actual behaviour or as an effective deterrent against violations. The concept of fiduciary duty originated from the equity jurisdiction and is embedded in the rich case law characterising the common-law system. Consequently, the transplant of the fiduciary duty concept to China seems particularly challenging, and the effectiveness of its transplant depends on how it is understood, legislated, interpreted, and ultimately applied by domestic institutions in China. The legal transplant of a common-law concept to China which is both a transitional economy and a civil-law jurisdiction triggers a fascinating question: to what extent the legal transplantation of common-law fiduciary duties into Chinese company law is effective? What explains the effectiveness or ineffectiveness of the transplantation? This is precisely the research question that this PhD project intends to address.

Furthermore, by examining the effectiveness of this legal transplantation case study, this project aims to contribute to legal transplant scholarship by answering the following questions: How likely is it for a core common-law concept to be effectively transplanted to civil-law jurisdictions such as China? What can this legal transplant case study tell us about how the legislative, judicial, and administrative institutions rise to the challenges brought by the transplant of a foreign opened-ended legal concept? What can this legal transplant case study tell us about legal transplant theory? These questions are not merely academic. The developing world and international development agencies are frequently told that transplanting the correct legal code (i.e., the common law) will enhance economic development. Yet, if we blindly accept this proposition, or embark on legal transplant without a firm grasp of what is required of an effective legal transplant, significant resources may be wasted, and ensuing disappointment may hinder long-needed legal reform in developing countries.

In order to answer the central research question, the following research methods are adopted in this project. Firstly, this research is based on legal transplant theories, hence a comparative research method is adopted as the primary methodology. As the fiduciary duty in Chinese company law is a transplanted concept, it is essential to acquire an in-depth understanding of how corporate fiduciary duties are understood and applied in common-law counties such as the UK and the US. Correspondingly, how the law of corporate fiduciary duties is legislated, interpreted, and ultimately applied by domestic institutions in China will also be examined. Secondly, to explore how the law of corporate fiduciary duties is enforced by courts in China, this project also conducts empirical research. Thanks to the ready availability of several Chinese Law databases, it is today easier to access judicial cases to collect data for purposes of empirical research. A comprehensive analysis of the available case decisions will be conducted with a view to outlining how the law of corporate fiduciary duties is understood, interpreted, as well as applied by Chinese courts. In addition, this research project is firmly embedded in some legal and political economic theories, such as legal transplant and paths of legal reform in transitional economies. Therefore, an interdisciplinary research approach is also called into play.

This thesis begins with a systematic discussion of the existing legal transplant theories to provide a rich theoretical perspective to this research project. In particular, based on the existing classic literature on legal transplant theories, the first chapter formulates an analytical framework for assessing and explaining the effectiveness of China's transplantation of corporate fiduciary duties. Moreover, to set the scene for the case study of China's transplantation of fiduciary duty, the first chapter also introduces the historical background to how and why China introduced the common-law fiduciary duty into its company law. The second chapter of this thesis discusses the concept of fiduciary duty in common-law jurisdictions with a view to exploring the nature, content, as well as the functions of the fiduciary duty concept which provides a conceptual basis for the discussion of fiduciary duties in the UK, US, and Chinese company laws in subsequent chapters. This chapter also reveals how the concept of fiduciary duty relates closely to the equity tradition in common-law systems.

The third and fourth chapters discuss the UK and US/Delaware models of corporate fiduciary duties as leading models in common-law systems. These two chapters pave a way for the later comparative analysis between the UK and the US models of corporate fiduciary duties, for a critical evaluation of the appropriateness of the law in China. These two chapters also reveal how US states borrowed from English law to establish their law of corporate fiduciary duties and how US law subsequently diverged from its English origin. In the fifth chapter of the thesis, fiduciary duties in Chinese company law are examined in detail to lay out how the law of corporate fiduciary duties is legislated, interpreted, and enforced in China as product of legal transplantation and local adaptation. Based on the detailed examination of corporate fiduciary law in the UK, US, and Chinese jurisdictions, the sixth chapter uses the analytical framework formulated in the first chapter to assess the effectiveness of the legal transplantation case study and explain its effectiveness or ineffectiveness. The seventh chapter concludes with a complete answer to the main research questions of this thesis.

Chapter 1: Legal Transplantation: Theoretical Perspective

Introduction

In an effort to answer how likely it is for a common-law concept to be effectively transplanted into China, this chapter maps out the theoretical perspective and analytical framework underpinning the case study of transplanting common-law-style corporate fiduciary duties in China. The chapter is divided into three sections. The first introduces the concept of legal transplantation and the debate on its feasibility. Scholars use a variety of metaphors to interpret the concept of legal transplantation from different perspectives. However, the concept remains controversial in current legal scholarship. From a critical review of current literature, it is submitted that both the arguments that legal transplants are 'socially easy' and that legal transplants are 'impossible' are overly simplistic and that case studies of legal transplantation demand a more nuanced approach. Adopting a nuanced approach, the second section models the transplantation of a common-law concept into China's private and commercial law and presents an analytical framework for assessing and explaining the effectiveness of such a model transplant based on theoretical assumptions drawn from current legal transplant scholarship. To set the scene for the case study, the third section of this chapter introduces the historical background to transplanting the concept of a fiduciary duty into Chinese company law since the early 1990s, in particular why and how the concept was adopted in the 2005 Chinese Company Law (CCL2005).

1.1 Legal Transplants: Concept and Feasibility

> Legal transplants – the moving of a rule or a system of law from one country to another, or from one people to another – have been common since the earliest recorded history.[2]

Although Alan Watson, a renowned legal historicist, and the most prominent contributor to legal transplant literature, may not be credited with coining the term 'legal transplant',[3] he is undeniably the most prominent authority who has championed the study of legal transplantation as the principal approach in comparative legal studies. Based on selected historical evidence – in particular how Roman law was transplanted to different countries on

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[2] Alan Watson, *Legal Transplants: An Approach to Comparative Law* (2nd edn, University of Georgia Press 1993) 21.
[3] See FP Walton, 'The Historical School of Jurisprudence and Transplantations of Law' (1927) 9 Journal of Comparative Legislation and International Law 183, 183-192.

an historical timeline – he argues that very often law develops through legal borrowing and legal transplantation is the main means of effecting legal change.[4] This section first introduces various conceptualisations of legal transplantation in current legal scholarship, in particular relevant metaphors used to reveal the nature and key features of the process. This is followed by a discussion of the perennial debate in current legal transplant scholarship on the feasibility of legal transplantation.

1.1.1 Legal Transplants: Concept and Metaphors

As we saw above, for Watson legal transplantation refers to the phenomenon of 'moving of a rule or a system of law from one country to another, or from one people to another'.[5] Wise, too, interprets legal transplantation as 'the movement, the continual flow, of legal paradigms and ideas across national frontiers'.[6] In other words, legal transplantation serves as a generic term for the transnational or cross-border transfer of law. However, dissatisfied with some of the connotations of the term 'legal transplant', current legal scholarship has contributed a variety of alternative metaphors and catchy phrases to supplement or replace its use. These terms include 'transfer', 'exports', 'circulation', 'influence', 'borrowing', 'importation', 'reception', 'translation', 'diffusion', 'transportation', 'adaptation', 'irritants', 'institutional monocropping', 'convergence/divergence', 'salad bowl', 'melting pot', and many others.[7] This shows that legal scholars use different metaphors involving different assumptions to describe the phenomenon of borrowing and adapting foreign legal rules. Nevertheless, every metaphor represents a unique perspective as well as a heuristic device for understanding and analysing the phenomenon of legal transplantation.[8] As Nelken warns, it is futile to avoid metaphors as the effort to do so in talking about legal transplantation is almost certainly doomed to fail.[9]

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[4] Watson (n 2) 95.
[5] ibid 21.
[6] Edward M Wise, 'The Transplant of Legal Patterns' (1990) 38 The American Journal of Comparative Law 1, 1.
[7] See Esin Örücü, 'A Theoretical Framework for Transfrontier Mobility of Law' in Robert W Jagtenberg, Esin Örücü and Annie de Roo (eds), *Transfrontier Mobility of Law* (Kluwer Law International 1995) 5; Randall Peerenboom, 'What Have We Learned about Law and Development? Describing, Predicting, and Assessing Legal Reforms in China' (2006) 27 Michigan Journal of International Law 823, 825.
[8] Esin Örücü, 'Law as Transposition' (2002) 51 International and Comparative Law Quarterly 205.
[9] David Nelken, 'Towards A Sociology of Legal Adaptation' in David Nelken and Johannes Feest (eds), *Adapting Legal Cultures* (Hart Pub 2001) 16-17.

1.1.1.1 The Metaphor of Medical Transplant

The most common metaphor links the phenomenon of legal transplantation to medical or surgical transplantation. This metaphor emphasises the moving of law from one legal system and the reception of law by another. For example, Watson compares legal transplantation to 'that of a human organ'. He suggests that a successfully transplanted legal rule will – just as a successfully transplanted human organ becomes a functional part of the recipient's body – become a part of the law in the recipient country and continue to grow in its new environment.[10] Although Watson acknowledges the subsequent development or specific effect of the functioning of the transplanted rule in the recipient system, he warns that subsequent developments should not be confused with rejection.[11] After all, Watson points out that what happens post reception of the rule falls outside of the focus of his theory of legal transplantation.[12] In the same vein, Feldman finds it useful to compare the process of seeking legal transfers to the search for a compatible donor so as to offer hope to 'ailing members of the world community'.[13] The medical transplant metaphor is a powerful one given its ability to compare the source and recipient legal systems and the risk of rejection by the recipient system.[14]

Still, some scholars are highly sceptical of its suitability in explaining the legal transplant phenomenon. For example, Nelken offers two reasons in support of his criticism that the medical metaphor is too rigid as a heuristic device. One is that the metaphor fails to reveal the complexity of legal transplantation as a social process and the importance of subjective factors such as the creation and imposition of meaning (including definitions of 'similarity' and 'success').[15] Rather than there being an objective fit between healthy and diseased organs, legal transplants occur because of demands made by society for social change in certain directions. A second reason is that medical transplants involve a very high level of invasive surgery. Even if we know that this is in the interests of the body, the body does not. In this regard, the medical metaphor allows no distinction between a society seeking to adopt foreign

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[10] Watson (n 2) 27.
[11] ibid.
[12] See Alan Watson, 'Legal Transplants and Law Reform' (1976) 92 The Law Quarterly Review 79.
[13] Eric A Feldman, 'Patients' Rights, Citizen's Movements and Japanese Legal Culture' in David Nelken (ed), *Comparing Legal Cultures* (Dartmouth Publishing Company 1977) 215.
[14] Maximo Langer, 'From Legal Transplants to Legal Translations: The Globalization of Plea Bargaining and the Americanization Thesis in Criminal Procedure' (2004) 45 Harvard International Law Journal 1, 30.
[15] Nelken (n 9)18.

law and one having such adoption imposed on it.[16] There are also other objections to the medical metaphor. So, for example, Teubner argues that the medical metaphor implies that the result of transferring legal rules and institutions is either a complete success or total failure.[17] However, the dichotomy of success or failure should be avoided in articulating the outcome of legal transplantation which is, in reality, likely to be mixed.

1.1.1.2 The Metaphor of Botanical Transplant

Certain scholars acknowledge the usefulness of the medical transplant metaphor but regard a botanical metaphor more appropriate. In this botanical metaphor, legal transplantation is compared with transplanting crops or plants in foreign soil or grafting foreign plants. Baade claims that, for what Watson had in mind when he proposed the concept of 'legal transplant', a botanical transplant is more appropriate in that successfully transplanted crops or plants flourish in both their original environment and their new one.[18] For example, Roman law still applied in Rome after it had been transplanted to other countries such as Egypt. Transplanting an organ, by contrast, involves the 'implantation of one and the same organ removed from (typically) another member of the same species'.[19] Peerenboom takes a similar view arguing that the metaphor of botanical transplantation is preferable as it includes the possibility of fundamental system alteration in the recipient system in addition to discrete changes.[20] The medical metaphor, on the other hand, suggests that the transplant will lead only to discrete changes – ie, the replacement of one organ without any overall change as the recipient remains the same person.

However, the metaphor of botanical transplantation fares no better than its medical counterpart in the opinion of Nelken. He claims that, like the medical metaphor, the botanical metaphor implies that the ability of the plant to become part of its new environment may be conditional on it having no further link with its original source.[21] Legal transplantation is different in the

[16] ibid 18.
[17] Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergences' (1998) 61 Modern Law Review 11, 17.
[18] Hans W Baade, 'Transplants of Laws and of Lawyers' in Phaedon J Kozyris (ed), *Justice in Particular: Festschrift in Honour of Professor PJ Kozyris* (Athens: Ant N Sakkoulas 2007) 2.
[19] ibid.
[20] Peerenboom (n 7) 825-826.
[21] David Nelken, 'Legal Transplants and Beyond: Of Disciplines and Metaphors' in Andrew Harding and Esin Örücü (eds), *Comparative Law in the 21st Century*, vol 4 (Kluwer Law International 2002) 32.

sense that the recipient system may recreate a wider context similar to the 'host' country from which it was adopted.

1.1.1.3 Further Alternative Conceptions of Legal Transplants

Other than medical or botanical transplant metaphors, scholars – principally legal sociologists – use some alternative concepts to describe the legal transfer process. Their choice of other concepts is largely based on a shared dissatisfaction that the term 'legal transplant' is too static and rigid to describe a dynamic, interactive, and continuing process.[22] For example, Wise advocates the use of 'circulation' in preference to 'transplant' because the former better captures the metaphor of the continual movement and flow of legal ideas and rules.[23] Langer, however, is dissatisfied with the use of either 'legal transplant' or 'circulation'. He shares Wise's criticism of 'legal transplantation' as too rigid to account for the transformations that legal ideas and institutions may undergo when incorporated into a different legal system. As regards 'circulation', he condemns the notion that what is important is not how legal ideas and rules 'circulate', but how they are transformed in the process of transplantation. Langer consequently proposes the metaphor of legal translation in which the transferred rule is compared to the translated 'text', while the context in the source and recipient systems are compared to the 'language'.[24] He believes that the legal translation metaphor is capable of expressing the transformations of the rule both at the time of initial transplantation and once it has been incorporated in the recipient legal system.[25]

Teubner proposes the term 'legal irritants' in preference to the term 'legal transplant'. He argues that 'the concept of legal transplant supposes that the outcome of legal transplantation is either success or failure, while in reality it is more likely to be mixed'.[26] Therefore 'legal irritants' is a better concept in that it better describes the impact of the transferred rules on the recipient system. Moreover, he stresses that legal irritants cannot be domesticated because they are not adapted to a new cultural context and will 'unleash an evolutionary dynamic in which the external rule's meaning will be reconstructed and the internal context will undergo

22 Beata Kviatek, *Explaining Legal Transplant: Transplantation of EU Law into Central Easter Europe* (Wolf Pub 2015) 65.
23 Wise (n 6) 1.
24 Langer (n 14) 33.
25 ibid 33-34.
26 Teubner (n 17) 17.

fundamental change'.[27] This legal irritant metaphor, however, loses the comparative perspective of the transplant metaphors.[28] Similarly, Örücü believes the metaphor of 'transposition' is more apt, in particular to describe 'massive change based on competing models'.[29] Örücü argues that, as with musical transposition, a 'transposition' is made in the process of legal transplantation to suit the context and conditions in the recipient system.[30]

It can be seen that these different metaphors focus on different aspects of the legal transplantation process. Transplant metaphors tend to emphasise the moving of law from one legal system to another without rejection, while metaphors proposed by specialists in the sociology of law focus more on local adaptation and the effect of transplantation. Together these views contribute useful heuristic devices for understanding legal transplantation as a dynamic, continuous, and complex process involving not only the moving of law from its source system, but also its adaption in the recipient system.

1.1.2 Legal Transplants: Easy, Impossible, or Challenging?

As a fundamental question to begin with, is it even feasible for a legal rule to be transplanted from one country or legal system to another with a different social, economic, and political environment? Scholars have vastly varying answers to this question. This part analyses the debate over the feasibility of legal transplants in general and serves as a foundation for our subsequent legal transplant case study.

The idea of legal transplantation appears trite to some scholars while others remain sceptical of its feasibility. The debate around the feasibility of legal transplants famously took place between Watson, a comparative legal historian who views law as existing apart from its politico-social context, and who insists that legal transplantation is 'socially easy',[31] and legal sociologists and socio-legal writers who deny the possibility of legal transplants out of social and cultural context.

27 ibid 12.
28 Langer (n 14) 32.
29 Örücü (n 8) 207.
30 ibid.
31 Watson (n 2) 95.

Observing legal transplants as 'extremely common' in Western legal history as well as at present day, Watson argues that legal transplants, as the 'most fertile source' of legal change, are feasible and easy even if the recipient system is very different from or much less advanced than the source system.[32] In other words, legal transplants do not depend on a similarity of underlying social context or conditions.[33] This is because 'legal rules are not peculiar devised for the particular society' but can be 'adapted for the needs for many nations'.[34] In effect, Watson's legal transplant theory runs counter to a deeply held conviction about law – the 'mirror theory of law'– which holds that law mirrors a particular society's customs, morality, and culture.[35] According to Watson, the frequency of legal transplantation can be rationalised by certain 'habits of thought' within the legal profession which have played a central role in legal development.[36] Lawyers (referring to legislators, judges, legal advisors, or scholars) as society's law-making elites, tend not only to seek authority to justify their legal reasoning, but also to look to legal tradition rather than to economic, sociological, or political contexts for solutions. The frequency of legal transplantation as well as the longevity of ineffective or unsuitable law, as Watson asserts, serve as evidence of the relative autonomy of law.[37] He then argues that there is no close or fixed correlation between a private-law rule and its underlying social, political, or economic context – in short, law does not mirror society.[38]

Watson's articulation of the feasibility of legal transplantation has attracted ongoing criticisms of both his research approach and his data. Ewald, for example, criticises Watson's theorising on legal transplantation as founded primarily on his examination of Roman private law and its subsequent influence in continental Europe.[39] Thus, any attempted generalisation of his claims to non-Western societies or fields other than private law is logically suspect. Furthermore, given his historical approach, Watson's claims regarding legal transplantation should be understood in a macro-legal sense reflecting a broad trend on an historical timeline rather than a full range of individual cases.[40] Indeed, Watson's theories are supported, in the main, by his

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32 Watson (n 2) 95-96, 99.
33 Watson (n 2) 96. See also Alan Watson, *The Nature of Law* (Edinburgh University Press 1977) 110-112; Alan Watson, *Society and Legal Change* (Scottish Academic Press 1977) 98-114.
34 Watson (n 2) 96.
35 See Lawrence M Friedman, *A History of American Law* (Simon and Schuster 1973).
36 Watson (n 2) 99.
37 See Alan Watson, 'Law Out of Context' (2000) 4 Edinburgh Law Review 147.
38 See Alan Watson, *The Evolution of Law* (Blackwell 1985).
39 William Ewald, 'Comparative Jurisprudence (II): The Logic of Legal Transplants' (1995) 43 The American Journal of Comparative Law 489, 503.
40 Eric Stein, 'Uses, Misuses-and Nonuses of Comparative Law' (1977) 72 Northwestern University Law Review 198, 203-204.

observations drawn from a number of successful examples from legal history, while failures and rejections of legal transplantation are not examined in detail, which calls his conclusion that legal transplantation is 'easy' into question.

Montesquieu, the first comparative lawyer, states that law is so closely linked to its environment that only in the most exceptional cases can the institutions of one nation serve those of another.[41] Montesquieu's environmental criteria include geographical, sociological, economic, cultural, and political factors. Similarly, Legrand, as a comparative legal sociologist, claims that legal transplants are 'impossible'.[42] He argues that a rule whose meaning is established by interpretation, is deeply embedded in the culture of the society in which it has developed. If this is so, the rule may become permanently dysfunctional as soon as it is separated from its source society.[43] In a legal transplant case, when a legal rule is taken out of its original context and adopted in another system, its meaning changes simultaneously. Thus, in effect, the transplanted rule in the recipient system will always differ from 'the same' legal rule in the sources system.[44] Consequently, not only cannot a legal rule be transplanted, but legal transplants as a concept are impossible.

Legrand's requirement that the rule should have an 'identical' meaning in the recipient system to that in its source of origin may be unrealistically high and unnecessarily onerous. The existence of and necessity for local adaptation in the process of legal transplantation is widely agreed among scholars and particularly emphasised by legal sociologists.[45] The local adaptation will in certain cases require that both the term and the meaning ascribed to the transplanted rule differ from the original model. In fact, Watson and Legrand's disagreement centres on the change of law in the process of legal transplantation. Both acknowledge an inevitable change in the legal rule during the process of transplantation, but Watson views the change as a natural part of the process, while Legrand regards the change as indicative of the failure of the process.

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[41] Charles Montesquieu, *The Spirit of Laws* (Mortimer J Adler ed, Thomas Nugent & JV Prichard trans, Encyclopaedia Britannica 2nd edn 1990) 3. The term 'environmental' is in its broad sense to mean surrounding circumstances.
[42] Pierre Legrand, 'The Impossibility of "Legal Transplants"' (1997) 4 Maastricht Journal of European and Comparative Law 111. Also see Pierre Legrand, 'What Legal Transplant' in David Nelken and Johannes Feest (ed), *Adapting Legal Cultures* (Hart Pub 2001) 55.
[43] ibid 117-118.
[44] Pierre Legrand and RJC Munday, *Comparative Legal Studies: Traditions and Transitions* (CUP 2003) 277.
[45] See David Nelken and Johannes Feest (eds), *Adapting Legal Cultures* (Hart Pub 2001).

In recent years, both Watson's vision of ever flowing and socially 'easy' legal transplants and Legrand's gloomy prediction that 'legal transplants are impossible' have been seen as extreme and absolutist and rejected by mainstream legal scholars. In their absence, most current legal transplant scholarship opts for a middle ground. This development in research direction is aptly articulated by Cohn:

> Much of the study has followed a culturalist path, under which outmoded legal formalism was re- placed by realist, socio-politico-cultural theories that consider law as a living social construct. Here, legal culture was offered as a key determinant of the viability of transplantation; complete isolation- ism and hermeneutical closeness were replaced by a vision of law as rooted in its cultural/social frameworks, but also amenable to various influences, among them foreign ones.[46]

Otto Kahn-Freund, Professor of Comparative law, argues that not all legal rules or institutions are transplantable, and the feasibility of legal transplants belongs to the continuum between organ transplants and mechanical transplants.[47] In light of the 'process of economic, social, and cultural assimilation' as well as the 'process of political differentiation' worldwide in the 200 years since Montesquieu, Kahn-Freund observes that political factors have gained in importance as obstacles to legal transplantation, while other environmental factors have lost much of their validity.[48] Consequently, Kahn-Freund argues that the degree to which any legal rule can be transplanted depends largely on how closely it is linked to the power structure of the source country. The distinctive political environment in each country in the form of constitutional structure and interest-group coalitions means that successful transplantation is rare in that the feasibility of a legal transplant depends on the type of legal rule or institution involved.[49]

To summarise: it is no longer meaningful to debate whether legal transplantation is feasible or not. As I show in the next section, the effectiveness of legal transplantation depends on a range of factors. There is no magic formula for predicting the feasibility of legal transplantations and it is essential to undertake a detailed empirical study of specific cases before any reliable conclusions can be drawn. Furthermore, I should like to highlight that in contemporary China legal transplantation is the principal device for effecting legal and social change. This is

[46] Margit Cohn, 'Legal Transplant Chronicles: The Evolution of Unreasonableness and Proportionality Review of the Administration in the United Kingdom' (2010) 58 American Journal of Comparative Law 586, 587-588.
[47] Otto Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 Modern Law Review 1, 5-6.
[48] ibid 8-13.
[49] ibid 13.

inevitable since, as many Chinese scholars have pointed out, China's indigenous resources based on Confucianism, local customs, and ethical values are incompatible with certain modern values including a market economy, the rule of law, and democracy.[50] Globalisation and a rapidly changing China make it impossible for China to wait for the indigenous rules to grow and adapt to the changes – it must respond immediately to the changed way of life.[51] This means that in contemporary China the question is not whether to transplant or not to transplant, but how to transplant effectively so as to optimise chance of success.

1.2 Legal Transplantation Case Study: Model and Analytical Framework

To adopt a nuanced approach to the case study of China's transplantation of a common-law concept into its company law, this section first presents the major characteristics of such transplantation to establish a model for purposes of evaluation. The second part of this section formulates an analytical framework for evaluating a 'model transplantation' based on theoretical assumptions derived from current legal transplant scholarship in terms of the conditions for a model transplantation to be effective as well as the criteria for determining its efficacy.

1.2.1 Legal Transplantation Case Study: Model and Characteristics

Legal transplants can take various forms ranging from the adoption of an entire system of law to the borrowing of a single legal rule. In order to design an analytical framework for the case study of China's transplantation of a common-law concept, this part first sets a model based on Twining's naïve model of legal transplantation which identifies the characteristics of the legal transplantation case study.

1.2.1.1 The Naïve Model of Legal Transplantation

Twining suggests that mainstream comparative-law scholarship presupposes a naïve model of legal transplantation with the following characteristics:

> [A] bipolar relationship between two countries involving a direct one-way transfer of legal rules or institutions through the agency of governments involving formal enactment or adoption at a

[50] See eg, Deng Zhenglai, *Where Should Chinese Legal Research Go* (The Commercial Press 2006) 85.
[51] See Liu Xing, 'Re-understanding Legal Transplant: From History to Present' (2004) China Social Sciences 164.

> particular moment of time (a reception date) without major change. Although not explicitly stated […], it is commonly assumed that the standard case involves transfer from an advanced (parent) civil or common law system to a less developed one, in order to bring about technological change ('to modernize') by filling in gaps or replacing prior local law. There is also considerable vagueness about the criteria for 'success' of a reception - one common assumption seems to be that if it has survived for a significant period 'it works'.[52]

Twining recognises that the phenomena of 'legal transplants' is too varied to be reduced to a single model. He therefore proposes refining the naïve model and outlines twelve relevant elements. In doing so he lists both a standard case and certain variants as follows:[53]

- Source-destination: a bipolar transfer of law from a single exporter to single importer; and variants include single importer to multiple destinations, single importer from multiple sources, or multiple sources to multiple destinations.
- Level of transfer: a horizontal transfer between two municipal systems; and variants include cross-level transfers that include regional, sub- state, non-state transnational levels.
- Pathways: direct one-way transfers; and variants include complex paths, such as reciprocal influence and re-exportation.
- Manner of adoption: formal enactment or adoption; or informal, semi-formal, or mixed reception of law.
- Objects of transfer: legal rules and concepts; or any legal phenomena or ideas, including ideology, theories, personnel, 'mentality', methods, structures, practices (official, private practitioners', educational, and so on).
- Agents of transfer: governments; or any commercial and other non-governmental organizations, armies, individuals, and groups who 'bring law with them'.
- Timing of transfer: one or more specific reception dates or a continuing and lengthy process.
- Power and prestige: from advanced civil- or common- law countries to less developed law, but also the other way round.
- Change in object of transfer (adjustment): unchanged or only minor adjustments; or transformation of the foreign law before legal transplant.
- Relation to pre-existing law: no pre-existing law or entire replacement of pre-existing law; or there is struggle, resistance, and assimilation.
- Type of transplantation: a technical solution, or as an ideological consequence and cultural change.
- Impact: 'it works'; or measuring performance and enforcement through empirical research.

In the main, Twining uses the model above to show that almost all scholarship stemming from the 'Country and Western tradition' of comparative law tends to focus on the formal law of 'parent' civil- and common-law systems in the West and to ignore or marginalise other legal traditions or less formal types of law.[54] Almost all treat legal diffusion as involving one-way traffic between the municipal law of two countries as part of a process of 'imposed' or

52 William Twining, 'Diffusion of Law: A Global Perspective' (2004) 36 The Journal of Legal Pluralism and Unofficial Law 237, 247.
53 William Twining, 'Diffusion and Globalization Discourse' (2006) 47 Harvard International Law Journal 507, 514-515.
54 Twining (n 52) 238-239.

'voluntary' adoption by governments.[55] As a result, legal studies on reception or transplantation are too fragmented to ground an over-arching theory. He calls for consultation with the social sciences in search of richer theories to explain similar processes such as the diffusion of innovation.[56]

1.2.1.2 Legal Transplantation Case Study: Modelling

Twining's naïve model and its variants can serve as useful tools for modelling China's transplantation of a common-law concept such as the fiduciary duty into its private and commercial law as well as setting out its characteristics.

First, in contemporary China law reformers generally study and compare multiple models of foreign laws from many countries during the law-making process rather than simply transplanting rules from a single source system.[57] China places special emphasis on transplantation from civil-law jurisdictions such as Germany and Japan.[58] Common law has played an increasingly important role and the drafting of CCL2005 is a typical example. Second, legal transplants in China generally involve a horizontal, one-way transnational transfer from a foreign legal system to the Chinese legal system. In the case of a common-law concept being incorporated into Chinese Company Law one is dealing with the legal transplantation from common-law countries to China with its civil-law tradition. Third, in light of its civil-law tradition, China regards legislation as its primary source of law. The common-law concept is therefore transplanted by means of formal enactment and adoption into state-law-level legislation – e.g., CCL2005. Subsequently, lower-level legislation such as administrative regulations will include relevant rules for the regulation as well as enforcement of the transplanted common-law concept.

Fourth, what transfers from common-law systems to China is a common-law concept together with its sub-rules. However, ideologies, theories, methods, structures, and practices are generally not systematically or fully transplanted. In the case of the fiduciary duty, there is no evidence showing that the Chinese legislature also transplanted all common-law structures, methods, and practices associated with the concept and relevant rules. Fifth, the Chinese

[55] William Twining, 'Social Sciences and Diffusion of Law' (2005) 32 Journal of Law and Society 203, 207.
[56] ibid 219.
[57] Xin Chunying, 'Theory and Practice of Legal Transplant' (2007) 1(3) Bei Fang Fa Xue 5, 11-12.
[58] Gao Hongjun, *Comparative Law and Comparative Culture in Global Perspectives* (Tsinghua University Press 2015) 78.

government, in its broad sense including the National People's Congress of the People' Republic of China (the NPC) and its Standing Committee as China's legislative body, and administrative institutions such as the China Securities Regulatory Commission (the CSRC) are the pivotal agents in the process of legal transfer. In line with civil-law traditions, legal academics also contribute to the process of transplantation. This is illustrated by the debate in the early 1990s as to whether the civil-law concept of 'mandate' or the common-law concept of 'fiduciary duty' should be transplanted to China.[59]

Sixth, China's transplantation of a common-law concept or rule from advanced common-law systems is actually in pursuit of authority. In this regard, the transplant serves as a device for legal change in China's transitional economy. Seventh, China often adopts a common-law concept as a technical solution to a specific legal issue. For example, the concept of fiduciary duty was included in Chinese company law as a technical solution to tackle classic corporate governance problems in Chinese practice. There is no clear example of transplants that aimed at promoting ideological or cultural change. Eighth, in adopting a common-law concept the Chinese legislature and government agencies generally undertake some substantial adaptations based on local conditions. This was certainly the case as regards the transplantation of corporate fiduciary duties in China.

These characteristics of China's transplantation of a common-law concept delineate a model for legal transplantation and may, therefore, be used to formulate an analytical framework.

1.2.2 Legal Transplantation Case Study: Conditions for Success

In current legal transplant scholarship, there is little agreement among scholars on the conditions necessary for a successful transplantation. In light of the complex and intricate nature of the legal transplant phenomenon, there is obviously no straightforward answer to this question. For analysis of conditions for China's effective transplantation of a common- law concept, this part develops an analytical framework based on the theoretical assumptions on conditions influencing legal transplants drawn from the legal transplant literature.[60]

[59] See 1.3.1 for details.

[60] The discussion in this part is based solely on the legal transplant literature and focuses solely on factors remarkably related to legal transplantation without entering the field of sociology of law or broad social science.

1.2.2.1 Transferability of the Rule

First and foremost, a principal condition for successful legal transplantation involves the transferability of a legal rule. The transferability of a rule denotes the chances that it will be adjusted to the recipient system or, inversely, the risks that it will be rejected after transplantation.[61] Although Watson sees legal transplants as socially easy, he acknowledges the possibility of rejection.[62] Kahn-Freund proposes that legal rules are on a continuum between so-called 'organic' rules, which are difficult to adjust and subject to rejection if exported to a foreign environment, and 'mechanical' rules which transplant easily.[63] The extent of the chance of adjustment and of the risk of rejection determine the point on the continuum at which a transferring legal rule is situated. This notion of transferability is described by Teubner as the 'tight coupling' and 'loose coupling' of a legal rule and relevant social processes.[64] What Teubner emphasises that even in cases of loose coupling legal transplantation cannot be 'mechanically' easy as suggested by Kahn-Freund.[65] It is nevertheless fair to assume that in legal transplantation the transferability of a legal rule ranges from low to relatively high – the higher the transferability the more effective the transplantation tends to be.

Determining the transferability of a legal rule is not straightforward. Acknowledging that contextual factors may constitute obstacles to a successful legal transplant, Kahn-Freund argues that the transferability of a rule is determined by how closely it is linked to the power structure of the original legal system.[66] For example, constitutional models are the most difficult to transplant as they involve the allocation of political power and interference with local relationships.[67] Similarly, drawing a distinction between instrumental law and culturally-based law, Cotterrell argues that, in contrast to family law or constitutional and administrative law which are conditioned by a jurisdiction's social, cultural, or political context, company and commercial law are more easily transplanted even to a recipient system with an entirely distinct

[61] Kahn-Freund (n 47) 5-6.
[62] Watson (n 2) 27.
[63] Kahn-Freund (n 47) 5-6.
[64] Teubner (n 17) 18.
[65] ibid 19.
[66] Kahn-Freund (n 47) 13.
[67] ibid.

contextual background in that they are relatively culturally neutral.[68] However, in recent years legal transplants have become an increasingly 'hot topic' in comparative constitutional law.[69]

In my view, Kahn-Freund reflects a macro-approach premised on the universal processes of 'economic, social, cultural assimilation or integration' and 'political differentiation' dating from Montesquieu's time.[70] Increasingly divergent political contexts among countries make political factors greater obstacles to legal transplantation than other contextual factors. Consequently, a legal rule closely related to the political structure of a country is less likely to transfer successfully to another country. On a micro-level, what in effect determines the transferability of a legal rule in a given legal transplant in Kahn-Freund's terms is the extent to which the rule is linked to its original context, and the extent of relevant context differentiation between the original and the recipient systems. In other words, the transferability of a legal rule can be determined by how closely it is linked to its peculiar context in the source system. In a given legal transplant, if the rule is not closely related to local context, or the original and the recipient systems share similar contexts, the transferability of the rule tends to be relatively high. In contrast, if the legal rule is closely linked to a specific context in its source system and the recipient system lacks that context, the transferability of the rule to the recipient country is likely to be low. However, what does it mean if the transferability of a legal rule is low?

In a given legal transplantation, the transferability of the legal rule can serve to predict relevant challenges facing the recipient country due to the lack of particular contexts. Kahn-Freund suggests that law reformers should fully consider the transferability of a rule before embarking on a legal transplantation.[71] This can reveal the peculiar context in the source system as well as the link between the rule and that context. It will allow for the identification of corresponding challenges to or even possible solutions for local adaptation in the recipient system to compensate for lack of context. As Watson points out, in a given legal transplantation it is not difficult to identify the 'factors which would favour, or militate against' the success of the legal transplantation.[72] Transferability of the rule can therefore not be regarded as exclusively determinative of the success or failure of the legal transplant; much still depends on how local

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[68] See Roger Cotterrell, 'Is There a Logic of Legal Transplants' in David Nelken and Johannes Feest (eds), *Adapting Legal Cultures* (Hart Pub 2001).
[69] See Vlad Perju, 'Constitutional Transplants, Borrowing, and Migrations' in Michael Rosenfeld and Andrea Sajo (eds), *Oxford Handbook of Comparative Constitutional Law* (2012 OUP) 1304.
[70] Kahn-Freund (n 47) 8.
[71] ibid 17.
[72] Watson (n 2) 82.

adaptation rises to the challenges identified by examining the transferability of the rule. In cases where local adaptation cannot possibly address the problems identified, contextual differentiation and the low transferability of the rule can be material obstacles to successful legal transplantation. This results in 'transplant shock' – the possibility that legal rules that work well in one jurisdiction may not work well, and ultimately may be rejected, in a jurisdiction with a different historical, political, or cultural background.[73] In contrast, if local adaptation turns out to offer adequate solutions to the problems arising from context differentiation, the rule with low-transferability could still be effectively transplanted.

1.2.2.2 Transplant Adaptation

In response to the challenges raised by contextual differentiation between the source and recipient legal systems, legal transplants are commonly subject to local adaptation in the recipient country. Watson observes that in legal history a voluntary legal transplantation almost inevitably involved a 'change in the law' as a reflection of 'the Spirit of a People'.[74] Despite his assertion that legal reception is feasible and easy, Watson admits 'when the receiving society is much less advanced materially and culturally', local adaptation would need to be extensive.[75] Similarly, Berkowits, Pistor, and Richard claim on the basis of their legal transplant case studies, that a legal transplant with a 'significant adaptation of the foreign formal legal order to initial conditions' can increase its receptivity.[76] Scholars who specialise in the sociology of law also highlight the significance of fruitful local adaptation in legal transplants.[77] The underlying rationale for why effective local adaptation can be achieved is, according to Watson, that legal rules are not 'peculiar devised for the particular society'.[78] Although they are invented by some people or nation, their value can be appreciated by other people or nations and can be 'adapted for the needs for many nations'.[79]

Local adaptation, which Langer sees as analogous to text transformations in legal translation, in effect involves two phases of adaptation: adaptation at the time of initial transplantation

73 Curtis J Milhaupt, 'Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance' (2001) 149(6) University of Pennsylvania Law Review 2083, 2097-2102.
74 Watson (n 2) 97.
75 ibid 99.
76 Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 'Economic Development, Legality, and the Transplant Effect' (2003) 47 European Economic Review 165, 174.
77 See Nelken and Feest (n 45).
78 Watson (n 2) 96
79 ibid 100.

(transplant adaptation); and adaptation during subsequent enforcement (enforcement adaptation).[80] These two phases of adaptation are described respectively by Örücü using the metaphors of 'transposition' and 'tuning' in her discussion of legal transplantation and reciprocal influence among legal systems.[81] Both stages of adaptation, by their nature, purport to address context differentiation, major or subtle, which inevitably arises in any legal transplantation. As discussed above, the low transferability of a legal rule between two systems does not necessarily doom the transplantation to failure provided that local adaptation in the recipient system can meet the challenges arising from major context differentiation. In this regard, effective transplant adaptation and enforcement adaptation are important conditions for a legal transplantation to succeed.

Transplant adaptation, as the first stage in local adaptation, occurs when law reformers in the recipient country first transplant a legal rule from its source legal system by way of legislation. Law reformers' adaptation at this stage involves choosing a model of the transferring rule from optional models in foreign legal systems and modifying the chosen model before legislating it as part of domestic law. Örücü uses the metaphor of 'transposition' to depict transplant adaptation – in particular to describe 'massive change based on competing models'.[82] In cases where there are multiple optional models, there may be a number of transpositions. According to Örücü, in the process of legal transplantation 'transpositions' are made to suit the local context and needs in the recipient system.[83] Indeed, transplant adaptation constitutes the primary source of solutions to the challenges and problems arising from context distinction across legal systems and serves as the foundation for the subsequent internalisation of the transferring legal rule in the recipient country. Based on their empirical economic research, Berkowits, Pistor and Richard's argue that the adoption of foreign law in a manner that is sensitive to local needs and conditions has a positive impact on the effectiveness of legal institutions in the recipient country. This is because it produces 'context specificity law' the meaning of which can be clearer to local law users and so increase the frequency and efficacy of its application.[84] On the other hand, if the transplant adaptation fails to address major

[80] Langer (n 14) 33.
[81] Örücü (n 8) 207.
[82] ibid.
[83] ibid.
[84] Berkowitz *et al* (n 76) 174.

contextual obstacles, the transplanted rule would ‘either not be applied or applied in a way that may be inconsistent with the intention’ of the original model.[85]

Law reformers’ adaptability can first be manifested by their informed choice of the appropriate model of the transferring legal rule from multiple options in foreign legal systems. In this regard, important tools for law reformers include comparative research and economic analysis. According to Berkowits, Pistor and Richard, the ‘informed choice’ in respect of ‘alternative rules’ can be made on the basis of extensive comparative research.[86] A good example of choosing the appropriate model is Japan’s choice of German law in preference to French law as the model for its civil code during the Meiji restoration. As Sacco points out, the extensive reception of law that took place in antiquity generally proceeded ‘without prior comparison or on the basis of superficial comparisons’, while the comparative study intervenes at a later stage to analyse those receptions.[87] However, in light of the long evolution of law in legal history, the distinction between optional models of a legal rule can today be more nuanced and complex. The comparative research available today is nevertheless a useful tool in securing a better legal transplant. Other than comparative research, Ajani proposes an economic analysis of costs and benefits implied by the introduction of the model rule, because relevant economic rationales behind the model may conflict with local considerations in the recipient country.[88] In a comparative and/or economic analysis of optional rule models, law reformers should specifically inform themselves of the relevant underlying reasons why the rules differ. This may reveal whether a certain model is appropriate or, alternately, not an option given the local context.

Another manifestation of law reformers’ adaptability involves their sensible modification of the chosen model to meet local context and needs. When introducing the legal translation metaphor, Langer discusses three approaches to adaptation and points to examples of legal transplantation in each or in a mixture of the three approaches: first is ‘strictly literal translation’ which equates to a ‘copy and paste’ transplant; second is ‘faithful but autonomous restatement’ which balances faithfulness to the original context and meaningfulness to the local context; and third is ‘substantial recreation’ which prefers utility in the recipient country to fidelity to the

[85] ibid.
[86] ibid 180.
[87] Rodolfo Sacco, ‘Legal Formants: A Dynamic Approach to Comparative Law (Installment II of II)’ (1991) 39(1) American Journal of Comparative Law 1, 4.
[88] Gianmaria Ajani, ‘By Chance and Prestige: Legal Transplants in Russia and Eastern Europe’ (1995) 43 American Journal of Comparative Law 93, 115-116.

original context.[89] In my view each approach has its advantages depending on the circumstances surrounding the specific legal transplant. This said, however, it should be noted that the 'copy and paste' approach leaves little room for context differentiation, while the third – and most sophisticated approach – demands advanced technical competence of local law makers in the recipient system.

Basically, modifications to the original model of the legal rule being transplanted by legislation are aimed at addressing context differentiation across the legal systems. The extent of modification, 'copy and paste', or 'substantial recreation' depends on the extent to which the original model fits the local context in the recipient country. And in cases where the context differentiation necessitates a modification to the original model, it is advisable that law reformers modify the model after detailed analysis and with sound justification. Specifically, modification undertaken should be based on how exactly the lack of a particular context gives rise to challenges, difficulties, or problems in the recipient system. In this regard, the comparative research or economic analysis conducted in selecting the most appropriate model can also be of great use. However, law reformers' ability to effect suitable modifications to the original model could still be constrained by their law-making competence and technical skill. Insofar as the transplant adaptation has been conducted, it nevertheless serves as the basis for the enforcement adaptation at a later stage.

1.2.2.3 Enforcement Adaptation

Following the adoption of a legal rule in the recipient legal system, the next stage of local adaptation takes place through the enforcement of the rule. Örücü uses the metaphor of 'tuning' to illustrate the internalisation of borrowed law. She argues that the 'tuning', which takes place after 'transposition' by the 'appropriate actors' in the recipient country, is 'the key to success'.[90] During internalisation of the borrowed rule in the recipient system, adaptation occurs as a result of the interpretation and application of the rule by local legal institutions. In contrast to the intentional transplant adaptation conducted by law reformers, this stage of adaptation generally happens naturally during the process of law enforcement. The adopted rule develops in the recipient country through a dynamic circulation of trial and innovation,

[89] Langer (n 14) 33-34.
[90] Örücü (n 8) 207.

error and correction, and sensitivity to local conditions and needs.[91] How well the adaptive enforcement of the adopted rule is effected by legal actors in the recipient system is thus also a key determinant of the efficacy of transplantation. Fundamentally, enforcement adaptation by local role players is still aimed at overcoming contextual difficulties and accommodating local context.

The success of enforcement adaptation in legal transplantation can also be attributed to the adaptability of local actors. According to Berkowits, Pistor and Richard, effective legal institutions in legal transplants are subject to 'the judges, lawyers, and other legal intermediaries that are responsible for developing the law [being] able to increase the quality of law'.[92] Similarly, when turning the adopted rule 'on the books' into a 'rule in action', local enforcers' adaptability could be indicated by their ability to improve the quality of the adopted rule. It is to be noted, however, that as enforcement adaptation is based on the adopted rule, its success can be subject to the performance of transplant adaptation at an earlier stage. For example, an unwise choice of a rule model by law makers does not leave much space for law enforcers to change the model substantially simply through interpretation and application. On the other hand, insofar as law enforces are able to adapt the adopted rule, they are still able to improve its operation.

Moreover, in my view, local enforcers' adaptability should also involve their ability to effect the necessary institutional adaptation of local law enforcement. When enforcing a borrowed legal rule, local enforcers in the recipient system may be faced with challenges to their institutional capability. For example, they may not be able to interpret and apply the rule in the same manner as law enforces in the original system. Consequently, not only the rule itself but also how relevant enforcing institutions function in properly applying the rule, need to be adapted to the local context. This type of institutional adaptation may still happen naturally during the process of law enforcement, but this requires the local law enforces to display a high-level of adaptive competence. Failing this, it is suggested that local enforcers should be conscious of the necessity to adapt institutionally in enforcing a borrowed legal rule. To be clear, the adaptive functioning of enforcement institutions does not imply changing those institutions significantly – eg, changing the structures of the institutions. However, the necessary extent of institutional adaptation for a transplant to be successful depends on the

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91 Wise (n 6) 1-2.
92 Berkowitz *et al* (n 76) 174.

extent to which the enforcing institutions have been challenged by the lack of specific context in the recipient system. In this regard, law enforcers' adaptability can certainly be limited by the extent of institutional adaptation possible as part of the legal infrastructure in the recipient system.

After the period of internalisation, the legal transplantation process has largely been completed and the transplanted rule continues to evolve in the recipient system as part of local law. As Watson points out, a successfully transplanted legal rule – 'like that of a human organ – will grow in its new body, and become part of that body just as the rule or institution would have continued to develop in its parent system'.[93] It is worth noting, however, that the process of a borrowed legal rule being internalised in the recipient system during which the enforcement adaptation occurs, may take many years. During this period the application of enforcement adaptation by local law enforces may improve gradually.

1.2.2.4 Legal Demand in Society

Closely related to the internalisation of a borrowed legal rule in the recipient legal system is the social demand for such a rule. This also constitutes a critical condition for successful legal transplantation. As Berkowits, Pistor and Richard suggest, 'for legal institutions to be effective, a demand for law must exist so that the law on the books will actually be used in practice'.[94] Indeed, without relevant social demand, even if a legal rule is borrowed from its original system, it may turn out to be just another dead letter in the books in the recipient system. The enforcement of a borrowed rule, in particular a commercial or private-law rule, is in effect triggered, directly or indirectly, by local demand. The lack of social demand may result in the borrowed rule being rarely used or enforced in the recipient country. This is clearly the antithesis of a successful transplant. However, legal transplants do not necessarily result from or be accompanied by local demand for the relevant foreign law rule in the recipient society.

In general, the lack of local demand for a borrowed legal rule can be attributed to the absence of actual need in society, the existence of local substitutes for the rule, or citizens' ignorance of the rule. Whether a society in fact needs a legal rule relates closely to why the rule is

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[93] Watson (n 2) 27.
[94] Berkowitz *et al* (n 76) 167.

transplanted in the first place.[95] In cases of voluntary transplantation in pursuit of solutions to a legal issue, law reformers should have considered local demand as at least one of the reasons for transplantation of the law. However, actual legal demand is at times unclear and difficult to ascertain, especially in cases where there are local substitutes for the borrowed rule. Legal or non-legal local substitutes for a legal rule as solutions to legal issues are common in society. In cases where law reformers transplant legal rules in pursuit of foreign legal solutions while neglecting local substitutes, the borrowed legal rule may not actually be used or enforced in the recipient country.[96] Another factor that may affect the social demand for a borrowed legal rule in the recipient country is the local people's awareness of or familiarity with that rule. One of the presumptions advanced by Berkowits, Pistor and Richard in their research is that if 'the population within the transplant was not familiar with the law, then we would expect that initial demand for using these laws to be weak'.[97] Apparently, the unfamiliarity of a borrowed rule and the resulting lack of social demand for its use are matters of degree but that total ignorance of the rule is extremely rare. Nevertheless, if people in the recipient country are relatively unfamiliar with a borrowed rule, they would indeed be less likely to seek its private enforcement in the courts.

It is worth noting that local demand for a borrowed legal rule may change over time as either the actual social demand increases or relevant local substitutes lose significance. Firstly, the actual need for a legal rule in society may increase as the social context changes. In this regard, Small goes so far as to argue that a specific social context which tends to generate social demand for a certain legal rule can also be transplanted.[98] Secondly, extant local substitutes for a borrowed legal rule in the recipient country may disappear or dissipate. And thirdly, local people's familiarity with a borrowed rule can be promoted to increase social demand for its use. As Berkowits, Pistor and Richard suggest, 'substantial investments should be made in legal information and training prior to adoption of a law'.[99] As discussed earlier, the performance of enforcement adaptation by law enforcers may improve gradually over time. In fact, the increase in social demand for a borrowed rule in the recipient country can contribute to improved performance of enforcement adaptation.

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95 Hideki Kanda and Curtis J. Milhaupt, 'Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51 The American Journal of Comparative Law 887, 891.
96 ibid 897-899.
97 Berkowitz *et al* (n 76) 167.
98 See Richard G Small, 'Towards a Theory of Contextual Transplants' (2005) 19 Emory International Law Review 1431.
99 Berkowitz *et al* (n 76) 192.

1.2.2.5 Knowledge of the Rule and Other Factors

Successful legal transplantation demands knowledge of the borrowed legal rule among the people in the recipient country. Langer regards knowledge of the legal system from which the law is sourced part of law reformers' skills when initially transplanting the legal rule to the recipient system.[100] Similarly, observing a potential large gap between 'law on the books' and 'law in action' when it comes to legal transplantation, Berkowits, Pistor and Richard argue that the efficacy of a borrowed legal rule in the recipient country rests on knowledge and understanding of the rule and its underlying values among the local population.[101] Proper knowledge of a transferring legal rule can therefore facilitate the efficacy of the entire process of transplantation from the initial adoption of the rule, to its subsequent internalisation in the recipient system, and culminating in its adaptive enforcement.

The requisite knowledge of a transferring legal rule by the people of the recipient country may involve not only the rule itself, but also its underlying context in the source system. Kahn-Freund stresses the importance of understanding the social and political contexts of the original law in legal transplantation and in the use of the comparative method.[102] Watson counters this by arguing that without relevant knowledge of context, a legal rule can still be successfully transplanted in that what transfers is a legal idea.[103] Stein comments on the disagreement between Kahn-Freund and Watson and clarifies that legal ideas cannot be extracted from legal rules in 'complete ignorance' of their context; but if lawmakers indeed lack competence, practice in reality may conform to Watson's observations.[104] Indeed, a proper understanding of a transferring rule can hardly be achieved without some knowledge of its closely-related context in the original system. Even though the lack of context knowledge may not necessarily result in the failure of a legal transplant, understanding relevant context can definitely contribute to its efficacy.

Furthermore, the extent of the knowledge required when transferring a legal rule differs for legal professionals and the ordinary 'locals' in the recipient country. Ordinary members of society, according to Berkowits, Pistor and Richard, need only be aware of the basic concept

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[100] Langer (n 14) 33.
[101] Berkowitz *et al* (n 76) 173.
[102] Kahn-Freund (n 47) 17.
[103] Watson (n 13) 79.
[104] Eric Stein, 'Uses, Misuses-and Nonuses of Comparative Law' (1977) 72 Northwestern University Law Review 198, 208-209.

of the rule rather than the specifics as they can rely on lawyers as intermediates.[105] As discussed above, the awareness of a borrowed legal rule among ordinary people may increase social demand for the rule in the recipient country which is important for effective transplantation. For legal professionals to apply a borrowed legal rule they should grasp the wording of that rule, the concept behind it, the underlying values, and its position in the legal order as a whole.[106] Ideally, their understanding of the rule should match that of those applying the rule in its original legal system. However, full and absolutely accurate understanding of a borrowed rule, even for the legal elite in the recipient country, is an unrealistically high requirement. As Watson asserts, the misunderstanding of rules is common and can be attributed to the element of chance which is important in legal transplantation.[107] Indeed, for successful legal transplantation the required level of knowledge of a transferring legal rule is a matter of degree: the higher the degree, the more effective the transplantation tends to be.

Legal professionals' knowledge of a borrowed legal rule comes primarily from and can be improved by legal education and training, which is also a part of local adaptation in legal transplantation. According to Örücü, the 'tuners' of the 'internal tuning' are generally domestic judges, although, for successful legal transplantation tuning is necessary at all levels, including education.[108] An example from antiquity showing the link between law education and legal transplant is that of Roman law taught in the universities during the medieval and early modern ages which led to the spread of Roman law throughout Europe and provides the most important case of 'reception' in the history of Europe.[109] Legal education is the primary avenue by which legal professionals gain knowledge of a transplanted legal rule which has become part of their domestic law as judges, administrative officers, and lawyers graduate from local law schools. Legal professionals may also gain knowledge of the transplanted rule from their job training. For example, court judges may receive internal training in the judicial system with regard to the interpretation and application of transplanted law, and law firms may also provide relevant training to their attorneys.

The conditions conductive to effective legal transplantation considered above are not a *numerus clausus.* According to Watson, 'an element that cannot properly be factored in but

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105 Berkowitz *et al* (n 76) 173.
106 ibid.
107 Alan Watson, 'Aspects of Reception of Law' (1996) 44 American Journal of Comparative Law 335, 341.
108 Örücü (n 8) 208.
109 Michele Graziadei, 'Comparative Law, Transplants, and Receptions' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, OUP 2019) 446-448.

may still be important in reception is chance' and, he continues, 'the power of mistake must also not be overlooked.'[110] Watson actually views mistakes that happen in legal transplantation as a neutral element in that there are historical examples showing that 'foreign law can be influential even when it is totally misunderstood'.[111] Such elements that play out randomly make an analysis of conditions precedent for a legal transplant to succeed even more complex and demanding.

1.2.3 Legal Transplantation Case Study: Criteria for Success[112]

To evaluate the effectiveness of China's transplantation of a common-law concept, an inevitable question is how to define 'success' for purposes of evaluation. In this regard, Teubner warns that the outcome of legal transplantation is generally not either success or failure; in reality it is more likely to be mixed.[113] Nelken concurs, citing significant differences in legal transplantation practice which involve different regulatory areas, different regulatory purposes, and different social and legal contexts, in support of his view that it is difficult to develop a set of criteria for defining successful legal transplants in general.[114] In my view, it may be too challenging to define the success of legal transplants in a general sense, but it may be possible to evaluate a specific instance of legal transplant practice which has its own purpose, regulatory area, and social context. Indeed, the outcome of evaluating a specific case of legal transplantation could be a mixture of success and failure, and even a highly effective legal transplant can hardly be labelled a complete success.

In current legal scholarship there are two approaches to the evaluation of successful legal transplants. The first is to avoid making a normative evaluation and be purely descriptive or discuss only the effects of the transplantation.[115] Other scholars propose somewhat different criteria for success in their legal transplant theories or when evaluating empirical legal transplant cases. To evaluate the efficacy of China's transplantation of a common-law concept

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110 Watson (n 107) 339.
111 Watson (n 2) 99.
112 While conditions for success discussed in the previous part deal with factors influential for a legal transplantation to be successful, criteria for success are supposed to be used to evaluate how well the transplantation works. The discussion in this part is also based solely on the legal transplant literature and focuses solely on factors clearly related to legal transplantation without entering the field of legal sociology or broad social science.
113 Teubner (n 17) 17.
114 See David Nelken, 'The Meaning of Success in Transnational Legal Transfers' (2001) 20 Windsor Yearbook of Access to Justice 349.
115 See Juan Chen and SpringerLink (Online service), *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 40.

into its company law, this part formulates an analytical framework based on proposed criteria for successful transplantation drawn from legal transplant literature. In general, current literature identifies three dimensions in defining the success of legal transplants: the convergence dimension; the operative dimension; and the instrumental dimension.

1.2.3.1 Criteria for Success in the Convergence Dimension

On the convergence dimension, current legal scholarship reveals different opinions as to the 'similarity' required between the transplanted rule in the recipient system and its original model for a legal transplant to be successful. Watson's criterion for successful legal transplantation refers to the existence of rules 'expressed in apparently similar terms' or provisions with 'obvious similarities both of substance and of formulation' in two systems.[116] In extreme cases, according to Watson, provided the recipient system has a similar rule, even if 'little of importance was received apart from terminology', the use of the terminology would be likely to 'ensure the continuing influence' of the original system.[117] In light of the historical approach taken by Watson, those similar rules should have worked or operated without rejection in the recipient system for a (long) period. This means that the transplantation process ends at an earlier stage while the rule continues to evolve locally as domestic law. Considering the effects of both legal transplant adaptation and the subsequent local development, the rule in the recipient system may have changed considerably from its original model. Watson's criterion, therefore, does not accurately account for the extent of similarity between the transplanted rule and its original model required for successful transplantation.

In sharp contrast, Legrand, in support of his argument on the impossibility of legal transplantation, maintains that a 'meaningful' legal transplant can only occur if the 'propositional statement' and its 'invested meaning' which together constitute the legal rule, both transfer across systems.[118] Accordingly, his criterion for successful transplants requires that the rule in the recipient system consist of the same inscribed wording and the same meaning as in the source system.[119] Although this supports Legrand's argument, it seems unrealistically high and unnecessarily demanding for evaluating a legal transplant. Moreover, considering the significance of local adaptation in legal transplantation, the transplanted rule could well differ

[116] Watson (n 2) 20, 23.
[117] ibid 97.
[118] Legrand (n 42) 116-117.
[119] ibid 117.

from its original model. The question is rather the extent to which a transplanted rule may deviate from its original model of law in the interests of successful transplantation.

To evaluate China's transplantation of a common-law concept, it is submitted that the criterion for success in the convergence dimension requires that the transplanted rule in China should be in line with the conceptual core of the original rule in common-law system. On the one hand, under the beneficial adaptation of the original model on the basis of local context, the success of transplantation does not necessarily require identical replication of the original rule. On the other hand, an important element in China's transplantation of a common-law concept and its sub-rules, is the desire for authority.[120] As a result, local adaptation in China should not alter the original rule so substantially that it can no longer serve its original legal functions. Therefore, the transplanted rule must retain at least that which is necessary for it to serve its original legal functions – in short, the conceptual core of the legal rule must survive. Provided that the transplanted rule incorporates and properly reflects the conceptual essence of the original law, its departure from the original model resulting from local adaptation can have either positive or negative implications in the operative or instrumental dimensions.

1.2.3.2 Criteria for Success in the Operative Dimension

In the operative dimension, the criteria for success involve both the frequency and the manner in which the transplanted rule is used in the recipient system. The basic requirement in this dimension is that the transplanted rule should be in use in the recipient country. Clearly, in a successful legal transplant the transplanted rule is not intended to be a dead law on the books. It is fair to assume that the complete non-use of the transplanted rule in the recipient country means a failed transplant.[121] Indeed, as enforcement adaptation may extend over a considerable period and societal demand for the legal rule may change over time,[122] the non-use of the transplanted rule must similarly be long settled in the recipient system before it can be said that the transplant has 'failed'. On the other hand, the frequent use of the transplanted rule as a standard for successful transplant, is better measured as a matter of degree rather than quantitively. Basically, unless the transplanted rule is of no use or its use is very rare in legal enforcement and practice the standard will have been met. In that regard, a major indicator of

[120] See 1.2.1.2.
[121] Kanda and Milhaupt (n 95) 890.
[122] See 1.2.2.3 and 1.2.2.4.

the frequency of the use of a transplanted rule is the number of cases enforcing the rule in the courts.

The other standard of success in the operative dimension concerns how the transplanted rule is used or applied in the recipient system. In a case study, Kanda and Milhaupt set the standard as the 'use of the imported legal rule in the same way as it is used in the home country, subject to adaptations to local conditions'.[123] In contrast, Gal is of the opinion that a legal rule can be used in a different manner in the recipient system and 'still further social welfare'.[124] In fact, either of these views may be appropriate in a given legal transplant. In my opinion, if the transplanted rule is either used in a manner identical or reasonably similar to its use in the source system, or it is used in a manner that fits well into the recipient system, the standard of success in the operative dimension can be deemed to have been met to some extent. As a general matter, the original design of a legal rule – including its contents, application, and remedies – constitutes a unity that is conceptually sound. It is thus advisable that the recipient country borrow the 'whole package' and that the transplanted rule be used in a way that resembles its application in the original system.

On the other hand, where local context does not allow the transplanted rule to be used in a manner identical or reasonably similar to its use in the source system, the transplanted rule can still be applied in a way that fits in with the recipient legal system. The application of the transplanted rule is subject to a pre-existing legal infrastructure and legal tradition in the recipient system. For example, subject to the structure of the local judicial system and the provisions of local procedural law, enforcement of the transplanted rule in the recipient system may not provide the same remedies for its breach as those available in the original system. This is especially the case when there is serious contextual divergence between the original and the recipient systems – eg, between common-law and civil-law systems. However, local adaptation during the transplantation process could still incorporate the transplanted rule into the recipient legal system in a way that suits the system. In this regard, adaptation to the usage of the transplanted rule at least situates the rule and allows it to operate within the recipient system.

[123] Kanda and Milhaupt (n 95) 890.
[124] Michal S Gal, 'The Cut and Paste of Article 82 of the EC Treaty in Israel: Conditions for a Successful Transplant Special Issue Approximation to EU Law' (2008) 9(3) European Journal of Law Reform 467, 471.

In this regard, the standard of succuss in this operative dimension can still be deemed as being satisfised.

1.2.3.3 Criteria for Success in the Instrumental Dimension

As regards the instrumental dimension, the criterion for success involves evaluating the functioning of the transplanted rule in the recipient country as the outcome of the legal transplantation. Many scholars propose to assess the success of a legal transplant based on whether the goals or objectives of the transplant have been achieved. Focusing on the 'transplanting country's needs and special conditions', Gal suggests that the success of a legal transplant should be defined as 'the ability of the transplanted law to achieve its goals in the transplanting country' regardless of its application history in the original system.[125] While it is true that law reformers generally embark upon legal transplantation with specific goals for the receiving system in mind, as these goals are multifarious their achievement in a broad sense cannot be analysed or assessed without entering into the realm of sociology. Moreover, particular goals or objectives which were deemed important by law reformers at the time of their initial transplantation may have lost significance or even become irrelevant in the recipient society as the process of transplantation approaches its conclusion. In such a case it would be inadvisable to evaluate the transplantation on the basis of the achievement or non-achievement of its initial goals or objectives.

The instrumental dimension of China's success in adopting a transplanted common-law concept is evaluated by assessing whether the transplanted rule is achieving its legal purpose in the Chinese system. As discussed, in pursuit of authority, China transplants a common-law concept as a technical solution to specific local legal issue.[126] In consequence, regardless of specific objectives or detailed considerations, the most significant purpose of the transplant is that those legal functions which the concept and its sub-rules are capable of achieving in the original common-law system, could also be achieved in China. In other words, the legal transplant intends to render the common-law concept and its sub-rules functional within the Chinese legal system. To evaluate how well the transplanted common-law rule functions in China, the rule itself as well as its application in courts and in society at large are evaluated

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125 ibid 472.
126 See 1.2.1.2.

from a macro-perspective. On the other hand, relevant factors that may limit the ability of the transplant rule to achieve its functions in China can also be identified.

It is to be noted, however, that it is impractical to measure the exact extent to which the transplanted common-law rule is achieving its legal functions in China. Even in the original common-law systems, this question is difficult to answer. Moreover, the evaluation of China's adoption of a common-law concept based on the criterion of success in this instrumental dimension should exclude factors irrelevant to the transplantation itself. To what extent the common-law rule is functioning effectively in China depends not only on the efficacy of the transplantation process, but also on other domestic Chinese factors which fall outside of scope of legal transplantation assessment. In other words, even if the legal transplantation has been effective, the functioning of the transplanted common-law rule may be unsatisfactory for reasons extraneous to the transplantation. Therefore, to assess China's reception of a common-law concept, the criterion for success should rather focus on whether the transplanted common-law rule is achieving its legal functions in the Chinese system. Using the metaphor of botanical transplantation, the success of a transplant in effect means that the plant has taken root in foreign soil; but it need not necessarily thrive.

1.3 Legal Transplantation Case Study: Setting the Scene

To set the scene for the transplant case study, this section first introduces why and how China transplanted the common-law concept of fiduciary duty into its company law from an historical perspective. The second part addresses the differing contexts in the UK and the USA as the source systems of the transplant, and China as its recipient since contextual differentiation is the most prominent feature of the transplant case study. The historical story of China's reception of the common-law fiduciary duties in its company law can be divided into two phases: the attempted introduction in the 1993 Chinese Company Law (CCL1993); and the official adoption in the CCL2005.

1.3.1 The Sceptical Attitude towards Fiduciary Duty in the 1993 Chinese Company Law

The corporate form of business has been known in China since the beginning of the twentieth century. After being defeated in the Opium War, the late Qing dynasty recognised the need to ‘promote the creation of Chinese companies to compete with the foreigners who were producing and marketing their goods on Chinese soil’, and promulgated the first company law in the modern sense in 1904.[127] The succeeding nationalist government continued the efforts to modernise China and codified a new Company Law in 1929.[128] After the Chinese Communist Party came to power in 1949, however, all privately held companies were nationalised or collectivised in order to eliminate any remaining vestiges of capitalism.[129] This situation persisted until Deng Xiaoping initiated reform and adopted the opening-up policy in the early 1980s. Under Deng’s leadership, China began to allow private enterprises to operate in 1981.[130] The amended Chinese Constitution recognised the rights of individual businesses and private enterprises in 1982.[131] The General Principles of the Civil Law of 1986 further provided a concrete legal basis for private businesses by recognising them, together with Sino-foreign joint ventures and state-owned enterprises (SOEs), as ‘legal persons’.[132] As a legal person, a private business may lawfully conduct business and enjoy its legal rights and obligations independently of its owners.

China’s economic reforms in the 1980s not only led to a surge in privately held enterprises owned by Chinese nationals, but also attracted numerous foreign direct investments. The increasingly heated market competition resulting from the entry of new competitors resulted in two phenomena. On the one hand the Chinese rapidly accumulated personal wealth and private savings; while on the other, grossly inefficient SOEs were unable to compete with private enterprises and became debt-ridden. By end of 1994, 41 per cent of China SOEs were running in the red and in desperate need of restructuring.[133] Under such circumstances, the Chinese government saw the huge advantage of transforming these dying SOEs into modern shareholding companies and even listing them on stock exchanges so as to provide urgently needed capital.[134] It follows that the government allowed thousands of former SOEs to convert to companies through a series of laws and administrative regulations enacted to regulate their

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[127] William C Kirby, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 Journal of Asian Studies 43, 43.
[128] ibid 51-52.
[129] Alison W Conner, ‘To Get Rich Is Precarious: Regulation of Private Enterprise in the People’s Republic of China’ (1991) 5 Journal of Chinese Law 1, 5.
[130] Matthew D Bersani, ‘Privatization and the Creation of Stock Companies in China’ (1993) 1993 Columbia Business Law Review 301, 303.
[131] The Constitution of the People’s Republic of China (1982 Rev) arts 8 & 11.
[132] The General Principles of the Civil Law of the People’s Republic of China (1986) art 2.
[133] Michael Irl Nikkel, ‘Chinese Characteristics in Corporate Clothing: Questions of Fiduciary Duty in China’s Company Law Note’ (1995) 80 Minnesota Law Review 503, 516-520.
[134] Preston M Torbert, ‘China’s Evolving Company Legislation: A Status Report’ (1993) 14 Northwestern Journal of International Law & Business 1, 33.

transition.[135] The most prominent 'opinions' issued by the PRC Commission on Restructuring of the Economic System in 1992 were 'Opinions on Standards for Limited Liability Companies' and 'Opinions on Standards for Companies Limited by Shares'.[136] Based on these two opinions, the NPC enacted China's first-ever nationwide Company Law in 1993.

The CCL1993 contained no separate chapter setting out directors' duties which were instead scattered throughout the statute. Article 59(1) provides that 'directors and managers shall perform their duties faithfully and maintain the interests of the company and shall not take advantage of their position, functions and powers in the company to seek personal benefits'.[137] Articles 59–62 then provide rules prohibiting directors and senior officers from accepting bribes or other unlawful gains, misappropriating corporate funds, engaging in business activities that compete with the company, engaging in transactions with the company without approval, or divulging the company's confidential information without approval.[138] Textually, the phrase 'perform their duties faithfully' means that directors must act in good faith in performing their duties.[139] However, the wording of article 59(1) also reflects the notion of a fiduciary duty of loyalty and the limitations in articles 59–62 appear to govern common instances involving a breach of the fiduciary duty. Nonetheless, in contrast to the later version in the CCL2005, the CCL1993's provisions were not entirely clear as to whether or not the law of fiduciary duties had indeed been adopted. The CCL1993 was also criticised as being too vague to be invoked by plaintiffs in practice.[140] Moreover, in terms of remedies for breach of directors' duties, the CCL1993 provided that directors were liable to pay compensation only if their breach caused harm to the company.[141] Clearly, the CCL1993 did not introduce relevant fiduciary remedies in its original common law systems. As some commentators argue, these new provisions represented 'a step further towards the concept of "fiduciary duty" under common law'.[142]

[135] There are four levels of legislation in China: the constitution, state laws, administrative regulations, departmental and local regulations.
[136] Wei Shujun, 'Company Law's One Hundred Years of History in China' (2005) 72 Journal of East China University of Political Science and Law 78.
[137] Art 123 of CCL1993 has a similar provision applying solely to companies limited by shares.
[138] 1993 Chinese Company Law arts 59-62.
[139] Nicholas Calcina Howson, 'Twenty – Five Years On – The Establishment and Application of Corporate Fiduciary Duties in PRC Law' (2017) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3102551 accessed 10 December 2021.
[140] Rebecca Lee, 'Fiduciary Duty without Equity: "Fiduciary Duties" of Directors under the Revised Company Law of the PRC' (2007) 47 Virginia Journal of International Law 897, 901.
[141] 1993 Chinese Company Law art 63.
[142] Nikkel (n 133) 527.

At least one possible reason why the fiduciary duty was not clearly incorporated in the CCL1993 was because influential senior Chinese academics who were important participants in the drafting of the CCL1993, felt that the common-law corporate fiduciary duty did not fit China's context and was inconsistent with the country's civil-law tradition.[143] Instead, they argued for drawing on other East Asian countries such as Japan and Taiwan with their Confucian heritage and civil-law tradition. In both Japan and Taiwan it has long been established that the relationship between a company and its directors should be construed in accordance with the provisions regarding 'mandate' (weiren) which is understood as that the mandatory (company directors) having a 'duty of due care of a faithful good manager' towards the mandator (the company).[144] By virtue of this duty, directors are held to the professional negligence standard in the performance of their duties.[145] With such consideration, senior Chinese academics vigorously criticised the idea of transplanting the Western corporate fiduciary duty in China and supported the 'mandate' concept as applied in Japan and Taiwan. As one leading Chinese company law scholar argued:

> For China's legislators and corporate law scholars, we must conform to our own national situation, and introduce doctrine that is consistent with China's legal tradition...Most importantly, the concept of 'fiduciary duty' originally comes from the common law tradition, which is very unfamiliar for China - a nation used to a very long tradition of the civil law system. If we use this concept to explain the relationship between a director and the company, it will be difficult for people to become accustomed to it or accept it in their hearts. Conversely, if we introduce the 'mandate' (weiren) concept to explain the relationship between a company and its directors, it conforms quite well to the customs and traditions of the Chinese people.[146]

However, even though the final 1993CCL contained no clear reference to the fiduciary duty of loyalty, it also did not reflect the academics' proposal to adopt the 'mandate' concept. Indeed, the 'mandate' concept has never been part of the Chinese company law.

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143 Howson (n 139) 6.

144 Japanese Corporate Code s 330; Japanese Civil Code art 644; Taiwan's Company Law art 192; Taiwan Civil Code art 535.

145 Lawrence S Liu, 'Global Markets and Parochial Institutions: The Transformation of Taiwan's Corporate Law System' in Curtis J Milhaupt (ed), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-border Deals* (Columbia University Press 2003) 406.

146 Wang Baoshu, 'Directors and the Board of Directors at Companies Limited by Shares' (1994) 1 Foreign Legal Studies Commentary and Explanation 5.

1.3.2 The Introduction of the Fiduciary Duty in the 2005 Chinese Company Law

The NPC adopted the extensively amended Chinese Company Law on 27 October 2005. It has been hailed as a significant milestone in the reform of the Chinese economy.[147] The CCL2005 devotes its entire Chapter 6 to the qualifications and obligations of the directors, supervisors, and senior officers of a company. One of the most important changes in the wholly revised company law was the inclusion of article 148 in Chapter 6, an entirely new substantive provision that for the first time in China's history provided that corporate directors and senior officers owe a common-law-style fiduciary duty to the company. Article 148 provides that:

> Directors, supervisors, and senior officers should abide by the laws, administrative regulations and the company's articles of associations, and owe duties of loyalty and diligence to the company.[148]

Article 148 is clearly an improvement on the old article 59(1) which vaguely stated that directors should 'perform their duties faithfully'. According to the Circular Concerning the Explanation of the Company Law Reform Bill, the revised Company Law imposes a duty of loyalty and a duty of diligence on directors so that directors' statutory duties could be clarified.[149] As Lee notes, 'while it is not clear whether the intent of articles 148 and 149 of the revised company law is to import Anglo-American fiduciary concepts to China, it is at least arguable that those express stipulations could produce such effect'.[150]

There are at least four reasons explaining why China finally incorporated the fiduciary duty of loyalty in the CCL2005. First, due to poor performance of SOEs, corporatisation but not full privatisation – as the state retains majority equity stakes – had become official policy of the Chinese government.[151] Once corporatisation had been introduced, the new types of shareholder, including private, foreign, and institutional investors, naturally demand functioning mechanism to monitor, check, and hold directors and officers appointed under the CCL2005 to manage other people's money, accountable – the classic 'agency cost' problem. The CCL1993 provided only a vague and limited basis for this type of accountability. Nor was it possible to rely on established business practices or cultural or Confucian ethical norms to

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[147] Wang Baoshu and Hui Huang, 'China's Revised Company Law and Securities Law: An Overview and Assessment' (2005) 19 Australia Journal of Corporate Law 229, 231-232.
[148] 2005 Company Law of the People's Republic of China (2018 Rev) art 148.
[149] Circular Concerning the Explanation of the Company Law Reform Bill (1993).
[150] Lee (n 140) 908-909.
[151] Yuwa Wei, 'Corporatization and Privatization: A Chinese Perspective' (2002) 22 Northwestern Journal of International Law & Business 219, 225-226.

regulate so fundamental a conflict of interests between shareholders and the management. Therefore, the lack of any substitute for the corporate fiduciary duty is a strong reason for the adoption of the common-law fiduciary duty in Chinese company law.[152]

Second, the external force of demand by the regulators of international capital markets and other participants also played a key role in motivating the transplantation of corporate fiduciary duties in China. For example, in the early 1990s, to diversify its concentrated capital structure, gain access to international capital markets, and improve corporate governance, some Chinese SOEs attempted to list on Hong Kong stock exchange. In an effort to meet the listing requirements, the Chinese government declared in a confirmation letter to the Hong Kong Securities and Future Commission in 1992, that the provision stating that 'directors and managers shall assume a duty of good faith and diligence to the company' in the then 'Opinions on Standards for Companies Limited by Shares' had the same doctrinal meaning as fiduciary duties under Hong Kong law.[153] Thereafter, although the subsequent enactment of the CCL1993 failed to offer sound provision as regards directors' duty of loyalty,[154] the CSRC which had been established in 1992, worked diligently to push the notion of a fiduciary duty in the corporate governance of Chinese listed companies. In this regard, even though the concept of fiduciary duty was not formally introduced into Chinese company law until 2005, it is incorrect to assume that Chinese government agencies such as the CRSC were unfamiliar with the concept.[155]

Third, even though other Asian neighbours with civil-law traditions such as Japan and Taiwan conceptualise the relationship between directors and the company as a 'mandate' rather than a fiduciary relationship, they have in fact imported a separate duty of loyalty into their company law which has gained increasing significance. In the main this can be ascribed to the strong American influence after the Second World War and the increasing engagement of the firms with global capital markets.[156] For example, in Japan their imported USA-style fiduciary duty of loyalty has operated since the late 1980s in court practice after not having been used for decades. Similarly, Taiwan amended its company law in 2001 to recognise a separate duty of

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[152] Nicolas Howson, 'The Doctrine that Dared not Speak its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence' in Hideki Kanda, Kon-sik Kim and Curtis Milhaupt (eds), *Transforming Corporate Governance in East Asia* (Routledge 2008) 199-200.
[153] ibid 210.
[154] Lee (n 140) 908-909.
[155] Howson (n 152) 210-211.
[156] Howson (n 139) 8.

loyalty and making it clear that the 'mandate' relationship represents the duty of care for a faithful manager. These new developments had a strong influence in China and reduced the resistance of Chinese legal scholars who had used China's status as a civil-law jurisdiction to justify their rejection of the common-law concept of fiduciary duty.

Concluding Remarks

This chapter discusses legal transplant theories to lay out a theoretical foundation for the case study of China's transplantation of common-law fiduciary duties in its company law. In order to evaluate and explain the effectiveness of the transplantation case study, this chapter formulates an analytical framework based on the current legal transplant scholarship. Furthermore, to set the scene for the transplantation case study, this chapter introduces the historical background of how and why China introduced common-law fiduciary duties into its company law.

In current legal scholarship, various metaphors are used for conceptualising the legal transplantation phenomenon. Transplant metaphors thereby contribute useful heuristic devices for understanding legal transplantation as a dynamic, continuous, and complex process involving not only the moving of law from its source system, but also its adaption in the recipient system. On the other hand, it is debatable in the legal transplant scholarship over the feasibility for a legal rule to be transplanted from one country or legal system to another with a different social, economic, and political environment. The debate famously took place between Watson who insists that legal transplantation is 'socially easy', and legal sociologists and socio-legal writers who deny the possibility of legal transplants out of social and cultural context.

In contrast to the debate from a macro and overall perspective, evaluating the transplantation case study entails a nuanced approach. Based on theoretical assumptions derived from current legal transplant scholarship, an analytical framework is formulated for analysing the transplantation case study. There are five major factors influencing the effectiveness of legal transplantation: the transferability of a legal rule from the original legal system to the recipient legal system, the transplant adaptation made by law reformers in the recipient legal system when initially transplanting the rule, the enforcement adaptation made by local law enforcers when subsequently enforcing the rule, the local demand for the legal rule in the recipient society, and the knowledge of the rule by various actors in the recipient country. Moreover, the efficacy of the transplantation can be evaluated in three dimensions: the convergence dimension regarding the contents of the transplanted law; the operative dimension as regards how the transplanted rule is used in the recipient system; and the instrumental dimension regarding the functioning of the transplanted rule in the recipient country. This theoretical framework serves as an analytical tool for evaluating and explaining the effectiveness of China's transplantation of common-law corporate fiduciary duties.

Chapter 2: The Common-Law Concept of Fiduciary Duty

Introduction

The fiduciary duty is a core concept in Anglo-American corporate law for delineating the duties and responsibilities of directors and senior officers. Although of fundamental and pervasive importance, the concept of fiduciary duty is widely regarded as one of the most elusive, resilient, and flexible concepts even in the original common-law systems. Part of the reason for its elusiveness is that the concept is not unique to company law but is deeply embedded in the fiduciary doctrine in equity. As will be explored in detail in Chapter 5 of this thesis, one of the fundamental challenges with regard to China's transplantation of directors' and senior officers' fiduciary duties is that China only borrowed fiduciary duties and rules, such as the prohibition of self-dealing and exploitation of corporate opportunity, without transplanting its associated legal tradition such as equity supporting the sound functioning of the fiduciary duties in the company-law context.

The purpose of this chapter is to explore the concept of fiduciary duty to provide a conceptual perspective for the discussion of fiduciary duties in company law. Part I asks what functions the concept serves generally in society, and particularly in the corporate law setting. Part II considers the elusive nature of fiduciary duty arguing that its irreducible core idea is undivided loyalty and that fiduciary duties are standard-based default rules. Part III discusses the contents of fiduciary duty with a focus on the duty of loyalty. The curious status of the duty of care is also examined in this part. Part IV examines how the concept of fiduciary duty is embedded in common-law tradition of equity.

2.1 The Functions of the Common-Law Fiduciary Duty

The common-law concept of fiduciary duty serves some unique functions not only in the corporate context but also for the benefit of the entire society.

2.1.1 To Maintain the Integrity of Fiduciary Relationships

The first function of the common-law fiduciary duty is to maintain the integrity and utility of certain socially and economically important relationships.[157] When the concept of fiduciary duty was first invoked more than three hundred years ago, inter-personal associations in which people helped to manage the affairs of another became common in society.[158] In modern society, some economic interactions where people provide expert services to another also manifest the same kind of inter-personal mutual reliance.[159] These personal or commercial relationships have been very valuable in society since the earliest time as they promote social productivity and specialisation, and increase fiscal wealth and human knowledge.[160] For example, corporate directors' management of companies have greatly increased the wealth of shareholders as well as the society. On the other hand, these relationships are clearly based on a high level of trust but are susceptible to an equally high risk of abuse which can destroy trust. After all, people's affairs are in the hands of someone else who has expert knowledge and skills.

The fiduciary duty functions precisely to maintain these socially crucial relationships by removing the threat of mistrust that might otherwise undermine or even destroy such relationships.[161] The concept of fiduciary duty is designed to ensure the fiduciary's complete fidelity in managing the affairs of another through expert services. It thus allows people to trust fully in the honesty and integrity of their fiduciaries. The protection of trust consequently facilitates the preservation and promotion of human interdependence and specialisation within the society.[162] Moreover, although the aim of fiduciary duty is to protect fiduciary interactions, its ancillary effect is to protect the interests of people whose affairs are managed by others. In the corporate context, because the fiduciary duty of corporate fiduciaries offers meaningful protection to shareholders, investors are encouraged to invest in companies. The other side of the coin is equally true; without the functioning of the fiduciary duty, investors and the public at large would be unlikely to interact in these relationships perceived to be of value in society.

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[157] PD Finn, 'The Fiduciary Principle' in TG Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell 1989) 26.
[158] See Tara Helfman, 'Land Ownership and the Origins of Fiduciary Duty' (2006) 41 Real Property, Probate and Trust Journal 651.
[159] Tamar Frankel, *Fiduciary Law* (OUP 2011) 6-7.
[160] Leonard I Rotman, *Fiduciary Law* (Thomson Carswell 2005) 259, 302.
[161] Leonard I Rotman, 'Understanding Fiduciary Duties and Relationship Fiduciarity' (2017) 62 McGill Law Journal 975, 988.
[162] ibid 1021.

2.1.2 To Protect the Performance of non-Fiduciary Duties

The second function of the fiduciary duty is to improve the chances of proper performance of the non-fiduciary duties that comprise the fiduciary's undertaking by protecting against influences that might tempt him or her away from proper performance.[163] In light of the complexity of a fiduciary relationship, a fiduciary owes the fiduciary duty concurrently with non-fiduciary duties.[164] In the corporate setting, directors owe a set of non-fiduciary duties and responsibilities in managing the affairs of the company. The 'no-conflict' and 'no-profit' principles of the fiduciary duty serve to protect the due performance of non-fiduciary duties in cases where there involves a fiduciary's self-interest or self-benefit. For example, a director of a company owes a non-fiduciary duty to negotiate contracts on behalf of the company on terms most beneficial to the company. But if he or she has a personal interest in the transaction, for instance, he or she is also a principal in the firm selling the products in question, then he or she will not be able to perform his or her non-fiduciary duty because of improper influences arising from this personal and conflicting interest.

The function of the fiduciary duty in this regard is to strike at situations in which the fiduciary may be tempted to act in breach of the non-fiduciary duty. Specifically, the object of fiduciary principles is to remove or neutralise incentives that might tempt or otherwise motivate a fiduciary not to perform his or her non-fiduciary duties properly, in particular in situations where the wrong is more likely to occur, namely where the fiduciary's self-interest is involved. By doing so, the fiduciary duty operates to make committing wrong less likely. The protection provided by the fiduciary duty to non-fiduciary duties is thus preventative in nature.[165] Looking at it from this perspective, Birks describes the fiduciary duty as 'parasitic',[166] while Conaglen, more sensitively, terms it as 'subsidiary' to non-fiduciary duties.[167] They both indicate the function of the fiduciary duty is to ensure a fiduciary's due performance of his or her non-fiduciary duties and responsibilities.

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[163] Matthew Conaglen, 'The Nature and Function of Fiduciary Loyalty' (2005) 121 Law Quarterly Review 452, 480.
[164] See *Bristol and West Building Society v Mothew* [1998] Ch 1, 16-17.
[165] Ernest J Weinrib, 'The Fiduciary Obligation' (1975) 25 University of Toronto Law Journal 1, 5.
[166] Peter Birks, 'The Content of Fiduciary Obligation' (2000) 34 Israel Law Review 3, 29.
[167] See Conaglen (n 163).

2.1.3. To Address the Agency Problem and Reduce Agency Costs

The third function of the fiduciary duty is, in economic terms, to address the agency problem and reduce agency costs.[168] As fiduciaries manage the affairs of another through expert services, what economists term an 'agency problem' may arise when one person, the agent, exercises a discretion which is not readily observable and which affects the wealth of another person, the principal.[169] The losses and other inefficiencies associated with the misalignment of the interests of the principal and the agent are what economists call 'agency costs'. The key issue of the agency problem is that the agent may favour his or her own interests over those of the principal when their interests diverge. In other words, there is no guarantee that the agent will always act in the interests of the principal, particularly when the agent must exercise a discretion in ways that the principal cannot effectively observe or verify.[170] In the corporate context, for example, the manager may be focussed on an easy life, on-the-job perks, and empire building. Only he or she may be privy to how hard he or she works and to private information of the firm's profitability.[171] All these make it challenging for the principal shareholders, often widely dispersed, to be confident that their managers will always choose the actions or level of effort that best serves the shareholders' interests.

To limit the agent's discretion is not an option because the discretion is essential for him or her to manage the affairs of the principal and any limitation would undermine the object of retaining an agent.[172] It is also not feasible to dictate in advance how the agent should manage the asset in the beneficiary's best interests in that asset management necessarily involves risk and uncertainty.[173] Furthermore, actively to monitor the agent is not a solution to the agency problem not only because it is both impractical and costly, but also because the principal may lack the expertise to do so.[174] While some market mechanisms can provide incentives that might protect the principal and also ameliorate the agency problem – eg, professional

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168 See Robert Cooter and Benjamin Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 New York University Law Review 1045.
169 Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305, 308. The economic terms 'agent' and 'principal' do not refer to the legal terms in the common law of agency, but generally mean the fiduciary and the other party in a fiduciary relationship.
170 RH Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 Boston University Law Review 1039, 1042.
171 Oliver Hart, 'An Economist's View of Fiduciary Duty' (1993) 43(3) The University of Toronto Law Journal 299, 300.
172 Sitkoff (n 170) 1040-1041.
173 Cooter and Freedman (n 168) 1047.
174 Sitkoff (n 170) 1041.

associations, the market-contract regime, and incentive-based compensation arrangements – these cannot solve the agency problem entirely.[175]

The fiduciary duty is designed to reduce agency costs and ensure the fiduciary's complete fidelity in managing the affairs of another through expert services. More specifically, the fiduciary duty functions to address the agency problem through deterrence.[176] The agent is given broad discretionary powers to act on behalf of the principal, but the principal retains the right to scrutinise whether the agent has fulfilled his or her fiduciary duty, ie, has acted in the interests of the principal. The agent's failure to do so triggers a wide range of remedies, such as accounting for profits, which serve to deter the agent by the threat of liability based on *ex post* scrutiny of his or her actions.[177] From this we can see that the fiduciary duty reduces the need for people to monitor their fiduciaries and limits the risk of opportunism inherent in the agency problem.

2.1.4 To Fill Gaps in Incomplete Contracts

Fourthly, the contractarian approach to corporate law advocated by law and economics scholars posits that the fiduciary duty essentially functions as a gap-filler to help resolve the so-called 'incomplete contract' problem, rather than as a means of imposing inflexible moral standards on business parties or accommodating other public-policy considerations.[178] The incomplete contract theory argues that in a real world of inevitable transaction costs, information asymmetry and humans' bounded rationality, it is impossible for parties to draft contracts that cover all possible contingencies *ex ante*.[179] The parties may therefore follow the more efficient route of mapping out only the major aspects of the agreement and leaving non-specified issues to be resolved through some other means. How the law can help to reduce the incomplete contract problem is by providing default rules in which the terms that the parties would have negotiated in a world of zero transaction costs and unlimited foresight are set out.[180] Practically, courts could provide either a tailored provision aimed at providing the terms for which the

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175 Frankel (n 159) 30-35; Jean-Jacques Laffont and David Martimort, *The Theory of Incentives: The Principal-Agent Model* (Princeton University Press, 2002) 3.
176 Frank H Easterbrook and Daniel R Fischel, 'Corporate Control Transactions' (1982) 91 Yale Law Journal 698, 702.
177 Sitkoff (n 170) 1042-1043; Cooter and Freedman (n 168) 1051-1053.
178 Frank H Easterbrook and Daniel R Fischel, 'Contract and Fiduciary Duty' (1993) 36 Journal of Law & Economics 425, 430; Jonathan R Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 Stetson Law Review 23, 26-31.
179 Iain MacNeil, 'Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 Journal of Corporate Law Studies 107, 113-114.
180 Easterbrook and Fischel (n 178) 430.

specific parties before the court would have contracted; or alternatively, courts could seek an untailored default provision that corresponds to the majoritarian terms most parties would have chosen.[181]

The fiduciary duty is precisely this untailored default that serves to fill the blanks and provide rules and standards that most parties in the various fiduciary relationships would want.[182] In the corporate context, the economic theory conceptualises a firm as 'a nexus of contracts'[183] in that the duties of corporate fiduciaries cannot be exhaustively specified in the corporate contracts because anticipating and contracting all contingencies is impractical or extremely costly. The concept of fiduciary duty allows the courts to decide whether, given all the facts and circumstances, the fiduciary has acted in accordance with that to which the parties would have agreed had they anticipated those facts and circumstances.[184] In this regard, the fiduciary duty in fact enables the courts to complete the contract between the parties. As a consequence, the parties only need contract provisions covering important and anticipated contingencies and the fiduciary duty fills the gap as other contingencies in fact unfold.[185]

It thus can be seen that the common-law fiduciary duty functions to maintain the integrity and utility of fiduciary relationships, to ensure the due performance of non-fiduciary duties by fiduciaries, to address the agency problem and reduce agency costs, and to fill gaps in incomplete contracts between the parties. In spite of these important functions, the nature of the fiduciary duty is far from straightforward.

2.2 The Nature of the Common-Law Fiduciary Duty

This part critically analyses the nature of the fiduciary duty in its original common-law systems. Because the traditional fiduciary jurisprudence has yet to develop a unifying principle for the fiduciary relationship, the concept of a fiduciary duty is widely regarded as elusive.

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181 Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 Yale Law Journal 87, 91.
182 Mariana Pargendler, 'Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered' (2008) 82 Tulane Law Review 1315, 1325; Deborah A DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' (1988) 1988 Duke Law Journal 879, 879.
183 William Bratton Jr, 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989)74 Cornell Law Review 407, 446-465.
184 Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 90-93.
185 ibid.

2.2.1 The Elusive Nature of the Fiduciary Duty

The concept of a fiduciary duty originates from the long-standing common-law 'equitable fiduciary doctrine' which applies to all fiduciaries. The history of the fiduciary doctrine in English law dates back more than three hundred years,[186] and pleadings alleging breaches of the fiduciary duty are commonplace in all common-law jurisdictions. In general, the fiduciary doctrine provides that once a fiduciary relationship has been identified, the party occupying the fiduciary position in the relationship – the fiduciary – is subject to a fiduciary duty and a breach of this duty results in fiduciary liability and remedies.[187] It is because a fiduciary relationship is susceptible to abuse that courts of equity in common-law systems provide for control of the mischief through the imposition of the fiduciary duty.[188] Under the fiduciary doctrine, concepts such as 'fiduciary relationship', 'fiduciary', 'fiduciary duty', and 'fiduciary remedy' are so closely interwoven that a unified principle or theory of fiduciary duty is clearly desirable. However, although the fiduciary doctrine is deeply embedded in the common-law systems, the precise nature of the fiduciary relationship remains a source of constant confusion and dispute.

Courts have traditionally declined to provide any comprehensive definition of a fiduciary relationship, preferring to preserve flexibility in the fiduciary doctrine.[189] More recently, the courts' attempts to formulate the descriptors of a fiduciary relationship have resulted in 'bewilderingly disparate characterisations', such as inequity, vulnerability, repose of trust and confidence, and reliance.[190] These criteria are invariably vague or ambiguous, and critics have accused courts of having 'turned to whatever is appropriate in given circumstances'.[191] Similarly, academic commentators have formulated numerous theories to characterise the fiduciary relationship,[192] including the commercial utility theory,[193] the undertaking theory,[194] the reasonable expectations theory,[195] the power and discretion theory,[196] and the

[186] See *Keech v Sandford* (1726) Sel Cas T King 61, 25 ER 223 (Ch), the seminal case that is generally referenced as the first to express fiduciary principles in English law. Also see *Walley v Walley* (1687) 1 Vern 484, 23 ER 609 (Ch), the first fiduciary law case decided in England.
[187] See John (Barrister) McGhee *et al*, *Snell's Equity* (33rd edn, Sweet & Maxwell 2015) Chapter 7.
[188] Tamar Frankel, 'Fiduciary Duties as Default Rules' (1995) 74 Oregon Law Review 1209, 1215-1223.
[189] McGhee *et al* (n 187) 7-005.
[190] Paul B. Miller, The Identification of Fiduciary Relationships, in Criddle E J *et al* (ed), *The Oxford Handbook of Fiduciary Law* (OUP 2019) 374.
[191] Finn (n 157) 25.
[192] See J C Shepherd, *The Law of Fiduciaries* (Carswell 1982) 96; JC Shepherd, 'Towards a Unified Concept of Fiduciary Relationships' (1981) 97 Law Quarterly Review 51, 74–76.
[193] Ernest J Weinrib, 'The Fiduciary Obligation' (1975) 25 University of Toronto Law Journal 1.
[194] Austin W Scott, 'The Fiduciary Principle' (1949) 37 California Law Review 539; James Edelman, 'When Do Fiduciary Duties Arise?' (2010) 126 Law Quarterly Review 302.
[195] Finn (n 157). See also Paul D Finn, *Fiduciary Obligations* (Law Book Company 1977).
[196] Paul B Miller, 'A Theory of Fiduciary Liability' (2011) 56 McGill Law Journal 235.

entrustment theory.[197] None of the proposed theories has as yet gained wide traction in that they are either too over-inclusive in the sense that they fail to distinguish fiduciary relationships from non-fiduciary ones, or so under-inclusive that they exclude certain well-settled fiduciary relationships.[198] This explains why it has been famously observed that 'the fiduciary relationship is a concept in search of a principle'.[199]

On the other hand, some categories of legal relationship are well-established in common law as fiduciary *per se*, including the trustee/beneficiary, agent/principal, director/corporation, partners, and solicitor/client relationships. These relationships have long been recognised by the common-law courts as fiduciary in nature and are also regarded as such by society. Historically, these classic fiduciary relationships were established through a jurisprudence of analogy rather than principle.[200] For example, common-law courts identified the relationship between a director and the company as fiduciary based simply on sufficient similarity to the relationship between a trustee and *cestui que trust*. Consequently, it is fair to say that the status-based approach to fiduciary relationships in modern times rests on unreflective and unreasoned reliance on conventional wisdom.[201] Clearly, without a conceptual justification, this type of 'status' conception of fiduciary relationships cannot 'have any real explanatory power'[202] and thus can hardly mitigate the elusiveness of the fiduciary concept. Moreover, in the absence of an analytical construct for identifying fiduciary relationships, judges, although they have the rudimentary notion of the fiduciary concept to enable them to recognise a typically fiduciary relationship, clearly may run into problems in marginal cases.[203]

More significantly, the common-law countries have no agreed position as regards the nature of the fiduciary duty. All accept in general terms that a fiduciary duty is the standard of conduct expected of fiduciaries which serves to protect the beneficiary/principal/company, but they diverge in their understanding of the purport of this. The most contentious dispute involves the proscriptive or prescriptive nature of the fiduciary duty.[204] In the conventional conception the

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197 Frankel (n 159) Ch1.
198 Sarah Worthington, 'Fiduciary: When Is Self-Denial Obligatory?' (1999) 58(3) Cambridge Law Journal 500, 505.
199 Anthony Mason, 'Themes and Prospects' in P.D. Finn (ed), *Essays in Equity* (Law Book Company 1985) 246.
200 Sarah Worthington, *Equity* (2nd edn, OUP 2006) 129.
201 Miller (n 190) 370-373.
202 Edelman (n 194) 304.
203 Anthony Mason, 'The Place of Equity and Equitable Remedies in the Contemporary Common Law World' (1994) 110 Law Quarterly Review 228, 245.
204 See Darryn Jensen, 'Prescription and Proscription in Fiduciary Obligations' (2010) 21 King's Law Journal 333, 333-354; Remus D Valsan, 'Understanding Fiduciary Duties: Conflict of Interest and Proper Exercise of Judgement in Private Law' (PhD Thesis, McGill University, 2012) 34-56.

fundamental nature of the fiduciary duty is proscriptive rather than prescriptive. Proponents of this proscriptive view typically confine the sphere of fiduciary duty to the duty of loyalty, in particular the 'no-conflict' and 'no-profit' rules.[205] As a proscriptive duty, the fiduciary duty prevents fiduciaries from conflicts of duty and private interest or conflicts of duty and duty, and from making profits through their fiduciary position. They consider the positive duties to which fiduciaries are subject, despite their having been affirmed by courts as fiduciary duties, as non-fiduciary in nature.

The proscriptive view is clearly the dominant approach in British jurisprudence as courts rarely identify any duty which falls outside of the operation of the no-conflict and no-profit rules as fiduciary.[206] On the other hand, UK courts do not appear overly concerned with the proscriptive/prescriptive dichotomy itself. Only in the case of *Attorney-General v Blake* has the English Court of Appeal made it clear that 'equity is proscriptive, not prescriptive…It tells the fiduciary what he must not do. It does not tell him what he ought to do.'[207] Similarly, the proscriptive fiduciary duty is the dominant view in Australian jurisprudence with a long line of High Court authorities having ruled those fiduciary duties exclusively proscriptive.[208] In *Breen v Williams* the High Court of Australia clearly confined the realm of fiduciary duty to the no-conflict and no-profit rules, and rejected the plaintiff patient's claim of right of access to the records of her medical treatment based on the defendant doctor's fiduciary duty.[209] While this exclusively proscriptive approach was challenged in *Westpac Banking Corp v Bell Group Ltd* where Carr AJA observed that directors' duties 'to act bona fide in the interests of the company and to exercise their powers for proper purposes…have long been described as fiduciary obligations',[210] Derham ASJ soon reverted to the orthodox proscriptive view and described Carr AJA's observation as typically fiduciary 'standing in lonely isolation' in Australian jurisprudence.[211]

The proscriptive nature of the fiduciary duty is, in the main, grounded on its origin in equity. Traditionally, equity jurisdiction was concerned with preventing abuse through the harsh use

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205 Finn (n 157); Conaglen (n 163). Also see Robert Flannigan, 'The Core Nature of Fiduciary Accountability' (2009) 3 New Zealand Law Review 375.

206 See Robert Flannigan, 'The Boundaries of Fiduciary Accountability' (2004) 83 Canadian Bar Review 35.

207 *Attorney-General v Blake* [1998] Ch 439, 455.

208 The majority judgement of the High Court of Australia affirms that fiduciary obligations are proscriptive rather than prescriptive in nature; a quasi-tortious duty to act solely in the best interests of their principals is not imposed upon fiduciaries.

209 *Breen v Williams* (1996) 186 CLR 71.

210 *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)* (2012) 270 FLR 1, [1962].

211 See *Hoh v Frosthollow Pty Ltd* [2014] VSC 77.

of common-law rights not intervening to dictate a prescriptive standard of conduct.[212] In this regard, equity also provides remedies very different from those available at common law. In other words, the role of equity differs from that of the common law in that equity is proscriptive – it prohibits things rather than mandating them.[213] In the case of the fiduciary doctrine, equity forbids fiduciaries from acting for themselves, and, if they indeed do so, equity provides remedies as if they had acted for the beneficiary/principal/company. Another reason for the proscriptive view of fiduciary duty is that the fiduciary doctrine operates as a general practice in all common-law jurisdictions, predominantly by virtue of the functioning of the no-conflict and the no-profit rules. This has led at least some judges and academic commentators to equate fiduciary duties with the no-conflict and no-profit rules. In other words, they recognise nothing that falls outside the realm of these proscriptive principles as a fiduciary duty.[214]

In contrast to the proscriptive orthodoxy, the alternative view sees that the 'no-conflict' and 'no-profit' rules do not represent the full scope of the fiduciary duty. The prescriptive notion of the fiduciary duty is evident to varying degrees in both the law and theory of common-law countries, and in particular in the US and Canada. One approach to the prescriptive fiduciary duty is to acknowledge certain positive duties as fiduciary. Indeed, common-law courts have a track record of describing certain positive duties to which the fiduciary is subject in fiduciary terms. An example of this approach is the widely accepted practice in US jurisprudence of characterising the duty of care as a fiduciary duty[215] – although US courts do not appear unduly concerned with the proscriptive/prescriptive distinction of fiduciary duties.[216] The fiduciary duty of disclosure is also found in Canadian authorities who treat an adviser's duty to disclose material facts to his or her client as a fiduciary duty. For example, in *McInerney v MacDonald* the Supreme Court of Canada described physicians' fiduciary duty to provide their patients with access to information as typically fiduciary regarding the fiduciary scope of their interaction.[217] Such a prescriptive approach to fiduciary duties has also been embraced by some distinguished scholars. Frankel, in her encyclopaedic work on fiduciary law, adopts the approach of US courts in discussing fiduciary duties of loyalty and care.[218] Birks goes further and conceptualises the fiduciary duty as a compound duty with both prescriptive and

[212] David Hayton, 'Fiduciaries in Context: An Overview', in Peter Birks (ed) *Privacy and Loyalty* (OUP 1997) 286-292.
[213] PJ Millet, 'Equity's Place in the Law of Commerce' (1998) 114 Law Quarterly Review 214, 222-223.
[214] See Flannigan (n 205); Rotman (n 161).
[215] Cooter and Freedman (n 168) 1047.
[216] Rotman (n 161) 318-319.
[217] *McInerney v MacDonald* (1992) 93 DLR (4th) 415 (SCC).
[218] Frankel (n 159) Chapter 3.

proscriptive elements.[219] According to Birks, a trustee fiduciary duty transmissible to any fiduciary is 'an obligation to promote and preserve the interests of the beneficiary with the care and skill of a prudent person of business and to abstain from the pursuit of all interests which might conflict with that duty'.[220] Smith goes still further and argues that the comprehensive set of duties that a fiduciary owes to the beneficiary/principal/company are fiduciary duties.[221]

Another approach embodying a fundamental objection to the proscriptive orthodoxy, is the overarching notion of the prescriptive fiduciary duty. As a prescriptive duty, a fiduciary duty demands affirmative action, and the breach or non-breach of the fiduciary duty depends on the effects of that action. Canadian jurisprudence, without directly addressing the prescriptive/proscriptive debate, appears to articulate a prescriptive fiduciary duty to act in the best interests of the other party in a fiduciary relationship. In *Guerin v R*, a case involving the surrender of Aboriginal reserve lands for development, the Supreme Court of Canada held that the federal Crown holds a fiduciary duty 'to deal with the land for the benefit of the Indians'.[222] Academic commentators, too, have fashioned the fiduciary duty as a prescriptive model of general duty. Laby, viewing the proscriptive orthodoxy as too narrow, argues that 'the irreducible core of the fiduciary relationship is the fiduciary's obligation to adopt the principal's goals, objectives, or ends'.[223] According to Laby, adoption of the principal's objectives or ends, joined with the absence of a particular formula for achieving those ends, is 'the animating principle of fiduciary law'.[224] Similarly, Smith proposes a fiduciary duty to exercise judgement in what the fiduciary perceives to be the best interests of the beneficiary.[225] For Smith, this duty is not prescriptive because it does not prescribe any particular course of action, while it does prescribe how judgement, in an entirely subjective way, is to be exercised.[226]

The elusive nature of the fiduciary duty can be ascribed to the unique and complex character of a fiduciary relationship. The relationship between a fiduciary and the other party is complex because multiple legal relationships invariably and inextricably co-exist. Accordingly, in

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219 Birks (n 166).
220 ibid 28-29.
221 See Lionel Smith, 'Prescriptive Fiduciary Duties' (2018) 37 University of Queensland Law Journal 261.
222 *Guerin v R* (1984) 13 DLR (4th) 321 (SCC) 334. The prescriptive model of the Crown's fiduciary duty was further affirmed in other decisions of Supreme Court of Canada involving fiduciary consideration.
223 Arthur Laby, 'The Fiduciary Obligation as the Adoption of Ends' (2008) 56 Buffalo Law Review 99, 103.
224 ibid 146.
225 See Lionel Smith, 'Fiduciary Relationships: Ensuring the Loyal Exercise of Judgement on Behalf of Another' (2014) 130 Law Quarterly Review 608.
226 ibid.

addition to the fiduciary doctrine, some primary bodies of general law also constitute or govern the incidents of the relationship between the fiduciary and the other party, including contract law, tort law, and other non-fiduciary equitable doctrines.[227] These legal relationships co-exist in an intricate relation. First, a fiduciary relationship arises from the fiduciary's undertaking to act in the interests of another.[228] Second, the fiduciary undertakes so to act because of his or her responsibility to act for or on behalf of or in the interests of another in relation to a particular matter or aspect under a contract or nominated law.[229] Third, the fiduciary inevitably receives discretionary power to fulfil his or her undertaking from the other party's unilateral express authorisation.[230] It thus attracts some non-fiduciary equitable doctrines to govern the exercise of such power.[231] Fourth, tort law also intervenes to regulate the fiduciary's act in the interests of another with due care. The unique and complex character of the fiduciary relationship makes any theorising or generalisation extremely challenging, if not impossible. The lack of a clear and precise account of the character of a fiduciary relationship leads to equal uncertainty as to the nature of fiduciary duty.

2.2.2 Fencing and Rationalising the Nature of Fiduciary Duty

In spite of the elusiveness of the fiduciary duty concept, if it is properly fenced as a duty peculiar to fiduciaries, the nature of fiduciary duty as such can be better revealed.

The concept of fiduciary duty can be properly fenced as a duty peculiar to fiduciaries. As Millett LJ stated in *Bristol and West Building Society*, the expression 'fiduciary duty' is 'properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties'.[232] Despite the widely accepted complexity of a fiduciary relationship, it essentially creates a category of duty differing from and more demanding than that deriving from other bodies of law. It is because certain mischief peculiar to a fiduciary relationship cannot be addressed by other bodies of law that the fiduciary doctrine serves to provide equitable protection by

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[227] Finn (n 157) 28.
[228] See Edelman (n 194). The author argues that fiduciary relationships arise by construction of voluntary undertakings based upon consent.
[229] Jensen (n 204) 336-337. In rare cases, the fiduciary's responsibility to act for or on behalf of or in the interests of another also results from specific order or declaration of a court.
[230] See Paul B Miller, 'The Fiduciary Relationship' in Andrew S Gold and Paul B Miller (eds), *Philosophical Foundations of Fiduciary Law* (OUP 2014) 3. The author argues that fiduciary relationships arise upon the fiduciary's undertaking of a mandate under which he or she receives discretionary legal powers to be exercised for other-regarding purposes.
[231] See Richard Nolan, 'Controlling Fiduciary Power' (2009) 68 Cambridge Law Journal 293.
[232] *Bristol and West Building Society* (n 164) 16. See also *Attorney-General* (n 207) 455.

imposing the fiduciary duty on the fiduciary. Arguably the imposition of fiduciary duty is necessary only if without it other legal means would be ineffective in regulating the relationship – namely that, without it duties imposed by other bodies of law would be inadequate.[233] For example, a breach of fiduciary duty is subject to peculiar equitable remedies, such as accounting for profits, rather than mere compensation for financial loss.[234] In this regard, a fiduciary duty can be appropriately construed as a higher standard of conduct prescribed by equity.[235]

To label a fiduciary's duties imposed by bodies of law other than the fiduciary doctrine 'fiduciary duties' is conceptually unsound. For one thing, to attach a fiduciary label without fiduciary remedies points to a loose use of terminology.[236] It is rejected by common-law authorities as 'unthinking resort to verbal formulae'.[237] This is typically the case in describing some common-law duties as fiduciary without the back-up of equitable remedies. If use of the 'fiduciary' tag generally refers to equitable duties, the underlying distinctions between fiduciary and other non-fiduciary equitable duties would need further explication. It is thus preferable to adopt a narrow usage of the 'fiduciary' term as to do otherwise may cause great imprecision and confusion in the application of the fiduciary concept.[238] For another thing, to use the fiduciary label in an instrumental fashion rendering fiduciary remedies available for non-fiduciary civil wrongs, means rejecting the link between the fiduciary tag and particular remedies. This approach contributes nothing to the 'doctrinal purity of fiduciary law' and contravene the basic jurisprudential norm that rights and remedies are closely related.[239] If the meta-fiduciary duty is stretched to its limits, contract and tort law are displaced from their currently settled roles in many relationships and nominated law is rendered superfluous.[240] This could arguably be exactly what happens if the proposal of a general prescriptive fiduciary duty to act in the best interests of the beneficiary/principal/company whose breach depends on whether the other party's interests have actually been served, is adopted.

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[233] Worthington (n 198) 506.
[234] Charles Mitchell, 'Equitable Compensation for Breach of Fiduciary Duty' (2013) 66 Current Legal Problems 307, 307-308.
[235] Mason (n 203) 245.
[236] Worthington (n 198) 501-502.
[237] *Bristol and West Building Society* (n 164) 16.
[238] Worthington (n 198) 502.
[239] ibid 501.
[240] Finn (n 157) 27. See also John D McCamus, 'Prometheus Unbound: Fiduciary Obligation in the Supreme Court of Canada' (1997) 28 Canadian Business Law Journal 107, 115.

If the concept of fiduciary duty is properly fenced as peculiar to fiduciaries, the nature of the fiduciary duty as such is also better revealed. As widely agreed, the unique and critical feature of a fiduciary relationship is its other-regarding character.[241] In a fiduciary relationship the fiduciary acts to serve the interests of the other party. On the one hand, a fiduciary relationship concerns the interests of only one party to the relationship, not both. Unlike other legal relationships in private law, there is no mediation or balance between interests in a fiduciary relationship.[242] It is inaccurate simply to describe a fiduciary relationship as a relationship to protect the interests of the beneficiary/principal/company in that the fiduciary's own interests are in no way involved. One the other hand, a fiduciary relationship requires only one party to the relationship to act rather than both.[243] It is the fiduciary who must act in the interests of the other party in relation to a specific matter or aspect. The other party to the relationship is neither looking after his or her own interests in that matter, nor does he or she control or supervise the fiduciary's actions in any effective way. To take the corporate setting as an example, because of the separation of ownership and control, corporate directors act in the interests of shareholders without being effectively regulated or monitored.

Apparently, although the role of a fiduciary in a fiduciary relationship is to serve the other party's interests, the fiduciary's action is in fact not subject to effective supervision. As a consequence, the relationship demands a high level of trust and confidence, and the fiduciary holds a position of superiority over the other party.[244] A fiduciary relationship is thus susceptible to abuse in that the fiduciary may take advantage of his or her position of superiority – ie, the fiduciary may be swayed by self-interest or the interests of a third party. This mischief is clearly peculiar to a fiduciary relationship. In contrast, those kinds of mischief that the fiduciary may fail to perform his or her responsibility, or may improperly exercise his or her discretionary power, or may carelessly harm the interests of the beneficiary/principal/company, are not unique to a fiduciary relationship. Courts of equity in common-law systems therefore offer protection against the fiduciary's 'inappropriate use of a position of superiority' through

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[241] ibid. See also Mason (n 203); DG Smith, 'The Critical Resource Theory of Fiduciary Duty' (2002) 55 Vanderbilt Law Review 1399; *Bristol and West Building Society* (n 164) 18.
[242] Finn (n 157) 27.
[243] Mason (n 203) 245-246.
[244] See McGhee *et al* (n 187) Chapter 7.

the imposition of a fiduciary duty.[245] In this regard, the fiduciary duty is designed to secure the fiduciary's loyal services to the other party's interests.[246]

It thus can be seen that, in essence, a fiduciary duty prohibits the fiduciary from acting other than in the sole interests of the other party to the fiduciary relationship. In other words, the fiduciary may not 'serve any interest other than the beneficiary's, be this his own or a third party's'[247] – '[t]hought of self was to be renounced, however hard the abnegation'.[248] This is precisely the so-called 'single-minded loyalty' commonly referred to. On the other hand, if self-interest or the interests of a third party does not arise in the context of the fiduciary's action, there is no breach of the fiduciary duty irrespective of how improper the act or harmful the outcome may be. In this sense the fiduciary duty is clearly proscriptive rather than prescriptive. If the fiduciary acts obediently in the sole interests of the other party to the fiduciary relationship his or her fiduciary duty requires no 'special' action – the fiduciary duty ensures loyalty by preventing the fiduciary from acting disloyally.[249]

2.2.3 Fiduciary Duties[250] as Mandatory and/or Default Rules

Legal provisions are termed default rules when they apply only if the parties have not entered into an express agreement on how they should act in the event of a particular contingency, whilst mandatory rules leave no room for manoeuvre – the parties must conform.[251] At first blush the concept of a fiduciary duty appears mandatory in that it deters fiduciaries from serving any interest other than that of the principals. The mandatory nature is essential to compensate both for the absence of true bargaining between the parties and for the inevitable divergence of interests between the principals (company and shareholders) and their agents (corporate fiduciaries).[252] However, fiduciary duties, supposedly the most mandatory inner core of corporate law, have relaxed substantially over the years.[253] Some progressive scholars

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245 ibid 7-001.
246 Finn (n 157) 27.
247 ibid.
248 See *Meinhard v Salmon* 164 NE 545, 548 (NY 1928).
249 Millet (n 213) 222.
250 Although a fiduciary duty is a general duty, the term of 'fiduciary duties' is sometimes used to mean fiduciary principles or the duties as contents of fiduciary duty.
251 Reinier H Kraakman, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 18-19.
252 Melvin Aron Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461, 1462; Victor Brudney, 'Corporate Governance, Agency Costs, and the Rhetoric of Contract' (1985) 85 Columbia Law Review 1403, 1410-1411.
253 John C Coffee, 'The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role' (1989) 89 Columbia Law Review 1618, 1621.

who advocate the contractarian approach to corporate law have adopted the view that fiduciary relationships are nothing other than contracts. This means that the fiduciary duty is grounded in expressed or implied provisions of the agreements between the parties and enforced as a contractual obligation.[254] The middle ground that emerged from the debate between contractarian and anti-contractarian scholars appears to be that most fiduciary rules are more commonly categorised as default rules.[255]

Most areas of fiduciary law allow the parties a significant degree of discretion to alter the default regime. Fiduciaries may be exempted from their fiduciary duties if they fulfil certain mandatory conditions, for instance, if they have made full disclosure and obtained the informed consent from the beneficiary/principal/company. Moreover, fiduciary duties are, in Ayres and Gertner's phrase, 'untailored default' in the sense that they supply the parties with a 'single, off-the-rack standard that in some sense represents what the majority of contracting parties would want.'[256] Courts therefore do not inquire whether the specific directors before them would have agreed to a duty of loyalty. Fiduciary duties apply in all fiduciary relationships if the parties have not expressly agreed to the contrary. There are indeed good reasons for viewing fiduciary duties as default rules. Default rules are in the 'public good' in that they provide a standard-form contract which reduces the parties' planning and transaction costs and fills the gaps which the parties failed to address in their initial undertakings.[257] But if people wish to deviate from the default rules, they should be free to do so as private ordering between the parties will lead to more efficient outcomes, unless there are compelling reasons to hold them to the mandatory rules – in particular when beneficiaries' interests are well protected – by requesting fiduciaries to follow specific procedures and conditions.[258]

However, there is mandatory core to the fiduciary obligation that cannot be overridden by agreement. For example, the fiduciary cannot be authorised to act in bad faith. Also, the fiduciary must comply with all mandatory procedural and substantive safeguards before his or her fiduciary duties can be waived. In some circumstances, even if the procedures are followed and beneficiaries' have given their informed consent, courts and legislatures might refuse to

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[254] Henry Butler and Larry Ribsten, 'Opting Out of Fiduciary Duties: A Response to the Anti-contractrian' (1990) 65 Washington Law Review 1, 29-30. See also Mark P Gergen, 'The Use of Open Terms in Contract' (1992) 92 Columbia Law Review 997.
[255] MacNeil (n 179) 125-127; Frankel (n 188) 1211-1212.
[256] Ayres and Gertner (n 181) 91.
[257] Easterbrook and Fischel (n 178) 34-35.
[258] Frankel (n 188) 1234-1242. On a comprehensive analysis of the pros and cons of mandatory rules in the corporate context, see MacNeil (n 179) 121-123.

enforce waivers. Why parties should not have complete freedom to alter the terms of the fiduciary relationship is that the mandatory rules of fiduciary law serve an internal protective and cautionary function which protects the principal when doubts arise as to the quality of the beneficiaries' consent. There is also a need to preserve institutions in society that are based on trust.[259] In particular, it is argued that fiduciary rules should, in the main, be mandatory for publicly-held companies. This is because when compared to private fiduciaries, public fiduciaries have greater power for centralised management, public beneficiaries are passive investors so their consent is weak and indirect, and that the actions of public fiduciaries have a greater impact on the economy, the financial system, and society.[260]

2.2.4 Fiduciary Duties as Standards or Rules

The distinction between rules and standards is the extent to which efforts to give content to the law are undertaken *ex ante* or *ex post* individuals act.[261] A rule generally entails a prior determination of what conduct is permissible so that the adjudicator is left solely with factual questions. By contrast, a standard may leave both the specification of what conduct is permissible (or prohibited) and the determination of factual issues to the adjudicator. Fiduciary duties are by and large standards rather than rules.[262] Indeed, the fiduciary duty is an example of a highly incomplete law. The nature of a fiduciary duty such as undivided loyalty is clearly situation specific. It is impossible to specify *ex ante* whether, and exactly how, the fiduciary may act in self-interest or the interests of a third party in particular situations or circumstances. This broad and abstract proscription encompasses all actions by fiduciaries that hold the potential of violating the rights of beneficiaries/principals which are inherently difficult to circumscribe exhaustively. As Robert Clark puts it, as a residual concept, the fiduciary duty concept can include factual situations that no one has foreseen or categorised.[263] Therefore, the meaning of fiduciary duty cannot easily be specified in a detailed legal document. Attempts to do so will either leave out many actions or factual situations no one anticipated, or will be phrased so broadly that the meaning can be understood only in the context of specific cases.[264]

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[259] Eisenberg (n 252) 1046-1048.
[260] Frankel (n 188) 1253-1260.
[261] Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 Duke Law Journal 557, 560.
[262] Pargendler (n 182) 1321.
[263] Robert C Clark, *Corporate Law* (Little Brown 1986) 141.
[264] Katherina Pistor and Chenggang Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory' in Curtis J Milhaupt (ed), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (Columbia University Press 2003) 77, 78.

The fiduciary duty is thus 'moulded according to the nature of the relationship and the facts of the case'.[265]

But it must be noted that the law of fiduciary duty also embodies rules. Specific applications of fiduciary principles have over time been carved out and codified.[266] Consequently, the law is able to prescribe certain fiduciary actions with sufficient certainty *ex ante*. This is the case, for example, regarding interested transaction regulation and usurpation of corporate opportunities in the corporate law context. Indeed, one may argue that there are more cases where codification might be possible and desirable. What I should like to emphasise, however, is that those specific obligations that have not been codified or where codification still leaves room for ambiguity as to the scope and meaning of the law, will have to be identified by courts in the process of adjudication. Thus, a core feature of the fiduciary duty is the allocation of power to the courts which exercise law enforcement power reactively and make law *ex post*.[267] The case-law tradition in common-law system provides courts with such law enforcement flexibility as well as law-making power.

To summarise, the nature of fiduciary duty is, on the one hand, highly elusive and controversial even in its original common-law manifestation; one the other hand, if properly fenced, it can be fairly construed as undivided loyalty. The fiduciary duty so construed is a general duty characterised by situation-specificity and flexibility, while fiduciary principles and rules are largely standard-based default rules.

2.3 The Contents of the Common-Law Fiduciary Duty

Although a fiduciary duty is a general notion of duty, the operation of the fiduciary doctrine is not based on the general duty alone; the courts in common-law systems have included certain core principles and specific duties under the umbrella of the fiduciary duty. However, what should be included under this umbrella varies in the courts across jurisdictions and is also heavily debated among commentators. It is now generally accepted that the distinguishing obligation of a fiduciary is a duty of loyalty which entails the no-conflict and no-profit rules.

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[265] McGhee *et al* (n 187) 7-012.
[266] Sarah Worthington, 'Reforming Directors' Duties' (2001) 64 Modern Law Review 439, 455-456.
[267] Pistor and Xu (n 264) 99.

Other than this relatively clear core, the precise boundary of the content of the fiduciary duty remains largely unsettled in common-law systems.

2.3.1 Duty of Loyalty

It is the consensual view across jurisdictions and across theories in common-law systems that the duty of loyalty is the irreducible core of the fiduciary duty and the distinguishing duty of a fiduciary. This position, widely cited throughout the Commonwealth, is aptly captured by Millett LJ:

> The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.[268]

Academic commentators share the same consensus on the significance of the duty of loyalty. Even the most innovative academic commentators agree that the duty of loyalty is the core content of the fiduciary duty.[269] As discussed above, if the fiduciary duty is properly construed as a duty peculiar to fiduciaries, the content of a fiduciary duty so construed would be confined to the duty of loyalty only. As the irreducible core of fiduciary duty, any uncertainty or controversy as regards the duty of loyalty results directly from the elusiveness of the fiduciary-duty concept. Accordingly, the fiduciary duty of loyalty has attracted a wide range of explanatory accounts as we saw above. One view confines the duty of loyalty to the no-conflict and no-profit rules. The alternative view sees the duty of loyalty as a general notion standing independently of the no-conflict and no-profit rules. Even in this view, the proscriptive and prescriptive debate rages. This notwithstanding, the no-conflict and no-profit rules remain the incontrovertible core of the duty of loyalty.

2.3.1.1 No-Conflict and No-Profit Rules

The fiduciary doctrine generally operates on the basis of the no-conflict and no-profit rules. There are two strands to the no-conflict rule: the no-conflict of interest and duty rule; and the no-conflict of duty and duty rule. The no-conflict of interest and duty rule prohibits a fiduciary from acting in a situation where there is a conflict between the fiduciary's self-interest and his

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[268] *Bristol and West Building Society* (n 164) 18.
[269] Birks (n 166) 28-29.

or her duty to the beneficiary/principal/company.[270] It applies to situations where a fiduciary's self-interest either actually conflicts or possibly may conflict with his or her duty. On the other hand, if there is no duty owed to the beneficiary/principal/company in the circumstances, even if the fiduciary has a personal interest, there is no conflict between interest and duty and so no breach of the no-conflict rule. The second strand of the no-conflict rule prohibits a fiduciary from acting where there is a conflict between the duties owned by the fiduciary to multiple beneficiaries/principals/companies.[271] In contrast to the no-conflict rule, the no-profit rule prohibits a fiduciary from making a profit by virtue or in the course of his or her fiduciary position.[272] It can be seen that the no-conflict and no-profit rules are fiduciary principles aimed at excluding a fiduciary's self-interest and the interests of third parties from the fiduciary's consideration.

In general, the courts apply fiduciary principles to capture any breach of fiduciary duty and to grant fiduciary remedies accordingly. If a fiduciary breaches either of the two no-conflict principles or the no-profit principle without due authorisation, he or she is liable for breach of a fiduciary duty and fiduciary remedies will be triggered. Moreover, in addition to this general application, the courts have identified numerous instances in which fiduciary principles are commonly applied. The common situations in trust law, agency law, corporate law, and other contexts are, with some exceptions, essentially similar.[273] In the corporate-law context, such common situations include interested transactions, the misappropriation of corporate opportunities, property and information, multiple directorships, accepting commission and bribery. To address these common situations, fiduciary principles have evolved to include some specific fiduciary rules that have subsequently gained a separate existence.[274] One example is the self-dealing rule. However, if the facts do not fall within the ambit of a specific fiduciary rule, the no-conflict and no-profit principles are still in place to be applied.

The application of fiduciary principles in common-law systems is characterised by its strict nature. Generally, the no-conflict and no-profit principles operate rigorously with the result that a variety of factors that appear relevant are actually not considered at all in the application of fiduciary principles These include the fiduciary's good or bad faith; whether the

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[270] McGhee *et al* (n 187) 7-018.
[271] ibid 7-036.
[272] ibid 7-041.
[273] See ibid Chapter 7.
[274] Sitkoff (n 170) 1044-1045.

beneficiary/principal/company has suffered harm or loss; or even whether they have benefited or profited. The strict application of fiduciary principles was made clear in the seminal 1726 case of *Keech v Sandford* by Lord Chancellor King who stated that:

> This may seem hard, that the trustee is the only person of all mankind who might not have the lease; but it is very proper that rule should be strictly pursued and not in the least relaxed; for it is very obvious what would be the consequence of letting trustees have the lease on refusal to renew to the *cestui que* use.[275]

This statement suggests that the strict character of fiduciary principles is a deliberate design of law with sound rationales, despite it not being specifically stated in *Keech v Sandford*. Subsequently, leading fiduciary-law cases in common-law systems have followed the strict orthodoxy in applying fiduciary principles.[276] Although the strict nature of fiduciary principles is well-settled, it is not free from challenges from academics who argue for relaxing the strict application, in particular the disregard of 'good-faith'.[277] The 'mechanical application' is believed to cause 'hardship' to good-faith fiduciaries who should rather be encouraged than punished.[278] Other commentators question the rationality of the strict application of fiduciary principles in trust law[279] and corporate law.[280] To some extent, these commentators may have overlooked the essence of the strictness of fiduciary principles.

The strict nature of fiduciary principles is indeed intentional and duly justified. One rationale for the strict application of fiduciary principles regardless of plausibly relevant factors, is the problem of evidence. As explained in *Ex Parte Lacey* by Lord Eldon:

> [T]hough you may see in a particular case, that [the trustee] has not made advantage, it is utterly impossible to examine upon satisfactory evidence in the power of the Court, by which I mean, in the power of the parties, in ninety-nine cases out of a hundred, whether he has made advantage, or not.[281]

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275 *Keech v Sandford* (n 186).
276 See *Ex Parte James* 8 Ves 337, 345; *Aberdeen Railway Co v Blaikie Bros* [1843-60] All ER Rep 249; (1854) 1 Macq 461, 471; *Bray v Ford* [1896] AC 44, 51; and *Guth v Loft Inc* 5 A2d 503, 514 (Del 1939).
277 See Gareth Jones, 'Unjust Enrichment and the Fiduciary's Duty of Loyalty' (1968) 84 Law Quarterly Review 472; Lionel Smith, 'The Motive, Not the Deed' in Joshua Getzler (ed), *Rationalizing Property, Equity and Trusts: Essays in Honour of Edward Burn* (LexisNexis Butterworths 2003).
278 ibid 486.
279 John Langbein, 'Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?' (2005) 114(5) Yale Law Journal 929.
280 See John Lowry and Rod Edmunds, 'The Corporate Opportunity Doctrine: The Shifting Boundaries of the Duty and Its Remedies' (1998) 61 Modern Law Review 515.
281 *Ex Parte Lacey* (1802) 6 Ves 625, 627.

In essence, the evidential problem is epistemological rather than technical.[282] The concern is not about judicial techniques in evidence gathering, but about the availability and credibility of evidence in view of the fiduciary's superior position which allows him or her to conceal or colour not only misconduct but also relevant evidence resulting in a 'detection concern'.[283] If factors other than a fiduciary's objective act are considered relevant in the application of fiduciary principles, the fiduciary certainly can produce evidence to that effect. Moreover, given the myriad possibilities in reality, any inquiry as regards what would have happened must be speculative.[284] In short, the strict nature of fiduciary principles is grounded on the uniqueness of fiduciary relationships.

Another rationale for the strict character of fiduciary principles is their prophylactic function.[285] This means that the strict application of fiduciary principles – regardless of other plausibly relevant factors – is designed to secure due compliance with fiduciary principles by fiduciaries. It sends a message that all factors are irrelevant to the operation of fiduciary principles and should therefore not be taken into consideration by a fiduciary.[286] For example, a fiduciary is not supposed to consider the possibility of a 'win-win' situation for both him- or herself and the beneficiary/principal/company. Rather, if any factor is otherwise affirmed by the courts as an exception to the application of fiduciary principles, it is highly likely that the factor would eventually be used by the fiduciary as a means for self-benefit. Fundamentally, the strict character of fiduciary principles is justified on the fallibility of human nature. Since self-benefit is inherent in human nature, the strict application of fiduciary principles prevents and protects the fiduciary from temptation.[287] Furthermore, even good-faith fiduciaries can be subject to self-deception and thus unconsciously pursue self-interest whenever they see the opportunity.[288] Either because of their failure to resist temptation or because they are deluded, or both, the fiduciaries will then in all likelihood manipulate any legitimate factor to serve their interests.[289] In contrast, the absolute exclusion of those factors reduces the likelihood that

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282 David Kershaw, 'Lost in Translation: Corporate Opportunities in Comparative Perspective' (2005) 25 Oxford Journal of Legal Studies 603, 621-622.
283 Robert Flannigan, 'The Strict Character of Fiduciary Liability' (2006) New Zealand Law Review 209, 210-211.
284 Irit Samet, 'Guarding the Fiduciary's Conscience: A Justification of a Stringent Profit-Stripping Rule' (2008) 28 Oxford Journal of Legal Studies 763, 768-769.
285 Alternatively, this function is deemed a deterrent. The precise distinction of prophylaxis and deterrence see Lionel Smith, 'Deterrence, Prophylaxis and Punishment in Fiduciary Obligations' (2013) 7 Journal of Equity 87.
286 Samet (n 284) 772.
287 See *Harris v Digital Pulse Pty Ltd* (2003) 56 NSWLR 298, [413]. Heydon JA explained that fiduciary principles 'tend to prevent the disease of temptation in the fiduciary–they preserve or protect the fiduciary from that disease.'
288 Samet (n 284) 772-775. 'Self-deception' refers to a psychological mechanism that leads people to unwarrantedly hold the belief that is more conformable for them.
289 Flannigan (n 283) 213.

fiduciary principles will be breached. In this regard, the strict application serves a preventative function ensuring proper compliance with fiduciary principles by fiduciaries.

In effect, the strictness of fiduciary principles is part of the overall design of the fiduciary doctrine. In the overall structure, the fiduciary doctrine frames the fiduciary duty as a fiduciary's standard of conduct and designs fiduciary principles and remedies so as to secure the performance of fiduciary duty by the fiduciary. Firstly, the fiduciary doctrine frames the proscription on acting other than in the sole interests of the principal/beneficiary/company as the general fiduciary duty. As discussed above, the fiduciary duty requires a fiduciary's undivided loyalty and acting in the sole interest of the beneficiary/principal/company. Secondly, the fiduciary doctrine has adopted the no-conflict and no-profit principles denoting the proscription of other-regarding acts in a measurable manner. Because of the situation-specific character of the fiduciary duty coupled with the myriad of eventualities in practice, 'determining whether the agent's acts were other-regarding or self-regarding often proves to be a guessing game'.[290] Fiduciary principles apply to all situations in which a fiduciary can act in self-interest or the interests of third parties. Fiduciary principles are structured to provide benchmarks for both fiduciaries' conduct and fiduciary accountability.

Thirdly, fiduciary principles are applied strictly to secure the performance of the proscription of 'otherwise acting' by fiduciaries. As we have seen, the strict application of fiduciary principles serves a preventative function with regard to human nature. Yet, in essence the prophylactic function protects the performance of the general fiduciary duty and not only the fiduciary principles as such. Fourthly, fiduciary remedies are designed to render any other-interest action pointless and 'give-teeth' to the proscription on other-interest acts. Breach of the fiduciary duty leads to fiduciary liability and relief through range of fiduciary remedies, such as the accounting for profits, constructive trust, equitable compensation, and injunction.[291] The effect of these fiduciary remedies makes any profits or losses that result from a fiduciary's other-interest actions accountable to the beneficiary/principal/company. Consequently, both the strict character of fiduciary principles and the effect of fiduciary remedies serve to protect the due performance of fiduciary duties in a prophylactic way.

[290] Cooter and Freedman (n 168) 1049.
[291] See 2.4.3 for a detailed discussion of fiduciary remedies.

Other than the no-conflict and no-conflict principles, it is debatable whether the duty of loyalty embodies any other elements. Under Delaware's corporate law there is a mandated requirement of good faith as an element of the duty of loyalty by corporate fiduciaries.[292] Some academic commentators have also written to argue the element of good faith as part of the corporate duty of loyalty.[293] However, it is unclear what this element of good faith requires of the fiduciary or how it relates to the duty of loyalty.[294] Conceptually, the duty or notion of good faith is most often used to govern the exercise of power, either fiduciary or non-fiduciary, but is not linked to the fiduciary doctrine.[295] The good faith element of the duty of loyalty is thus not yet well-established in law or in theory. Therefore, the duty of loyalty as a fiduciary duty has core content consisting of the no-conflict and no-profit principles.

2.3.2 Duty of Care

In English law – like many other common-law jurisdictions including Australia and Canada – it has been firmly established that the duty of care is not part of the fiduciary duty but a matter for the general law of negligence.[296] As to the UK's position, Lord Millett LJ explained the rationale for categorising the duty of care as a non-fiduciary duty in the Court of Appeal's 1996 decision in *Bristol and West Building Society*:

> The expression 'fiduciary duty' is properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties. Unless the expression is so limited it is lacking in practical utility…[297]

Therefore, according to Lord Millett, the term fiduciary duty is reserved for those duties 'peculiar' to a fiduciary, which is the duty of loyalty.[298] By contrast, the duty of care is regarded as not distinctively fiduciary because many persons, by virtue of the law or their own contractual undertakings, owe duties of care to other persons with whom they have non-

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292 See *Stone v Ritter* 911 A2d 361 (Del 2006).
293 See Hillary A Sale, 'Delaware's Good Faith' (2004) 89(2) Cornell Law Review 456; Andrew S Gold, 'The New Concept of Loyalty in Corporate Law' (2009) 43(2) UC Davis Law Review 457; Leo E Strine Jr *et al*, 'Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law' (2010) 98(3) Geo LJ 629.
294 See Melvin A Eisenberg, 'The Duty of Good Faith in Corporate Law' (2006) 31(1) Del J Corp L 1; Stephen M Bainbridge, Star Lopez & Benjamin Oklan, 'The Convergence of Good Faith and Oversight!' (2008) 55(3) UCLA Law Review 559.
295 Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010) 40-44.
296 Matthew Conaglen, 'Interaction between Statutory and General Law Duties Concerning Company Directors Conflicts' (2013) 31 Company and Security Law Journal 403, 405.
297 *Bristol and West Building Society* (n 164) 16.
298 See 2.2.2 for detailed discussion on how to limit the nature of the fiduciary duty in this way.

fiduciary relationships, such as a pharmacy to its customers or a driver to people in her vicinity.[299] It has nothing to do with any position of advantage on the side of a fiduciary or vulnerability on the side of the beneficiary/principal/company. It is not a duty that stems from the requirements of trust and confidence imposed on a fiduciary. Moreover, the distinction between the fiduciary duty of loyalty and the non-fiduciary duty of care can be drawn by the availability of equitable remedies: restitutionary or restorative remedies are only available when the fiduciary duty of loyalty is breached. In corporate law, a breach of the duty of care attracts standard remedy of compensation to recompense the company for the harm caused to it by the director's breach.[300] Section 178 of the Companies Act 2006 makes this distinction clear by providing that all other duties 'with the exception of the duty to exercise reasonable care, skill and diligence' are enforceable in the same way as any other fiduciary duty owed to a company by its directors.[301]

Contrary to almost all other common-law jurisdictions, in the US both the duty of loyalty and the duty of care are characterised as fiduciary duties. The rationale for this position has never been explicitly stated in law, although it appears that US law's divergence from other common-law jurisdiction dates from the earliest of times. In US corporate law, corporate directors' duty of care can be traced back to *Charitable Corporation v Sutton*,[302] one of the earliest reported English cases decided in 1742. Here, the court found that the directors of a charitable corporation, although they had not participated in the wrongs, had failed to monitor the loan procedures of the corporation in making unsecured loans to fellow directors. The Lord Chancellor held that 'by accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it…'[303] Based on the standard of reasonable diligence, the directors were held liable for the resulting loan losses as their actions constituted gross negligence. Ever since this earliest case, the duty of care together with the duty of loyalty are commonly referred to as fiduciary duties in US law and practice.

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[299] DeMott (n 182) 915.
[300] Paul L Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2016) 495.
[301] Companies Act 2006 s 178.
[302] *The Charitable Corporation v Sutton* [1742] 2 Atk 400, 9 Mod Rep 349. The two reports have some differences and the quotations are taken from both reports.
[303] ibid 406.

The fiduciary duty of care has also not been justified as a matter of doctrine or normative theory. The centrality of loyalty to fiduciary law has raised scepticism as to the nature of directors' duty of care, a parallel duty to the duty of loyalty designed to address a fiduciary's negligent management of corporate assets.[304] A number of US corporate law scholars have criticised the US practice labelling it 'a perversion of words' and concluding that this conceptual confusion is responsible for the recurrent over-enforcement of the duty of care in Delaware courts.[305] On the other hand, certain scholars argue that, although the duty of care owed by fiduciaries does tend to share important characteristics with duties of care owed outside of fiduciary relationships, the duty of care takes on special attributes which reflect the fiduciary context. For example, in corporate law if economic efficiency demands, directors' duty of care (including the extent of liability) can be relaxed by agreement and courts tend to under-enforce the duty of care.[306] These special features make duty of care in corporate law less demanding and less vigorously enforced than tort duties of care and may help to justify a fiduciary duty of care.[307]

As fairly commented, the English view is properly supported by sound principle, and the US view practically supported by the imperative of economic dominance.[308] For current purposes, as the nature of fiduciary duty has been duly fenced – as we saw in the previous part – to the proscription of the fiduciary's other-interest action, the duty of care can clearly not properly be included in this notion of fiduciary duty and is thus not part of the fiduciary duty so construed. This also reflects the law of most common-law jurisdictions other than the US.

There are certain other duties that have on occasion been labelled 'fiduciary' primarily because they are also duties that fall to fiduciaries, for instance, the duty to exercise power for a proper purpose. The nature of these duties differs from that of the fiduciary duty. 'Not every breach of duty by a fiduciary is a breach of fiduciary duty.'[309] To summarise, in light of the elusiveness of the fiduciary concept, the content of fiduciary duty is also subject to divergence

304 Andrew S Gold, 'The Loyalties of Fiduciary Law' in Gold and Miller (n 230) 176. See also *Meinhard v Salmon* (n248) 546.
305 Christopher M Bruner, 'Is the Corporate Director's Duty of Care a "Fiduciary" Duty? Does it Matter?' (2013) 48 Wake Forest Law Review 1027, 1039-1051.
306 Julian Velasco, 'A Defense of the Corporate Law Duty of Care' (2015) 40 Journal of Corporation Law 647, 678.
307 See John CP Goldberg, 'The Fiduciary Duty of care' in Evan J Criddle, Paul B. Miller and Robert H Sitkoff (eds), *The Oxford Handbook of Fiduciary Law* (OUP 2018).
308 Robert Flannigan, 'A Fiduciary Duty of Care for Canada' (2018) 134 Law Quarterly Review 368, 369.
309 *Bristol and West Building Society* (n 164) 18.

and confusion. Nevertheless, the duty of loyalty, and in particular its fiduciary principles, undeniably constitute the irreducible core of fiduciary duty.

2.4 The Context of the Fiduciary Duty Concept in Common-Law Systems

This part examines how the concept of the fiduciary duty is embedded in the equity tradition of common-law systems. It is submitted that equity, in which the concept of fiduciary duty originated, serves as the philosophical and institutional foundations of the concept. In other words, equity constitutes the most important context of the idea of a fiduciary duty in common-law systems.

2.4.1 Equity Tradition in Common-Law Systems

The concept of the fiduciary duty originated in English equity jurisdiction. The equity jurisdiction of the Court of Chancery existed in English law from the fourteenth century until its abolition by the Judicature Acts of 1873 and 1875 when it started to infiltrate the common-law jurisdiction.[310] Jurisdictions following the English common-law system inherited the English equity tradition, although they differ somewhat in their subsequent treatment of equity. In the US, the Equity Rules of 1912 and the Law and Equity Act in 1915 merged the common-law and equity jurisdictions although in effect the merger applied in procedural rather than substantial areas.[311] Notably, the Chancery Court of Delaware is still a separate court of equity operating under an equitable dispensation. In this sense, equity refers to a body of doctrines and remedies that developed from the equity jurisdiction of the Court of Chancery in the English legal system.[312] These doctrines and remedies still have certain unique characteristics that stem from their origins in equity jurisdiction.

The distinctive features of equity jurisdiction can best be revealed from an historical perspective. Equity jurisdiction in England originally emerged to ensure full justice in special cases where the common law failed to address the true merits of a case because of its rigor or harshness.[313] The Chancellor traditionally intervened on the ground of conscience and granted

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[310] Holdsworth, *A History of English Law* vol 1 (Methuen & Co Ltd 1956) 400–404. 'Common law' here refers narrowly to the jurisdiction in which could only award money damages and recognised only the legal power of property.
[311] Frankel (n 159) 262-263.
[312] Mason (n 203) 238.
[313] John H Baker, *An Introduction to English Legal History* (5th edn, OUP 2019) 135-144.

relief to abuse of conscience, although the meaning of conscience kept evolving during the evolution of equity jurisdiction.[314] Initially, conscience referred to knowledge of facts that the Chancellor could rely on in deciding cases. The Chancery jurisdiction of fraud, accident, and confidence, as described at the time, actually referred to doctrines highly dependent on the inquiry of the parties in terms of their private knowledge of facts in cases.[315] In deciding these cases, the Chancellor adopted a flexible fact-finding approach during the judicial process for the sake of true justice. Later, the conception of conscience in equity shifted to a moral standard to which the defendant was subject when enforcing his or her common-law rights. Conscience as a moral standard not only justified the equity intervention, but also provided the Chancellor with a substantial discretion in dispensing justice. The equity jurisdiction during this period was thus alleged to be an unprincipled system of justice based on the Chancellor's discretion.[316]

Subsequently, because of the repeated practice of Chancellors applying the same principles in deciding all cases, the moral standards of conscience were gradually developed in a principled and systematic manner and became formalised equitable doctrines.[317] Ultimately, these equitable doctrines evolved into fixed principles with an equivalent degree of technicity to those of the common law, while justice based on the Chancellor's discretion was relegated to the history books and a matter for reproach in Chancery.[318] Accordingly, any appeal to conscience or justice without reference to a specific doctrine as ground of recovery became insufficient to justify relief in courts of equity. Similarly, moral standards of behaviour other than those recognised in developed equitable doctrines were not recognised as a basis for deciding cases in courts of equity. On the other hand, in light of the historical development, the concept of conscience as a moral standard and the substantial and procedural justice with flexibility and discretion have been enshrined in the formalised equitable doctrines.

2.4.2 Equity as Philosophical Foundation for the Fiduciary-Duty Concept

The fiduciary doctrine is one of the equitable doctrines originating in equity jurisdiction and therefore has some identifying characteristics stemming from its equity beginnings. Doctrinally, the concept of a fiduciary duty is situation-specific, flexible, and based in morality all of which

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[314] See Dennis R Klinck, *Conscience, Equity and the Court of Chancery in Early Modern England* (Ashgate 2010).
[315] McGhee *et al* (n 187) 1-008.
[316] Thomas Audley, *Sources of English Legal History* (Butterworths 1986) 104.
[317] Klinck (n 314).
[318] McGhee *et al* (n 187) 1-013.

constitute the hallmarks of equity. For one thing, the standard-based and situation-specific character of the fiduciary duty results from its equity origin. As described above, equity originally served a secondary or complementary role to ameliorate the rigor and harshness of common-law jurisdiction and ensure justice in special cases. In this regard, equity itself can be deemed, in a functional sense, a decision-making model targeting opportunists who may abuse structural gaps in common-law jurisdiction.[319] The interstitial nature of equity's function makes it inevitable that the Chancellor worked in a flexible manner with a wide discretion, either in an earlier procedural or later substantial sense. As a consequence, even those gradually formalised equitable doctrines take the form of substance-over-form principles or standards resistant to precise definition. As Smith comments, '[e]quity is an all-purpose anti-avoidance standard, and fiduciary law not unexpectedly partakes of this approach'.[320] Such situation-specific standards are of necessity flexible in their application based on the facts and circumstances in any given case.

For another thing, as a higher standard of conduct, the concept of fiduciary duty reflects morals in the sense that fiduciary relationships are other-regarding and the fiduciary duty is altruistic.[321] In the history of English equity, conscience was conceptualised as moral standards which subsequently evolved into formalised equitable doctrines. In this regard, morality is inevitably reflected in equitable doctrines. As famously endorsed by Judge Cardozo in *Meinhard v Salmon*, fiduciaries are held to the 'the punctilio of an honour the most sensitive'.[322] On the other hand, the significance of the morality reflected in the fiduciary-duty concept is more rhetorical than substantial. As mentioned above, the common-sense standards of morality as the basis of the Chancellor's discretionary justice were condemned at the time of their introduction. Since the fiduciary duty is today delicately conceptualised, the moral rationalisation has by and large lost significance.

It thus can be seen that the close link between the concept of a fiduciary duty and the equity tradition in common-law systems is more than a mere path dependence; it is also philosophical and functional.

319 Henry E Smith, 'Why Fiduciary Law Is Equitable' in Gold and Miller (n 230) 262-272.
320 ibid 273.
321 Alexander Styhre, 'What We Talk About When We Talk About Fiduciary Duties: The Changing Role of a Legal Theory Concept in Corporate Governance Studies' (2018) 13(2) Management & Organizational History 113, 127.
322 *Meinhard v Salmon* (n 248) 546.

2.4.3 Equity as Institutional Foundation for the Fiduciary-Duty Concept

Fiduciary doctrine opens up a comprehensive range of remedies for breach of a fiduciary duty, including the accounting for profits, proprietary constructive trust, rescission of resultant transactions, equitable compensation, and injunction.[323] First, the remedy of accounting for profits is crucial to fiduciary liability and perhaps the most important of the fiduciary remedies. It requires a fiduciary to account for profits obtained in breach of his or her fiduciary duty and which actually accrue to the beneficiary/principal/company. Second, under constructive trust the court may decide that the defendant fiduciary holds gains from breach of his or her fiduciary duty as if they were held in trust for the beneficiary/principal/company. For this remedy to be granted, relevant gains need to take the form of specific property or a specific sum of money rather than a general award of profits which is the case in accounting for profits.[324] For example, a constructive trust may be awarded as regards a corporate opportunity exploited by a director of a company. This remedy is advantageous because it is a proprietary remedy and may ensure the beneficiary/principal/company priority in bankruptcy.[325] Third, the remedy of rescission applies to rescind a transaction entered into by a fiduciary in breach of his or her fiduciary duty. The fiduciary's breach in effect renders the transaction voidable rather than void. The recission remedy is available even if the transaction has been executed or even where the property has changed in value, although the courts may refuse to grant rescission in respect of a transaction that is fair and enforceable.[326]

Fourth, equitable compensation as a remedy is an offshoot of the accounting for profits and arises when the accounting of loss by the beneficiary/principal/company arises from the fiduciary's breach of the no-conflict principles.[327] For this remedy to be awarded, there must be a causal link between the loss suffered by the beneficiary/principal/company and the breach of no-conflict principles. Despite of its similarity to the paradigmatic remedy of damages in tort, equitable compensation is in essence different – although the extent to which the courts acknowledge the difference depends largely on their familiarity with equity.[328] Fifth, resort to

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323 McGhee *et al* (n 187) Ch7 sec 6.
324 Samuel L Bray, 'Fiduciary Remedies' in Evan J Criddle *et al* (ed), *The Oxford Handbook of Fiduciary Law* (OUP 2019) 454-455.
325 ibid 455-456.
326 Such considerations of fairness in a remedial sense significantly influenced how the regulation of interested transactions evolved in US history. See 4.1.1 for details.
327 Matthew Conaglen, 'Equitable Compensation for Breach of Trust: Off Target' (2016) 40 Melbourne University Law Review 126, 127.
328 Bray (n 324) 457.

an injunction as a remedy is not often successful. In cases where a fiduciary serves multiple clients whose interest may potentially conflict, a prohibitory injunction may be granted against the fiduciary to prevent him or her from continuing to act. However, corporate fiduciaries who breach their fiduciary duty in this way can instead be removed from office. Notwithstanding this complex confusion as to their classification as legal or equitable, fiduciary remedies are equitable in both origin and essence.[329]

The distinctive attributes of fiduciary remedies are characteristic of equity. Firstly, fiduciary remedies are flexible to provide appropriate relief for breach of fiduciary duties. Since equity provides an extensive range of remedies for breach of the fiduciary duty, the courts will grant fiduciary remedies appropriate to the facts and circumstances of the case before them. In fact, the courts commonly award multiple remedies in a single decision, though they must ensure that there is no double recovery.[330] Significantly, in case of alternative and inconsistent remedies the beneficiary/principal/company is entitled to elect the remedy that is to his or her advantage.[331] Overall, fiduciary remedies are advantageous because they are equitable. As Birks points out, the dangers in over-extending the concept of 'fiduciary' can be based on the desire to ensure a proprietary remedy.[332] Secondly, as equitable remedies, fiduciary remedies in effect require performance. The extensive range of fiduciary remedies discussed above requires the fiduciary to perform his or her fiduciary duty by force of law.[333] For example, the accounting for profits in effect serves as the enforcement of the fiduciary's compliance with the fiduciary duty.[334] This performance-requiring character results from their equity pedigree. As Lord Millett explains, equity adopts what 'may be described as the "good man" theory of law', even when a fiduciary acts in self-interest rather than in the interests of the beneficiary/principal/company, equity insists on approaching the situation as if the fiduciary had acted in accordance with his or her duty.[335] Clearly, such performance-requiring character of fiduciary remedies can only be seized based on sufficient familiarity with relevant features of the equity jurisdiction.

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329 ibid 464-466.
330 David Heydon *et al*, *Meagher, Gummow and Lehane's Equity: Doctrines and Remedies* (5th edn, Lexis Nexis 2015) 909.
331 McGhee *et al* (n 187) 7-052.
332 Peter Birks, 'Restitutionary Damages for Breach of Contract: Snepp and the Fusion of Law and Equity' (1987) Lloyd's Maritime and Commercial Law Quarterly 421, 438-439. See also Finn (n 157) 56.
333 Bray (n 324) 463-464.
334 Joshua Getzler, '"As if" Accountability and Counterfactual Trust' (2011) 91 Boston University Law Review 973, 978. See also Peter Devonshire, 'Account of Profits for Breach of Fiduciary Duty' (2010) 32 Sydney Law Review 389, 394.
335 Sir Peter Millett, 'Bribes and Secret Commissions' (1993) 1 Restitution Law Review 7, 20.

Third, as equitable remedies, fiduciary remedies are not intended to be punitive.[336] Fiduciary remedies function to limit any advantageous effect resulting from a fiduciary's breach of his or her fiduciary duty and not to punish the fiduciary. For example, when the courts exercise their discretion in awarding an account of profits, the accounting should not unjustly enrich the beneficiary/principal/company. The non-punitive character of fiduciary remedies conforms to the rudimental methodology of equity. As referred to the historical development of equity, the Chancellor traditionally intervened to grant justice not to inflict a penalty. Equity 'tries to correct injustice, but without doing injustice to the defendant. It tries to prevent injustice not through an adjustment of the costs and benefits perceived by the defendant, but through an adjustment of the defendant.'[337] Given the other-regarding feature of a fiduciary relationship, there is no basis for punitive remedies as they tend to cause injustice to fiduciaries and may reduce their incentives to serve others' interests.

Concluding Remarks

The chapter discusses the common-law fiduciary duty in terms of its functions, nature, contents, and its context in equity. It provides a conceptual basis not only for the discussion of fiduciary duties and rules in UK and US corporate law in Chapters 3 and 4, but also for revealing how the concept of fiduciary duty is embedded in common-law legal tradition and what exactly are the challenges posed to Chinese law reformers and enforcers in the transplantation of common-law corporate fiduciary duties.

The concept of a fiduciary duty serves important functions in society as well as in the corporate-law context. In society, the fiduciary duty maintains the integrity of fiduciary interactions that are socially and economically important. In the corporate setting, the fiduciary duty secures the proper performance of corporate directors' and officers' non-fiduciary duties and responsibilities, reduces agency costs, and fills the gaps in incomplete contracts between a company and its shareholders and corporate fiduciaries.

In the absence of an agreed definition of the fiduciary relationship, the nature of fiduciary duty remains elusive. My analysis shows that the fiduciary duty is proscriptive rather than

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336 Heydon *et al* (n 330) 865.

337 Samuel L Bray, 'Punitive Damages Against Trustees?' in Gordon Smith and Andrew Gold (eds), *Research Handbook on Fiduciary Law* (Edward Elgar 2018) 201, 214.

prescriptive; that the fiduciary duty embodies standard-based default rules; that the duty of loyalty is the irreducible core of the fiduciary duty; and that the fiduciary duty is deeply embedded in the equity tradition peculiar in common-law systems. All these distinctive features of the fiduciary duty raise fundamental challenges when the duty is transplanted in a civil-law country such as China.

Chapter 3: The United Kingdom's Model of Corporate Fiduciary Duties

Introduction

The equitable fiduciary doctrine has operated in the corporate context to impose fiduciary duties on corporate directors from the earliest times in the UK, to establish and develop the law on interested transactions and corporate opportunities in a history spanning more than two hundred years, and to allow for the dynamics of the current law of corporate fiduciary duties. The corporate fiduciary law originated in the UK, while US law was itself a product of legal transplantation. The UK model of corporate fiduciary duties therefore serves as not only a leading model, but also an original model of law. It thus provides authoritative and valuable law model for China's transplantation.

This chapter examines fiduciary duties in UK company law with a view to answering the flowing questions: (1) How has UK corporate fiduciary law evolved to its current model since the earliest time? (2) Who owe fiduciary duties to whom in UK company law – ie, who stand in corporate fiduciary relationships? (3) What are the principal fiduciary duties and rules in UK company law as an exemplary model of corporate fiduciary duties? These three key questions are discussed and answered in Parts I, II and III respectively. By answering these questions, a picture of the UK model of corporate fiduciary law is drawn as a leading model in common-law systems. This part lays the foundation for a comparative and critical evaluation of the appropriateness of the law in China.

3.1 Fiduciary Duties in UK Company Law: Historical Developments

With a view to delineating how the contents and contours of fiduciary duties have evolved in UK company law, this part divides the historical developments into three main stages. In the first stage, Chancery Courts identified corporate directors as fiduciaries and applied the equitable fiduciary doctrine in the company context to establish the directors' duty of loyalty. In the second stage, courts first applied fiduciary principles establishing the rule on self-dealing and the doctrine of corporate opportunity. Subsequently, the law on self-dealing transactions and corporate opportunities evolved through the long history of case law from the mid-nineteenth century to modern times. The third stage addresses the codification of fiduciary principles and rules as part of directors' general duties in the Companies Act 2006.

3.1.1 The Introduction of Fiduciary Duties in Company Law

In the context of the emergence of the earliest corporate forms of business and the office of director in these early companies, courts of equity applied the fiduciary doctrine in the corporate setting establishing the fiduciary status of corporate directors.

Even before any substantial company law, the office of director featured early forms of companies. In the sixteenth century the earliest English 'companies' were incorporated through the grant of royal charters to engage in monopoly trade overseas. By mid-seventeenth century some of the chartered companies had evolved into 'joint stock' companies which operated for the profit of their members rather than for government purposes.[338] There was then an expansion of domestic companies in the form of joint stock companies or, more frequently, partnerships with joint stock. In fact, at that time the distinction between these business forms was far less clear than it is today. It was in these early companies that by the close of the seventeenth century the expression 'director' was first generally used and replaced the term 'assistant' used in chartered companies.[339] One example of the companies which adopted the position of director is the Bank of England.[340]

The expansion of domestic companies was followed by a boom in company speculation and flotation which resulted in the notorious South Sea Bubble. In 1720, the Bubble Act, as the first 'legislation of companies', was adopted to make it illegal for undertakings to act as a corporate body unless they were chartered companies either under an Act of Parliament or by royal charter.[341] The Bubble Act was condemned as 'deliberately [making] it difficult for joint stock societies to assume a corporate form'.[342] On the other hand, the legislation allowed for some grey areas in the case of partnerships leading to a rise in 'deed-of-settlement' companies which were in essence partnerships but operated, with legal innovation, to approximate companies.[343] It was typical that under a deed of settlement the management of the affairs of the company was delegated to a committee of directors, whilst the property of the company was vested in a

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338 Colin Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press 1950) Chapter 4.
339 See Ronald Ralph Formoy, *The Historical Foundations of Modern Company Law*, vol 8 (Sweet and Maxwell 1923).
340 Franklin A Gevurtz, 'The Historical and Political Origins of the Corporate Board of Directors' (2004) 33 Hofstra Law Review 89, 110-111.
341 Ron Harris, 'The Bubble Act: Its Passage and Its Effects on Business Organization' (1994) 54 The Journal of Economic History 610, 614.
342 William Searle Holdsworth Sir, *A History of English Law* (Methuen & Co 1903) 219-220.
343 LCB Gower *et al* (eds), *Gower's Principles of Modern Company Law* (4th edn, Sweet & Maxwell 1979) 32-33.

body of trustees. In this regard, the office of director became permanent in a deed-of-settlement company as a popular business form at the time.

In 1844, the Joint Stock Companies Act which established the principal building blocks of the modern company law was adopted. The significance of 1844 Act was two-fold: first, it drew a legal distinction between incorporated companies and unincorporated partnerships; and second, it provided a system for incorporation through registration as opposed to an Act or charter.[344] Following 1844 Act, there were three forms of company: the chartered company; the deed-of-settlement company; and companies registered under the 1844 Act.[345] The 1844 Act defined directors as 'persons having the direction, conduct, management, or superintendence of the affairs of the company'.[346] Subsequently, the Joint Stock Companies Act 1856 introduced major elements of modern company law. These Companies Acts gradually enabled the advantages of incorporated companies to exceed those of partnerships. With most deed-of-settlement companies registered and incorporated pursuant to the Companies Acts, the office of director was formalised and fixed in companies and persists to this day.

The flexibility of equitable principles to meet new circumstances meant that in cases where corporate directors failed properly to fulfil their responsibilities, courts of equity applied the equitable fiduciary doctrine to establish the fiduciary status of corporate directors. As Lord Thurlow stated: '[I]f a confidence is reposed, and that confidence is abused, a court of equity shall give relief.'[347] It was on this basis that the law of trusts emerged very early on as a distinct branch of fiduciary law. With the office of director firmly in place in early companies, courts of equity were also open to making equitable principles available in the corporate context. *The Charitable Corporation* in 1742 was the first reported case to clarify the legal status of the office of director and its attendant duties.[348] In this case, when certain of the officers committed fraud in the lending upon pledges business of the corporation through fictitious pledges and caused prodigious loss, the corporation filed proceedings to recover its loss not only from the fraudulent officers, but also from the seven committee-men (directors) on the

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344 The Joint Stock Companies Act 1844.
345 Gower *et al* (n 343) 41.
346 The Joint Stock Companies Act 1844 s 3.
347 *Gartside v Isherwood* (1788) 1 BroCC 558, 560.
348 *The Charitable Corporation* (n 302).

basis of breach of trust.[349] Lord Hardwicke LC identified the director's office as 'a private office in trust for other people' and further stated that:

> [By] accepting of a trust [that are committed by others], a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it, but that it was merely honorary; and therefore they are within the case of common trustees.[350]

The court thereby drew an analogy to 'common trustees' affirming the fiduciary nature of a director's office and held that directors as fiduciaries owe duties of fidelity and reasonable diligence.

As in *Sutton*, the early cases during this period in courts of equity typically regarded the director's position as an office of trust and held directors liable on the basis of general breach of trust. In the 1842 case of *Benson v Heathorn*, directors were held to be the persons to whom 'exclusively the entire management of the company's affairs was entrusted'.[351] In *York and North-Midland Rly Co v Hudson*, it was held that 'directors are persons selected to manage the affairs of the company, for the benefit of the shareholders; it is an office of trust…'[352] The specific acts of misconduct in early reported cases could involve 'not making use of the proper power invested by the charter',[353] 'receiving out of the funds of the company for commission and brokerage',[354] 'dispos[ing], for his own benefit, of property of the company',[355] 'acting beyond the scope of the trust delegated to them',[356] or 'ultra vires'.[357] As can be seen, in early case law 'breach of trust' could involve all forms of a directorate misbehaviour including both fiduciary and non-fiduciary breaches. The relief offered by courts of equity at this time was to a large extent based on discretion rather than concrete rules.[358]

In early cases, courts of equity invariably drew an analogy between 'trustees' and 'directors' when establishing the fiduciary status of corporate directors and applying equitable principles in the corporate context. In *Hudson*, the court explained that shares entrusted to directors by

[349] ibid.
[350] ibid 355.
[351] *Benson v Heathorn* (1842) 1 Y&CC 326, 356.
[352] *York and North-Midland Rly Co v Hudson* (1845) 16 Beav 485, 491.
[353] *The Charitable Corporation* (n 302).
[354] *Benson v Heathorn* (n 351).
[355] *Hudson* (n 352) 504.
[356] *Grimes v Harrison* (1859) 26 Beav 435, 446.
[357] *Joint Stock Discount Company v Brown* (1869) LR 8 Eq 381.
[358] LS Sealy, 'Fiduciary Relationships' (1962) Cambridge Law Journal 69, 70.

shareholder resolution must be disposed in the interests of the company just as trustees dealt with trust property for the benefit of their *cestuis que trust*.[359] The actual control of the property of the company resulted in judges seeing directors as analogous to trustees of the property.[360] The analogy to 'trustees' was intended to illustrate the fiduciary nature of directors' position in a company, as well as to impose fiduciary duties on directors.[361] Insofar as directors and trustees are both fiduciaries, their positions are analogous.

The analogy to 'trustees' applied at the level of fiduciary principles and was not intended to impose the technical trust-law rules on directors. Trusts had enjoyed a dominant position in the history of fiduciary law for centuries before courts started to decide corporate cases on equitable principles. In the early stages fiduciary principles were all trust principles by which directors' liabilities were initially determined.[362] In *Aberdeen Railway v Blaikie*, Lord Cranworth LC equated directors with agents and trustees to explain the application of the no-conflict principle.[363] General principles in equity were applied broadly to both trustees and directors to hold them subject to the same liabilities. However, equity judges refused to extend the strict rules governing trusts to directors.[364] Case law revealed that directors and trustees originally had functional differences which became increasingly marked due to the commercial factors.[365] In the early twentieth century, in *Re City Equitable Fire Insurance Co*, Romer J began to state that while directors and trustees were both fiduciaries, the duties of a director bore little resemblance to those of a trustee.[366]

In these earliest cases, the terms 'trust' or 'trustee' were actually used in a broad sense to mean 'fiduciary'. It was commonly stated by courts that directors had accepted a 'trust' to become a 'trustee' and therefore should be responsible for 'breach of trust'. However, it was apparent from the legal reasoning in these cases that these terms did not carry technical meanings as in the law of trusts. Because of the limitations of the legal vocabulary of the day, judges would use no other terms.[367] Before general principles gave way to detailed rules, simple legal terms

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359 *Hudson* (n 352) 491.
360 Mark Arnold, 'General Duties of Directors' in Simon Mortimore (ed), Company Directors: Duties, Liabilities, and Remedies (3rd edn, OUP 2017) 243. See also *Re Lands Allotment Company* [1894] 1 Ch 616, 631.
361 Simon Mortimore, 'Historical Introduction to the Law Relating to the Duties and Liabilities of Directors' in Simon Mortimore (ed), *Company Directors: Duties, Liabilities, and Remedies* (3rd edn, OUP 2017) 8.
362 LS Sealy, 'The Director as Trustee' (1967) Cambridge Law Journal 83, 86.
363 *Aberdeen Railway* (n 276) 252-253.
364 See eg, *Re Forest of Dean Coal Mining Company* (1878) 10 Ch D 450.
365 Sealy (n 362) 86.
366 *Re City Equitable Fire Insurance Co* [1925] Ch 407, 426.
367 Sealy (n 362) 85.

such as 'trust' and 'confidence' were adequate to reason the equity law.[368] This feature once resulted in a long-standing misunderstanding that directors were trustees in the strict sense in the early companies.[369] In fact, from the very beginning when directors emerged in the earliest companies, the offices of directors and trustees have been dealt with separately and have involved different functions. In the process of formulating concrete rules in various branches of fiduciary law, general words used when principles of equity were applied with great discretion, had to be replaced by standard technical terms.[370] Then when the words 'trust' or 'trustee' came to be identified as technical terms in the law of trusts, there was 'considerable uncertainty' as to whether other fiduciary situations could still use these terms.[371] Equity judges gradually began to refine their terminology until the expression 'fiduciary' was widely recognised from the mid-nineteenth century. In company-law cases, for instance *Hudson* and *Aberdeen Railway*, the courts began to use the term 'fiduciary' in their judgments. Eventually, the term 'fiduciary' was accepted as descriptive of all relationships which resemble trusts.

3.1.2 The Evolution of Corporate Fiduciary Duties in Case Law

In a long history stretching from mid-eighteenth century to the enactment of Companies Act 2006, fiduciary duties and rules evolved continuously, primarily in case law. Initially, fiduciary principles were applied in the company-law context to establish the self-dealing rule and the corporate-opportunity doctrine. The subsequent development of the law on interested transactions and corporate opportunity diverged significantly. The corporate opportunity doctrine developed within the ambit of fiduciary no-conflict and no-profit principles. In contrast, the law on self-interested transactions developed independently of the strict no-conflict principle taking the route of contracting-out of the self-dealing rule in UK companies' articles of association.

As the starting point of the UK's interested transaction regulation during the mid-eighteenth century, both statutory and case law prohibited directors from dealing with their companies without shareholder approval. The Joint Stock Companies Act 1844 provided that if a company

[368] Sealy (n 358) 70.
[369] See GW Keeton, 'The Director as Trustee' (1952) Current Legal Problems 11, 13; G A Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press 1950) 110-111.
[370] Sealy (n 358) 70-71.
[371] ibid 71.

intended entering into a contract or dealings in which any of its directors were directly or indirectly interested,

> …such contract or dealing shall be submitted to the next general or special meeting of the shareholders to be summoned for that purpose; and such contract shall not have force until approval and confirmed by the majority of votes for the shareholders present at such meeting.[372]

In effect this statutory provision rendered self-dealing contracts void absent shareholder approval. This mandatory rule was later abandoned in the Joint Stock Companies Act 1856 and the Companies Act 1862, which in effect made directors' self-dealings subject only to the case-law rule.[373]

In the case of *Aberdeen Railway*,[374] citing *Keech v Sandford*[375] and *Ex Parte James*,[376] the House of Lords applied the no-conflict principle to establish the self-dealing rule in the corporate-law context. The Law Lords decreed that self-dealing contracts are voidable at the option of the company regardless of their fairness or unfairness to the company. In *Aberdeen Railway* a chartered company purchased iron railway chairs from a partnership in which one partner was also the company's chairman of directors. The company then repudiated the contract in court claiming that the self-dealing nature of the contract rendered it unenforceable.[377] Lord Cranworth provided the classic formulation of the prohibition on self-dealing between a corporate fiduciary and the company:

> No one, having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect.[378]

The court found when a director deals with the company, he or she breaches the no-conflict principle in that the director's self-interest would conflict with his or her duty to act to best

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[372] Joint Stock Companies Act 1844 s 29. In contrast to the common-law self-dealing rule, this statutory rule only applied to joint stock companies and not to other forms of company regulated by other statutes at that time.
[373] In *Re Cardiff Preserved Coal and Coke Company (Ltd)* (1862) 23 LJ Ch 154 it was confirmed that 'no statutory enactment was required to invalidate a contract between a director and the company'.
[374] *Aberdeen Railway* (n 276).
[375] *Keech v Sandford* (n 186). The case laid out the rule that a trustee or agent entrusted with a sale (of land) should not contract for the benefit of himself.
[376] *Ex Parte James* (n 276).
[377] *Aberdeen Railway* (n 276).
[378] ibid 252.

promote the interests of the company.[379] The strict application of the no-conflict principle admits no inquiry into the merits of a self-dealing contract. Lord Cranworth points out that '[s]o strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into'.[380] This case in effect established the self-dealing rule prohibiting a director from dealing with the company in the absence of shareholder approval.

In commercial reality the self-dealing rule in *Aberdeen Railway*, however, proved impractical and inadvisable. In cases where companies could also benefit from self-dealing transactions, an outright ban on self-dealing contracts turned out not to be in the interests of the company. To seek shareholder approval for self-dealing contracts on a case-by-case basis can be administratively burdensome. Directors were 'unwilling to suffer the delay, embarrassment and possible frustration entailed by having to submit all such contracts to the company in general meeting'.[381] Consequently, it became common for companies to include in their articles of association a variant of the standard terms to allow for directors' self-dealings with the company.[382] In this regard, the modified term provided that the director's office would not be vacated only if he or she had disclosed the interested transaction or the transaction had been approved by disinterested directors. Such variants of constitutional terms in effect permitted interested transactions subject to relevant procedural requirements. Companies in the UK thereby contracted out of the common-law self-dealing rule by virtue of their corporate articles of association. However, companies not providing for such permission for directors' self-dealing in their articles of association, the self-dealing rule in *Aberdeen Railway* still served as the default rule.

Later, contracting out of fiduciary self-dealing rule was judicially affirmed in the Court of Appeal case of *Imperial Mercantile Credit Association v Coleman* where a director of a company purchased railway debentures at a five per cent commission and sold them to the company at a 1.5 per cent commission, and the company liquidator then sued the director for account of profits.[383] The court held that the defendant director was not liable to account for

[379] ibid 252-253. To be specific, according to the court the director's 'duty to the company imposed on him the obligation of obtaining these iron chairs at the lowest possible price', while his 'personal interest would lead him in an entirely opposite direction - would induce him to fix the price as high as possible'.
[380] ibid 252. See 2.3.1.1 for details on the strict character of fiduciary principles.
[381] Gower *et al* (n 343) 586.
[382] David Kershaw, *The Foundations of Anglo-American Corporate Fiduciary Law* (CUP 2018) 315-316.
[383] *Imperial Mercantile Credit Association v Coleman* (1873) LR 6 HL 189; (1870-1871) LR 6 Ch App 558.

profits because the company had adopted the articles-of-association permission for director's self-dealing and the director had duly disclosed the transaction and obtained approval from the disinterested board.[384] When deciding the case, the court first confirmed the no-profit principle as 'so firmly established that I should be extremely sorry to say anything which would in the slightest decree impeach it', but then acknowledged that 'the application of the principle is not always so easy' in the face of commercial practice and reality.[385] In discussing whether companies could contract-out of general rules of equity, the court pointed out that courts of equity had to 'lay down certain general rules', whilst companies could 'form their own contracts and engagements'.[386] The court thus made it clear that the self-dealing rule was 'open to contract between the parties' and construed the articles as 'a contract to which the rule of equity is not applicable'.[387] This case confirms the legality of contracting-out of the fiduciary self-dealing rule by modified constitutional terms which require, for example, the interested director's disclosure or/and disinterested board approval.[388]

Imperial Mercantile in effect made articles-of-association permission of director's self-dealing increasingly pervasive in UK companies. By the late nineteenth century, the great majority of UK companies had conditionally excluded the fiduciary self-dealing rule through modified constitutional terms.[389] This applied to companies large and small, public and private, and seemingly without distinction with regard to the self-dealing risk they posed.[390] As contracting-out under the articles of association became commonplace in companies, the fiduciary self-dealing rule in effect should not weigh heavily on directors. This form of self-regulation of interested transactions, however, subsequently proved inadequate and led to some adverse societal effects. For example, the practice of modified constitutional terms in UK companies was on occasion extreme culminating in article of association provisions on self-dealings waiving 'any obligation to disclose or abstain from voting'.[391] In response, the Companies Act 1929 was adopted and required directors to disclose their interest in any

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[384] ibid.
[385] ibid 566.
[386] ibid 568.
[387] ibid 570.
[388] It is worth noting that what *Imperial Mercantile* confirmed was that the self-dealing rule can be contracted-out of by shareholders of a company in any form they regard as appropriate.
[389] Timothy W Guinnane *et al*, '*Contractual Freedom and Corporate Governance in Britain in the Late Nineteenth and Early Twentieth Centuries*' (2017) 91(2) Business History Review 227, 269.
[390] ibid 227, 239-240 and 246-257.
[391] John H Farrar and Susan Watson, 'Self-Dealing, Fair Dealing and Related Party Transactions-History, Policy and Reform' (2011) 11 Journal of Corporate Law Studies 495, 514.

contract or proposed contract to their fellow directors and imposed a fine for failure to do so.[392] The statute therefore imposed a mandatory duty of disclosure on self-dealing directors as their minimum standard of conduct. This statutory duty to disclose, however, had no effect on the operation of the default self-dealing rule in common law, and also did not restrict companies' capacity to adopt modified constitutional terms as regards directors' self-dealings.[393] On the other hand, with the disclosure of interested transactions compulsory, UK companies tended to craft the terms of their articles of association around this requirement.

Significantly, Table A of the Companies Act 1985 included a term exempting the self-dealing rule if interested directors disclosed their interests in a self-dealing transaction to their fellow directors. As is clear from Table A, by fulfilling the duty to disclose the interested directors would not be accountable to the company for any profit and the relevant interested transaction or arrangement would not be avoided.[394] Since Table A set out model articles of association that applied by default to companies, directors' duty to disclose in effect became the foremost rule in the regulation of interested transactions. This was subsequently confirmed by the English and Scottish Law Commissions during the company law review which found that the 'informed consent [of interested transactions] is frequently given in the articles of association, but contingent on disclosure [by directors]'.[395] Furthermore, in the last quarter of the twentieth century, statutes started to regulate particular categories of interested transactions including substantial property transactions, loans, and contracts of employment. For example, as a 'hasty legislative response' to a series of scandals in the 1970s, the Companies Act 1980 made the validity of those transactions subject to approval by members.[396] These provisions were later incorporated in Part X of the Companies Act 1985 which turned out to be burdensome and was thus revised in the company law reform.

In contrast to the shift away from the fiduciary doctrine in the law on self-interested transactions, the corporate-opportunity doctrine developed within the framework of the no-conflict and no-profit principles over the long history of case law. In *Regal (Hastings) Ltd v*

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392 Companies Act 1929 s 149. Such section can be seen as the precursor of Companies Act 1948 s 199, Companies Act 1985 s 317, and the Companies Act 2006 ss 177 and 182.
393 Andrew F Tuch, 'Reassessing Self-Dealing: Between No Conflict and Fairness' (2019) 88 Fordham Law Review 939, 964.
394 Companies Regulations 1985 (Tables A to F) art 85.
395 The Law Commission and Scottish Law Commission, Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties - A Joint Consultation Paper (1998, Law Com No 153, Scot Law Com No 105) ('Law Commissions, *Consultation Paper*') 77.
396 Mortimore (n 361) 21. Companies Act 1980 ss 47-61.

Gulliver,[397] relying on *Keech v Sandford*[398] and *Ex Parte James*,[399] the House of Lords applied the fiduciary no-profit principle strictly in assessing the directors' exploitation of the corporate opportunity. In this case a company owned a cinema and the directors decided to lease two other cinemas through a subsidiary. When the landlord of two cinemas offered to grant the lease only if the rent was guaranteed by the directors or the subsidiary with a paid-up capital of £5,000. The directors assessed that the company was able to invest £2,000 at most in the subsidiary and decided that the balance of £3,000 should be found by the directors and the company's solicitor.[400] When the directors later sold their shares in the parent and the subsidiary to a third party as a single business, they made a profit as shareholders in the subsidiary. The court applied the no-profit principle and held that because the directors had obtained the shares of the subsidiary company by virtue of their directorship and in the course of the execution of the office as directors, they were liable to account for profits made.[401] The House of Lords applied the no-profit principle strictly despite the defendant directors having acted in good faith and in the interests of the company in that 'the only way to finance the matter was for the directors to advance the balance'.[402]

In the later leading corporate-opportunity case, *Boardman v Phipps*,[403] the House of Lords applied both the no-profit and the no-conflict principles to directors' exploitation of a corporate opportunity. Here a solicitor for the trustees of a will and a beneficiary of the trust, as representatives of the trustees,[404] used information acquired in their agent-fiduciaries capacity when dealing with the trust's minority shareholding in the company – they, for example, attended the general meeting of shareholders – to facilitate their personal acquisition of the company's shares and made a substantial profit from the acquisition.[405] The conduct of the two agent-fiduciaries was in good faith, and they kept one of the trustees informed of their purchase of the shares throughout the different phases of the transaction, although they failed to obtain the valid consent of all trustees. The House of Lords applied both the no-conflict and the no-profit principles and, in a majority decision, found the two agent-fiduciaries liable to

397 *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.
398 *Keech v Sandford* (n 186).
399 *Ex Parte James* (n 276).
400 *Regal (Hastings)* (n 397).
401 ibid.
402 ibid 139.
403 *Boardman v Phipps* [1967] 2 AC 46.
404 In this case, the appellants stood in a fact-based relationship with the company.
405 *Boardman* (n 403).

account for the profit made.[406] It should further be noted that the judges agreed on the applicable principles and differed only as to their application to the facts of the case.

The subsequent development of corporate-opportunity law reveals an increasing prominence of the no-conflict principle. In two similar cases – *Industrial Development Consultants Ltd v Cooley*[407] and *Bhullar v Bhullar*[408]– UK courts applied the no-conflict principle[409] to address the acquisition by directors of information regarding a business opportunity in their private capacities. In *Cooley*, the court applied the no-conflict principle to hold that a director who is offered and pursues a business opportunity in which the company is interested in his or her private capacity, has a duty to pass the opportunity on to the company. In *Cooley* the managing director of a company whose duties included procuring business for the company was offered a commercial opportunity in his private capacity.[410] The company had in fact been involved in unsuccessful negotiations for the same opportunity. Being required to contract personally and personally only, the managing director obtained his release from the company by dishonestly representing his ill health, and subsequently exploited that opportunity for his own benefit.[411] The court held that as the opportunity was of interest to the company and relevant for the company to know, the director had a duty to pass the information on to the company. Failing to do so rendered the director liable for breach of the no-conflict principle.[412] According to the court, the fact that the company would not have benefitted from opportunity had the director fulfilled his duty is irrelevant.[413]

In *Bhullar*, the opportunity was not one which the company had been pursuing or was even interested in as the board had decided to acquire no further property. In this case, a company whose objects included the acquisition of property for investment had acquired Springbank Works, an investment property.[414] The company was a family company. Relations between the two families broke down and they were in the process of negotiating the division of the assets and business of the company. In a board meeting, directors from one family stated that they were opposed to the company acquiring any further properties and other directors from

406 ibid.
407 *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443.
408 *Bhullar v Bhullar* [2003] 2 BCLC 241.
409 Since the opportunity came in private capacity, the no-profit principle is of not much use in this case. Info acquired in private capacity can hardly be said to be by reason of or in the course of directorship.
410 *Cooley* (n 407).
411 ibid 445.
412 ibid 453.
413 ibid.
414 *Bhullar* (n 408).

the other family accepted the suggestion in principle.[415] The defendant directors subsequently learned of and purchased in their personal capacities White Hall Mill, a property adjacent to Springbank Works, through a company they controlled. Finding *Cooley* the most relevant authority on the facts, the Court of Appeal adopted an approach virtually identical to that in *Cooley*. The court held that since 'the opportunity to acquire the property would have been commercially attractive to the company, given its proximity to Springbank Works', the opportunity was information which was relevant for the company to know, the directors were therefore under a 'duty to communicate it to the company'.[416] The court therefore held the directors liable for breach of the no-conflict principle. Again, whether the company 'could or would have taken that opportunity, had it been made aware of it' was held to be irrelevant.

With regard to the situation where directors exploit a commercial opportunity acquired in their private capacity, *Cooley* and *Bhullar* have in effect established UK's status-approach to the corporate-opportunity doctrine. Addressing whether the director acted in a fiduciary relationship with the company when acquiring information of a commercial opportunity in his or her private capacity, the courts in both *Cooley* and *Bhullar* held that the director had 'at the material time, one capacity and one capacity only in which he was carrying on business at that time' – ie, as director of the company.[417] These two cases affirm directors' fiduciary status regardless of whether or not the opportunity arose in their personal capacities. The fiduciary status consequently triggers the application of the no-profit and no-conflict principles to breach of fiduciary duties in corporate opportunity. These two cases thereby established the UK's status approach to the corporate opportunity doctrine. In *Ultraframe (UK) Ltd v Fielding*,[418] the High Court affirmed that the no-conflict and the no-profit principles must be considered independently as two strands of the fiduciary duty. Subsequent development in the UK corporate-opportunity doctrine is characteristic of the continuous application of both the no-conflict and no-profit principles to multifarious facts and circumstances arising in case law.

3.1.3 The Codification of Fiduciary Duties in the Companies Act 2006

The final stage of the legal development of the UK's corporate fiduciary duties is the codification of case law fiduciary duties in the Companies Act 2006 (CA2006). Generally

[415] ibid 244.
[416] ibid 256.
[417] *Cooley* (n 407) 451. *Bhullar* (n 408) 255.
[418] *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch).

speaking, the significance of such codification to the development of corporate fiduciary law is two-fold: the restatement of fiduciary duties in statutory law; and legislative reform of pre-existing case law.

The Company Law Review and the subsequent enactment of CA2006 have been the most recent and substantial move in the long-lasting company law reforms in the UK. In March 1998 the Department of Trade and Industry launched the most comprehensive review of the entire system of core company law in UK's history. The aim of this mammoth review was to produce 'a framework which is up-to-date, competitive and designed for the century, a framework that facilitates enterprise and promotes transparency and fair dealing'.[419] The government appointed the Company Law Review Steering Group (Steering Group) to manage the review to ensure an outcome that would be 'clear in concept, internally coherent, well-articulated and expressed, and workable'.[420] The general process was to consolidate pre-existing legislation and draft the biggest single statute in UK's legal history. When the company law review was announced in March 1998, the English and Scottish Law Commissions (Law Commissions) had already embarked on a review of directors' duties.[421] The Law Commissions worked to examine the law on directors' duties so as to make recommendations to the Steering Group as part of the company law review. The review work on directors' duties, both fiduciary and non-fiduciary, can generally be divided into two parts. First, was the statutory statement of directors' duties which previously existed mainly in case law. Both Law Commissions and the Steering Group strongly recommended this restatement which was subsequently endorsed by the parliament.[422] Second, reforms to the provisions regulating directors' self-interested transactions in the Companies Act 1985 which had to be modernised and rationalised.[423]

Codification is not a new issue in common-law jurisdictions. One of the statutory duties of the Law Commissions is to 'consider whether the law can usefully be codified'.[424] The proposed legislative statement of directors' duties, both fiduciary and non-fiduciary, was based on some important considerations. The first is to provide clear and accessible guidance for directors to

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[419] Department of Trade and Industry, *Modern Company Law for a Competitive Economy* (1998) Foreword and para 3.8.
[420] ibid para 7.2.
[421] Law Commissions, *Consultation Paper* (n 396). Also see the final report: The Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, (1999, Law Com No 261, Scot Law Com No 173) (Law Commissions, *Final Report*).
[422] See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report* (2001).
[423] See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure* (2000).
[424] Law Commission Act 1965 s 3(1).

improve corporate governance.[425] The empirical research conducted in the process of the Company Law Review showed that the proposed codification of directors' duties was widely supported by directors in UK companies as the duties imposed by case law were often felt to be difficult to meet without legal training.[426] Second, codification is supposed to clarify uncertainties in law.[427] Due to the dynamic nature of case law there could always be some tensions between case decisions resulting in uncertain issues even in a well-established field.[428] Third, the process of formulating statements of directors' duties would allow some defects in the law to be rectified 'in important areas where it no longer corresponds to accepted norms of modern business practice'.[429] Based on these considerations, the Steering Group concluded that the case for codification of directors' duties was 'well-founded'.[430]

On the other hand, in light of some features unique to fiduciary duties the proposed codification also attracted widespread concerns and challenges. The fundamental concern was the feasibility of codifying common-law duties. It was advised in consultation feedback that 'not all codification can be achieved or work'.[431] Considering the long development of law in the large body of case law spanning over two hundred and fifty years, the work of codification would clearly be both lengthy and complex. In fact, previous attempts at codifying fiduciary duties by both the Green and the Jenkins Committees concluded that the codification was 'impractical and undesirable'.[432] However, 'the difficulty of achieving full codification was no reason not to attempt it'.[433] A further concern was whether the case law on fiduciary duties was 'well-settled' – an essential condition for successful codification.[434] Views differed among those consulted: some argued that it had not yet settled;[435] while others regarded it as largely settled.[436] The long history and extensive body of case law had adequately shaped the contents and contour of fiduciary duties in UK's company law. However, given the dynamic nature of case law, even a well-established field of law can hardly be said to be well-settled.[437]

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425 Law Commissions, *Final Report* (n 422) para 3.7.
426 Law Commissions, *Final Report* (n 422) para 2.40
427 Law Commissions, *Final Report* (n 422) para 3.7.
428 Davies and Worthington (n 300) 464.
429 Law Commissions, *Final Report* (n 422) para 3.7
430 ibid.
431 Law Commissions, *Consultation Paper* (n 396) 247.
432 ibid 249.
433 Law Commissions, *Final Report* (n 422) para 4.20.
434 Law Commissions, *Consultation Paper* (n 396) 247; Law Commissions, *Final Report* (n 422) para 4.7
435 ibid.
436 Worthington (n 266) 455.
437 Davies and Worthington (n 428) 464.

The greatest challenge is that the dynamic and open-ended nature of the law of corporate fiduciary duties is not suited to codification – either in general or in detail. To codify fiduciary duties in general is imperfect because codified law always requires interpretation by courts leading to superficial accessibility and predictability.[438] The Law Commissions responded that although most acute in civil-law jurisdictions, this was a common problem facing all embarking on codification. On the other hand, the Law Commissions admitted that courts in civil-law jurisdictions are better qualified to apply statutory provisions, whilst common-law jurisdictions have traditionally followed a conservative approach to the interpretation of statutes.[439] To codify fiduciary duties in detail is still problematic because it may result in the loss of flexibility. If the entire body of case law is to be replaced by full codification the future evolution of law would only be possible through further codification.[440] As the fiduciary doctrine is characterised by its dynamic nature, the developments of fiduciary law in changing circumstances would be problematic.[441] Furthermore, irrespective of the form of codification adopted, the approach to the interpretation of statutes and case law would still be different.[442]

Taking possible concerns and challenges into account, the codification of fiduciary duties in CA2006 is indeed novel. The main work of the codifying process by the Law Commissions was to restate existing case law in statutory form. Based on consultation, they adopted the codification of directors' duties at a high level of generality and it was subsequently endorsed by the Steering Group and by parliament. After codification, the statutory law of directors' general duties supersedes pre-existing case law.[443] However, in the application and interpretation of the statutory duties regard shall still be had to pre-existing case law and its future development.[444] This unique mechanism aims to allow the courts to interpret and develop the provisions in a way that 'reflects the nature and effect of the principles they reflect'.[445] The significance of this mechanism for future developments in corporate fiduciary law is two-fold: first, the high-level statutory provisions will be interpreted to deal with new circumstances in the corporate context and commercial life; second, this mechanism allows

[438] Law Commissions, *Consultation Paper* (n 396) 248.
[439] ibid 249.
[440] ibid 248; Law Commissions, *Final Report* (n 422) para 4.16.
[441] Davies and Worthington (n 428) 464.
[442] Law Commissions, *Final Report* (n 422) para 4.7.
[443] Companies Act 2006 s 170(3).
[444] Companies Act 2006 s 170(4).
[445] Department of Trade and Industry, *Company Law Reform* (March 2005) 21.

courts to take into accounts future developments in fiduciary law so allowing fiduciary duties in company law to develop in line with other branches of fiduciary law.[446]

The statutory restatements of directors' general duties thereby by-and-large codify the pre-existing case law fiduciary duties. First, sections 175 and 176 of CA2006 codify fiduciary principles. Duties in these two sections in effect 'traverse the terrain of liability' previously captured by the no-conflict and no-profit principles applied in the corporate context.[447] Second, sections 177 and 182 of CA2006 codify a director's duty to disclose interested transactions. The provisions mirrored the effect of the articles-of-association practice in commercial reality which excluded the operation of the self-dealing rule and widely adopted the directors' duty to disclose as regulation of interested transactions.[448] Third, although section 175 specifies the situation of exploiting corporate opportunity as a common manifestation of the no-conflict duty, as CA2006 duties provide no details as regards the corporate-opportunity doctrine, the law of corporate opportunity still relies on pre-existing case law. In this regard, CA2006 has not altered the logic of the corporate-opportunity law the functioning of which has not been affected by the codification.[449] Recent cases indeed reveal that common-law authorities on the issue of corporate opportunity are still referred to.[450]

Although the Law Commissions were not mandated to recommended conscious changes to the substance of fiduciary duties,[451] the CA2006 codification in fact introduced a measure of law reform to the pre-existing case law. As part of corporate-opportunity law section 175 introduces the mechanism of approval by a disinterested board subject to certain limits as an alternative to shareholder approval.[452] In pre-CA2006 case law shareholder approval was required. With regard to the regulation of interested transactions, CA2006 officially excludes it from the application of the fiduciary no-conflict principle.[453] This is statutory acknowledgment of the departure of self-dealing regulation from the fiduciary ambit in the historical developments.[454]

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446 HL Debs, wol.608, col 244, 6 February 2006 (Grand Committee), Lord Goldsmith.
447 John Lowry, 'Codifying the Corporate Opportunity Doctrine: The (UK) Companies Act 2006' (2012) International Review of Law 1, 5.
448 Tuch (n 393) 983.
449 Lowry (n 447) 10-11.
450 See *Towers v Premier Waste Management Ltd* [2011] EWCA Civ 923; *Sharma v Sharma* [2013] EWCA Civ 1287.
451 Law Commissions, *Final Report* (n 422) para 1.3.
452 Companies Act 2006 s175 (5).
453 Companies Act 2006 s175 (3). See also Geoffrey Morse (ed), *Palmer's Company Law* (Sweet & Maxwell 2017) ¶ 8.3104.
454 John H Farrar and Susan Watson, 'Self-Dealing, Fair Dealing and Related Party Transactions - History, Policy and Reform' (2011) 11 Journal of Corporate Law Studies 495, 516.

In terms of directors' duty to disclose interested transactions, CA2006 differentiates between prior-transaction disclosure and in-transaction disclosure. Further, the extremely complex and lengthy rules on substantial interested transactions in the Companies Act 1985 have been reformulated in codification. These aspects of law reform during codification lead to concern on the future application of statutory changes in court cases. As pointed out, the Act itself does not stipulate these modifications resulting from the codification.[455] Indeed, how UK courts understand relevant statutory departure from the pre-existing case law can only be gradually revealed in post-CA2006 cases.

3.2 Fiduciary Relationships in UK Company Law

This part examines the forms of fiduciary relationship in UK company law. Three categories of director stand in fiduciary relationships with the company: *de jure* directors; *de facto* directors; and shadow directors. Directors' fiduciary duties are owed to the company, whilst they owe no fiduciary duties to stakeholders. They should, however, consider the interests of stakeholders in the management of corporate affairs.

3.2.1 Who Owes Fiduciary Duties in UK Company Law

In UK company law it is indisputable that directors owe fiduciary duties to the company.[456] In particular, for the purpose of exploring who qualify as fiduciaries in the corporate setting, UK law classifies directors in three categories: *de jure* directors; *de facto* directors; and shadow directors.[457] Fiduciary duties attach to the office of director who is recognised not only by title but also by his or her functions within the management of corporate affairs.[458] This position is essential to ensure that persons with real directorial control are held responsible as corporate fiduciaries and are bound by fiduciary duties. United Kingdom company law thereby adopts both a status-based and a fact-based approach in identifying all three types of director as corporate fiduciaries who owe fiduciary duties to the company.

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[455] Davies and Worthington (n 428) 464-465.
[456] Companies Act 2006 s 170 (1). See also *Percival v Wright* [1902] 2 Ch 421.
[457] Although there are various classifications of directors in UK company law, such as executive directors and non-executive directors, nominee directors, and alternate directors, for the purpose of discussing directors' fiduciary duties, these other classifications are of less significance.
[458] Mortimore (n 361) 3.

3.2.1.1 *De jure* and *De Facto* Directors

Under UK company law, fiduciary duties are clearly owed by *de jure* directors who have been properly appointed as directors of the company. In addition to *de jure* directors, both CA2006 and case law recognise *de facto* directorship as falling within the term 'director'. Section 250 of CA2006 provides that a 'director' refers to 'any person occupying the position of director, by whatever name called'.[459] Although section 250 does not offer a complete definition of 'director', it clearly implies that certain persons, despite the lack of a valid appointment as a director, may be regarded as such based on their factual position in the company. Although neither term appears in the Act, it is generally accepted that for the purposes of CA2006 'director' includes both *de jure* and *de facto* directors. Common law, too, has long recognised the concept of a '*de facto* director'.[460] In short, a *de facto* director falls within the ambit of the statutory definition of a director, although such a status normally requires judicial confirmation. Once *de facto* directorship has been established the same fiduciary duties and rules apply to *de facto* and *de jure* directors.[461]

The concept of a *de facto* director has, in the main if not entirely, been established by the courts' application of the common law. The notion of *de factor* director was initially used by the courts to deal with individuals who had been irregularly appointed as, or who had ceased to be, a director.[462] However, when the concept was extended to those who did not purport to have been appointed as directors but were nonetheless involved in the central management of corporate affairs, establishing their *de facto* directorship became less obvious and more challenging.[463] The courts then faced the problem of devising a satisfactory legal test to establish whether an individual could be classified as a *de facto* director. In this regard, several judicial tests have been formulated and cited with approval. First, in *Re Hydrodam (Corby) Ltd*[464] Millett J proposed that a *de facto* director is a person who assumes the right to act as a director. 'He is held out as a director by the company, claims and purports to be a director, although never actually or validly appointed as such.'[465] According to the judge, to establish

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[459] Companies Act 2006 s 250.
[460] See, eg, *Mangles v Grand Collier Dock Co* (1840) 10 Simons 519; *Foss v Harbottle* (1843) 2 Hare 461; *Murray v Bush* (1873) LR 6 HL 37.
[461] Law Commissions, *Consultation Paper* (n 396) 278.
[462] Adam Goodison, 'Directors and Other Officers: Requirement and Definitions', in Simon Mortimore (ed), *Company Directors: Duties, Liabilities, and Remedies* (3rd edn, OUP 2017) 58.
[463] See *Commissioners of HM Revenue and Customs v Holland in Re Paycheck Services 3 Ltd* [2010] 1 WLR 2793, 2825-2826.
[464] *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.
[465] ibid 183.

that a person is a *de facto* director of a company it is necessary to plead and prove that he or she undertook functions in relation to the company which could properly be discharged only by a director and not simply by a manager below board level.

Second, in *Re Richborough Furniture Ltd*[466] Lloyd QC argued that the identification of a *de facto* director could arise in two situations: an individual who 'had been either the sole person directing the affairs of the company'; or one who 'was acting on an equal footing with the [other directors] in directing the affairs of the company'.[467] Third, in *Secretary of State for Trade and Industry v Tjolle* Jacob J stated that the central question which the courts seek to answer is whether the alleged *de facto* director is 'part of the corporate governing structure'.[468] As part of that test, Etherton J added in *Secretary of State for Trade and Industry v Hollier* that someone involved only in 'part of the company's activities' rather than in its 'day-to-day control' could act as a *de facto* director.[469] These cases provide several useful tests for identifying *de facto* directors by examining their activities.

On the other hand, establishing *de facto* directorship is not straightforward and will always be a challenge for UK courts. As Lewison J emphasised in *Re Mea Corp Ltd*, for someone to be a *de facto* director, 'what is important is not what he calls himself, but what he did'.[470] In particular, as all the judges agreed in *Re Paycheck Services*, the key question is whether the person concerned was 'part of the corporate governance structure' or 'assumed the duties of a company director'.[471] Some factual evidence, such as 'holding out as a director by the company', 'purportedly appointed as a director', and 'having a right of access to important company information', although relevant in reaching the decision, are not essential.[472] However, as Lord Collins of Mapesbury JSC commented in *Re Paycheck Services*, 'it is just as difficult to define "corporate governance" as it is to identify those activities which are essentially the sole responsibility of a director or board of directors'.[473] Consequently, as Jacob J stated in *Tjolle*, there is no single test for the determination of whether an act would render someone a *de facto* director:

466 [1996] 1 BCLC 507.
467 *Re Richborough Furniture Ltd* [1996] 1 BCLC 507, 524.
468 *Secretary of State for Trade and Industry v Tjolle* [1998] 1 BCLC 333, 343-344.
469 *Secretary of State for Trade and Industry v Hollier* [2007] BCC 11, 25-26.
470 *Re Mea Corporation Ltd, Secretary of State for Trade and Industry v Aviss* [2007] BCC 288, 305.
471 *Re Paycheck Services* (n 463).
472 *Hollier* (n 469) 23-26.
473 *Re Paycheck Services* (n 463) 2826.

> For myself I think it may be difficult to postulate any one decisive test. I think what is involved is very much a question of degree. The court takes into account all the relevant factors.[474]

3.2.1.2 Shadow Directors

In addition to *de jure* and *de facto* directors, there is a third category of director known as a 'shadow director' in UK company law. The statutory definition of 'shadow director' is 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act'.[475] Although the term first appeared in the Companies Act 1980,[476] the concept dates back to the Companies Act 1917.[477] Section 251(2) of CA2006 provides two exceptions to this definition: one exception excludes professional advisers or parties acting under statutory or Ministerial authority; the other prevents holding companies from becoming shadow directors of their subsidiaries.[478] The existence of 'shadow director' as a third category of director gives rise to three questions in UK company law. First, how to identify an individual as a 'shadow director' in the UK courts. Second, how to distinguish between a *de facto* director and a shadow director. And third, whether a shadow director owes fiduciary duties to the company, and if so whether these differ from the duties owed by *de jure* and *de facto* directors.

Case law also provides some guidance on the identification of shadow directors. In *Re Hydrodam (Corby) Ltd*, Millett J proposed that, for someone to be a shadow director, four requirements must be met. First, both the *de jure* and *de facto* directors must be identified; second, the individual concerned must direct those directors as to how to act; third, the directors must act in accordance with the instructions given; and fourth, the directors must be accustomed to acting in this manner.[479] In particular, he emphasised that a shadow director 'lurks in the shadows' and the board does 'not exercise any discretion or judgment of its own'.[480] In terms of the level of control exercised by an alleged shadow director, according to Morritt LJ in *Secretary of State for Trade and Industry v Deverall*, a shadow director should have 'real influence in the corporate affairs of the company' although his or her 'directions and instructions do not have to extend over all or most of the corporate activities'.[481] It is also not

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[474] *Tjolle* (n 468) 343.
[475] Companies Act 2006 s 251(1).
[476] Companies Act 1980 s 63.
[477] Companies Act 1917 s 3.
[478] Companies Act 2006 s 251(2).
[479] *Re Hydrodam* (n 464).
[480] ibid 183.
[481] *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340, 354-355.

required to show that the *de jure* directors are subservient to the shadow director in all circumstances. With regard to the required number of directors who are accustomed to act accordingly, Lewison J confirmed in *Re Ultraframe (UK) Ltd v Fielding* that it should be 'a governing majority of the board'.[482]

In the latest High Court decision, *Smithton v Naggar*, the court's approach was to identify what 'hat' the defendant was wearing in his or her dealings with the company in question, while the description of the role was less important.[483] Since Naggar's involvement in the company business did not extend beyond what one would expect of a major shareholder and client, he was found not to be a shadow director. This ruling is consistent with *Ultraframe (UK) Ltd v Fielding*[484] in which Lewison J considered the position of a lender alleged to be a shadow director of the debtor company. He held that 'where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director'.[485] It is thus can be seen that to determine shadow directorship remains a complex process, not to mention drawing a distinction between shadow directors and *de facto* directors in judicial practice.

De facto and shadow directors were traditionally regarded as theoretically different concepts and in early stages the courts struggled to draw a distinction between *de facto* and shadow directors. For example, in *Re Hydrodam* Millett J stated that these two terms were 'mutually exclusive' alternatives:

> A de facto director… is one who claims to act and purports to act as a director, although not validly appointed as such. A shadow director, by contrast, does not claim or purport to act as director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself.[486]

At a later stage, however, courts saw the complexity of a precise distinction. In *Secretary of State for Trade and Industry v Deverall*[487] Morritt LJ found that the distinction between *de facto* and shadow directors by Millett J was not essential in determining shadow directorship.

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482 *Ultraframe* (n 418) 339.
483 *Smithton v Naggar* [2013] EWHC 1961 (Ch).
484 *Ultraframe* (n 418).
485 ibid 338.
486 *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, 183.
487 *Deverell* (n 481).

Although a shadow director may indeed claim not to be a director and frequently 'lurks in the shadows' there is no specific requirement that he or she must act in an indirect, covert, or undercover manner.[488]

Further, as discussed above, the definition and application of the *de facto* director concept has evolved since the 1980s. Whilst originally *de facto* directors were conceived as persons whose appointment was defective or deficient in some way, it has repeatedly been confirmed that *de facto* directorship can be ascribed to an individual who has never been appointed or purportedly appointed as a director. In view of these two trends, Walker LJ argued in *Re Kaytech International plc* that these two concepts have something in common in that both 'exercise real influence in the corporate governance of a company.[489] In *Re Mea Corp Ltd* Lewison J believed that 'there is no conceptual difficulty in concluding that a person can be both a shadow director and a *de facto* director simultaneously'.[490] In *Hollier*, Etherton J pointed out that '*de facto* directorships and shadow directorships are alternatives', although in some situations 'it may not be entirely straightforward which of the two descriptions is most apposite'.[491] In *Re Paycheck Services*, Lord Collins of Mapesbury JSC also stated that the distinction between *de facto* directors and shadow directors had been 'eroded' and is 'impossible to maintain'.[492]

The significance of the distinction is highlighted by the question of to what extent shadow directors owe fiduciary duties to the company. Unlike *de facto* directors who clearly owe fiduciary duties, in the UK company law it is only settled that shadow directors owe 'some specific duties' to the company when the statutory provisions so provide.[493] The original (now repealed) section 170(5) of CA2006 provided that the director's general duties applied to shadow directors 'to the extent that the corresponding common law rules or equitable principles so apply'.[494] This was replaced by the current section 170(5) of CA2006 which provides that 'the general duties apply to a shadow director… where and to the extent that they are capable of so applying'. This appears to suggest that those general duties stipulated in the CA2006 such as the regulation of interested transactions and exploitation of corporate opportunity are, in

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488 ibid [36].
489 *Re Kaytech International plc, Secretary of State for Trade and Industry v Kaczer* [1999] 2 BCLC 351, 424.
490 *Re Mea Corp Ltd* [2001] Ch 340.
491 *Hollier* (n 469).
492 *Re Paycheck Services* (n 463) 2825-2826.
493 Law Commissions, *Consultation Paper* (n 396) 279. See also Colin R Moore, 'Obligations in the Shade: The Application of Fiduciary Directors' Duties to Shadow Directors' (2016) 36 Legal Studies 326, 330.
494 Small Business, Enterprise and Employment Act 2015 substituted a new Companies Act 2006 s 175(1).

principle, applicable to shadow directors.[495] Nevertheless, the wording of this provision shows that the courts have a wide discretion which is to be exercised on a case-by-case basis.

Given the conflicting decisions in the courts, one cannot say that the fiduciary status of shadow directors is settled in UK company law. In *Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia* Toulson J held, without explanation, that the person held to be a shadow director in the case 'undoubtedly owed a fiduciary duty'.[496] However, in *Ultraframe*,[497] Lewison J arrived at a different conclusion after lengthy argument. He emphasised that the key component of the fiduciary duty is loyalty which requires the presence of a direct relationship of trust and confidence between the company and the shadow director.[498] Consequently, 'the *indirect influence* exerted by a paradigm shadow director who does not directly deal with or claim the right to deal directly with the company's assets will not usually, in my judgment, be enough to impose fiduciary duties upon him.'[499] The ruling of *Ultraframe* attracted sharp academic criticism. The view that a shadow director generally owes no fiduciary duties as he or she has no direct legal power or control over the company property is untenable.[500] In modern companies a director's fiduciary duties extend far beyond the handling of company property, and include avoidance of conflicts of interest and other obligations. Moreover, even some *de jure* directors, such as non-executive directors, may also never directly control or deal with company assets but nonetheless owe the full range of fiduciary duties to the company.[501]

More recently, in *Vivendi SA v Richards*,[502] Newey J focused on establishing the existence of a fiduciary relationship by finding an undertaking or assumption of responsibility. Drawing an analogy between a shadow director on the one hand, and *de facto* directors and promoters on the other, he concluded that 'a shadow director will typically owe [fiduciary] duties in relation at least to the directions or instructions that he gives to the *de jure* directors'.[503] The approach in *Vivendi SA v Richards* appears to be a step in the right direction in identifying shadow directors as corporate fiduciaries. Despite shadow directors' lack of direct legal control of the

[495] Moore (n 493) 334; Davies and Worthington (n 428) 519.
[496] *Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia* [1998] BCC 870, 884.
[497] *Ultraframe* (n 418).
[498] ibid 343.
[499] ibid 344.
[500] Dan Prentice and Jennifer Payne, 'Case Comment: Directors' Fiduciary Duties' (2006) 122 Law Quarterly Review 558, 562.
[501] Richard C Nolan, 'The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report' (2005) 6 Theoretical Inquiries in Law 413, 414.
[502] *Videndi SA v Richard* [2013] EWHC 3006 (Ch), [2013] BCC 771.
[503] ibid 806.

company affairs, the practical influence they exert over the board of directors constitutes a form of fiduciary power and they should consequently be bound by fiduciary duties in the same way as *de jure* and *de facto* directors.[504] Nevertheless, the extent to which shadow directors owe fiduciary duties remains unsettled in case law. The principal reason lies in the lack of a sufficiently principled test for the existence of fiduciary relationships resulting from the uncertainty and controversy in fiduciary jurisprudence as discussed in Chapter 2.[505]

In sum, UK company law adopts both a status-based approach in classifying *de jure* directors as fiduciaries, and a fact-based approach in also identifying *de facto* directors and shadow directors as corporate fiduciaries.

3.2.2 To Whom are Fiduciary Duties Owed in UK Company Law

In general, a director stands in a fiduciary relationship to the company and owes fiduciary duties to the company. Section 170(1) of CA2006 clearly provided that the general duties, both fiduciary and non-fiduciary, are 'owed by a director of the company to the company'.[506] In common law, as stated by Dillon LJ in *Multinational v Multinational Services*, the position is that:

> The directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders.[507]

Fundamentally, directors owe fiduciary duties to the company because of the fiduciary relationship between a director and the company.[508] In principle, directors do not owe fiduciary duties to individual shareholders.[509] The policy reason for denying such a fiduciary relationship is for the board to avoid multiple legal actions by dissenting minority shareholders. On the other hand, a director may owe fiduciary duties to shareholders in special circumstances,[510] although such a fact-based fiduciary relation between a director and an

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504 Moore (n 493) 346.
505 See 2.2.1.
506 Companies Act 2006 s 170 (1).
507 *Multinational Gas and Petrochemical Co Ltd v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258, 288, CA.
508 The fiduciary relationship between a director and the company is well-established and settled in UK company law. See 3.1.1 for a detailed discussions of how the fiduciary status of corporate directors was established in history.
509 *Percival v Wright* (n456).
510 *Peskin v Anderson* [2001] 1 BCLC 372, 379. The fiduciary duty owed to the shareholder is 'independent on establishing a special factual relationship between the directors and the shareholders in the particular case'.

individual shareholder arises in limited scenarios only. The common thread for such a special relationship is a small and closely held company, often with a family or other personal relationship between director and shareholder.[511] With regard to a company with a substantial number of shareholders, the only situation in which such a fiduciary duty applies is where advice is given by directors in the course of a takeover bid.[512]

In the UK company law, directors may consider the interests of the stakeholders based on the notion of enlightened shareholder value. Traditionally, as the fundamental philosophy in the British corporate governance, the shareholder-primacy theory believes that as shareholders 'own' the company the company exists only to make profit for shareholders.[513] This view has been accepted as the approach in the UK before the promulgation of CA2006.[514] In this regard, although some relaxation can be seen in cases, directors are not supposed to prioritise other stakeholders over the company. In *Charterbridge Corp v Lloyds Bank Ltd*, it was held that, in general, a director is not permitted to be guided by other parties if that might prove detrimental to the interests of the company in which the director serves.[515] Similarly, the board's decisions which are beneficial to employees as a whole will not be justified by the courts unless they are in the long-term interests of the shareholders. This is because the company is assumed to be 'the shareholders collectively' or 'the shareholders present and future' and no other groups of persons is recognised as having an interest in the company.[516]

The absolute 'shareholder-value' view has been challenged as increasingly out of touch with contemporary values. It has been recognised that if the sole purpose of a company is to maximise profit for shareholders, the society or human community may suffer - eg, serious environmental pollution, unacceptable working conditions for employees, and so forth.[517] Therefore, the absolute shareholder primacy perception in UK company law has gradually changed and boards are encouraged to consider the interests of stakeholders such as creditors, employees, suppliers, and customers when making business decisions. This approach is

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511 *Sharp v Blank* [2015] EWHC 3220 (Ch).
512 [1986] BCLC 382. See Gower and Worthington (n 300) 509.
513 See John Armour *et al*, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) British Journal of Industrial Relations 531; Christopher M. Bruner, 'Power and Purpose in the "Anglo-American" Corporation' (2010) 50(3) Virginia Journal of International Law 580, 603-610.
514 Lee Roach, 'The paradox of the traditional justifications for exclusive shareholder governance protection: expanding the pluralist approach' (2001) 22 Company Lawyer 9, 10.
515 *Charterbridge Corp v Lloyds Bank Ltd* [1970] Ch 62.
516 *Hutton v West Cork Rly Co* [1983] 23 Ch D 654; *Parke v Daily News Ltd* [1962] Ch 927.
517 Irene-Marie Esser and Jean du Plessis, 'The Stakeholder Debate and Directors' Fiduciary Duties' (2007) 19 South African Mercantile Law Journal 346, 350.

recognised as ‘enlightened shareholder value’ or ‘ESV’ in British corporate governance. The ESV has been officially adopted and enacted into law by section 172(1) of CA2006. In terms of this statutory provision, the director of a company is required to ‘promote the success of the company for the benefit of its members as a whole’ and directors are also encouraged to have regard to: (i) the likely long-term consequences of any decision; (ii) the interests of the company's employees; (iii) the need to foster the company's business relationships with suppliers, customers, and others; (iv) the impact of the company's operations on the community and the environment; (v) the desirability of the company maintaining a reputation for high standards in business conduct; and (vi) the need to act fairly to members of the company.[518]

Although section 172 is widely regarded as the most controversial provision in CA2006, it indeed serves to allow directors to consider the interests of stakeholders in business decision-making. Owing to the dearth of appropriate criteria for analysing these factors in section 172(1), it is difficult to assess how the interests of stakeholders should be taken into account when a director makes decisions, and UK courts have yet to establish rules in case law.[519] Moreover, although section 172 encourages directors to take matters listed in section 172(1)(a)-(f) into account, there is no means by which any stakeholder, other than a shareholder, can enforce this,[520] unless it can be proved that the company’s interest itself had been contravened, and the remedies can only be provided by a shareholder derivative lawsuit.[521] In fact, the reason for introducing ESV in UK company law was to allow directors of UK companies to make corporate decisions with non-commercial purposes without fear of incurring liability for breaching their duty to promote the success of the company. In this sense section 172 can be seen as educational by encouraging directors to be more socially responsible in their corporate decision making.[522]

However, in UK company law directors do not owe fiduciary duties to stakeholders. In terms of the relationship between the company’s directors and creditors, the general rule is that directors ordinarily owe no fiduciary duties to creditors, even if the company is close to insolvency.[523] Corporate bankruptcy is an exception to this principle. In terms of the

[518] Companies Act 2006 s172 (1).
[519] Irene-Marie Esser *et al*, ‘Engaging stakeholders in corporate decision-making through strategic reporting: an empirical study of FTSE 100 companies’ (2018) 29(5) European Business Law Review 729.
[520] Elaine Lynch, ‘Section 172: A ground-breaking reform of director's duties, or the emperor’s new clothes?’ (2012) 33 (7) Company Lawyer 196, 200.
[521] Esser and du Plessis (n 517) 353-354.
[522] Lynch (n 520) 203.
[523] Companies Act 2006 ss 170 (1) and 172 (3).

Insolvency Act 1986, the court is empowered to review directors' conduct during the period leading up to insolvency and to penalise directors who have failed to act in accordance with statutory standards to minimise loss to the company's creditors.[524] In theory, a special fact-based fiduciary relationship certainly could be established between directors and creditors although this has not been explored in any depth in case law, this field is largely unexplored.[525] Similarly, directors ordinarily owe no fiduciary duties to employees who are also not entitled to enforce directors' fiduciary duties in UK company law.[526]

3.3 Fiduciary Duties in UK Company Law: A Fiduciary Model

Generally speaking, the UK model of corporate fiduciary duties adopts an orthodox fiduciary approach incorporating no-conflict and no-profit principles as core fiduciary duties of directors. The UK corporate opportunity doctrine is also characteristic of the application of fiduciary principles to determine the scope of corporate opportunity. Although the UK's current law on self-interested transactions falls outside the ambit of fiduciary principles, the duty to disclose has been developed within the ambit of shareholder authorisation enshrined in the fiduciary doctrine and principles.

3.3.1 Duty to Avoid Conflicts of Interest

The duty to avoid conflicts of interest in section 175 of CA2006 is the statutory formulation of the fiduciary no-conflict principle.[527] In the corporate-law context, the common-law no-conflict principle prohibits a director from placing him- or herself in a position where his or her self-interest conflicts, or possibly may conflict, with his or her duty to the company.[528] Since section 175 basically codifies the fiduciary no-conflict principle, this no-conflict duty essentially functions as a source of principle to regulate the behaviour of directors as fiduciaries in the company-law context.

The no-conflict duty involves two themes which is in line with the fiduciary no-conflict principle. One theme is the conflict of interest and duty and prohibits a conflict between a

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524 Insolvency Act 1986 s 214.
525 Andrew Stafford and Stuart Ritchie, *Fiduciary Duties: Directors and Employees* (Jordans 2008) 84. Relevant claims have been rejected in *Yukong Line of Korea Ltd* (n 496).
526 Lynch (n 520) 199; Alan Dignam and John Lowry, *Company Law* (11th edn, OUP 2020) 346.
527 The duty is also described in post-2006 cases as the duty to observe the no-conflict principle. See, eg, *Towers* (n 450).
528 *Boardman v Phipps* (n403) 213, per Lord Upjohn.

director's personal interest and his or her duty to the company.[529] Traditionally, this theme involves self-interested transactions and the exploitation of corporate opportunity. However, in UK company law this theme excludes the situation of self-interested transactions,[530] but includes the situation of exploitation of property or information. The exploitation of corporate property or assets is a clear violation of the no-conflict duty and presents no special difficulty for even for unsophisticated directors to understand the prohibition.[531] In cases where exploitation of information or property leads to the exploitation of corporate opportunity, the corporate-opportunity doctrine applies. In other situations involving the exploitation of information, the breach or non-breach of the no-conflict duty requires the application of the no-conflict principle on a case-by-case basis.[532] The other theme refers to a conflict of duty and duty and prohibits the conflict between a director's duties to two competing companies.[533] This theme involves the situations of competing with the company and multiple directorships.

The no-conflict duty involves both actual and potential conflict - the latter captured by the phrase 'possibly may conflict'.[534] In *Boardman*, potential conflict was interpreted as the situation where 'reasonable men looking at the facts would think that there was a real sensible possibility of conflict'.[535] The state of affairs should realistically disclose a real, not a theoretical or rhetorical conflict of interest.[536] On the other hand, if 'the situation cannot reasonably be regarded as likely to give rise to a conflict of interest', the no-conflict duty is not breached. In fiduciary jurisprudence, such 'no possible conflict' situation refers to the situation where the fiduciary has no duty in light of the circumstances.[537] However, in the company context, a director's duties or responsibilities to the company can be extraordinarily broad. Nevertheless, since the no-conflict duty works as a principle, these situations of actual conflict, possible conflict, or no possible conflict require fact-specific analysis. One example of their application is the corporate opportunity doctrine as discussed below. Furthermore, the no-conflict duty is characteristic of strict application which is in line with the fiduciary no-conflict

[529] Companies Act 2006 s 175(7).
[530] ibid s 175(3).
[531] Gower and Worthington (n 300) 542.
[532] The exploitation of information is also regulated by the equitable doctrine of confidentiality.
[533] Companies Act 2006 s 175(7).
[534] ibid s 175(1).
[535] *Boardman v Phipps* (n 403) 124, per Lord Upjohn, followed by Jonathan Parker LJ in *Bhullar* (n 408).
[536] *Boulting v Association of Cinematograph, Television & Allied Technicians* [1963] 2 QB 606, 638 per Upjohn LJ. 'Different minds may reach different conclusions'; as to this see *Maguire v Makaronis* [1997] 188 CLR 449, 468.
[537] McGhee *et al* (n 187) 7-018. See, eg, *In Plus Group Ltd v Pyke* [2002] EWCA Civ 370, [76] and [90]; *Ultraframe* (n 418) [1308]-[1310] and [1330]. For more detailed analysis, see Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010) Chapter 7.

principle.[538] Fiduciary principles have worked rigorously since the earliest cases in fiduciary jurisprudence, and such rigor has been constant in the UK company law context.[539]

3.3.2 Duty not to Accept Benefits from Third Parties

The duty not to accept benefits from third parties in section 176 of CA2006 is the statutory formulation of the common-law no-profit principle.[540] The common-law no-profit principle in the corporate context is stated as the rule that a director should account to the company for any benefit obtained without consent of the company 'by reason and in the course of' his or her directorship without consent of the company.[541] Although section 176 codifies only a part of the broader no-profit principle and not its entire ambit,[542] this no-profit duty could be interpreted and applied to reflect the fiduciary no-profit principle. In this regard, the no-profit duty also functions as a source of principle to regulate the behaviour of directors as fiduciaries in the company-law context.

This no-profit duty prohibits a director from accepting any benefit from any third party conferred 'by reason of his being a director, or his doing (or not doing) anything as a director'.[543] Traditionally, the situation in which the no-conflict principle applies typically involves exploitation of corporate property, information, or opportunity.[544] A 'benefit' is not defined in CA2006, and as explained above, 'benefit' should be understood as 'the ordinary dictionary meaning of the word'.[545] Benefits in relation to a director's service contracts are explicitly excluded.[546] A director's salary, bonus, or pension thus should have been authorised and could be retained.[547] In its original form, the fiduciary no-profit principle applies only to unauthorised profits.[548] A 'third party' refers to any person other than the company, an associated company, or an agent of the company or its associated companies.[549] Importantly,

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538 Companies Act 2006 s 175(2). For detailed discussions about the strict character of fiduciary principles see 2.3.1.
539 In UK company law, since courts of the highest authority applied the fiduciary principles in their strict sense, lower courts can hardly challenge such authority.
540 According to the Explanatory Notes to the Companies Act 2006 section 176 codifies the 'rule prohibiting the exploitation of the position of director for personal benefit'.
541 See *Regal (Hastings)* (n 397) 140 per Lord Russel.
542 Worthington and Sealy (n 189) 408.
543 Companies Act 2006 s 176 (1).
544 CA2006 identifies that there are situations, such as a breach of the no-conflict duty because, according to s 176(4), the breach of no-conflict duty constitutes the foreground to the breach of no-profit duty.
545 HC Comm D, 11/7/06, cols 621-622. In it, the Oxford English Dictionary definition was given as an example referring benefit as 'a favourable or help factor, circumstance, advantage or profit'.
546 Companies Act 2006 s 176 (3).
547 Stafford and Ritchie (n 525) 45.
548 *Ultraframe* (n 418) [1322]; ibid 40.
549 Companies Act 2006 s 176 (2).

it is made clear that if the no-conflict duty in section 175 is not breached, the no-profit duty is not infringed.[550] The implications of this provision require an examination of post-2006 cases in the UK courts.

Furthermore, this no-profit duty includes directors receiving bribes or secret commissions.[551] UK courts have traditionally dealt with the issue of bribes or secret commissions as an independent category of cases rather than as fiduciary-duty cases and have established a whole body of independent rules.[552] These rules originated primarily in agency cases. Therefore, although this field of law cannot be strictly categorised as fiduciary rules, they are important rules sufficiently relevant to establishing a director's no-profit duty regarding bribes or secret commissions which may constitute 'benefits' under section 176 of CA2006. First the promise of bribes to be paid in future can constitute a benefit.[553] However, the mere belief on the part of a director that there is the prospect of receiving money does not amount to a bribe.[554] Second, it is irrelevant whether bribes are paid to the director him- or herself or to some other person, or even to an offshore company.[555] Once a bribe has been established the motive of the person paying the bribe is irrelevant. There is further an irrebuttable presumption that the director has been influenced by the bribe and that the company has suffered loss at least to the extent of the bribe.[556]

3.3.3 Corporate Opportunity Doctrine

A significant facet of the no-conflict and no-profit duties is the corporate-opportunity doctrine. The UK corporate-opportunity doctrine prohibits corporate directors from exploiting a corporate opportunity without first having passed it on to the company. UK law adopts a status approach[557] to the corporate-opportunity doctrine and applies the no-conflict and no-profit

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550 ibid s 176 (4).
551 Explanatory Notes to the Companies Act 2006.
552 Stafford and Ritchie (n 525).
553 *Shipway v Broadwood* [1899] 1 QB 369 CA; *Grant v The Gold Exploration and Development Syndicate Ltd* [1900] 1 QB 233 CA.
554 *Donegal International Ltd v Republic of Zambia* [2007] 1 Lloyd's Rep 397 [275].
555 *Logicrose Ltd v Southend United Football Club Ltd* [1988] 1 WLR 1256; *Shetty v Al Rushaid Petroleum Investment Co* [2013] EWHC 1152.
556 Stafford and Ritchie (n 525) 299.
557 UK's corporate-opportunity doctrine is referred to as a no-conflict approach by some commentators, see David Kershaw, 'Does It Matter How the Law Thinks about Corporate Opportunities?' (2005) 25 Legal Studies 533. It is also referred to as a status approach by some other commentators. See DD Prentice and Jenny Payne, 'The Corporate Opportunity Doctrine' (2004) 120 Law Quarterly Review 198, 200; Martin Gelter and Geneviève Helleringer, 'Opportunity Makes a Thief: Corporate Opportunities as Legal Transplant and Convergence in Corporate Law' (2018) 15 Berkeley Business Law Journal 92.

principles to determine a corporate opportunity. In other words, any commercial opportunity captured by the application of principles falls into the category of corporate opportunity. The CA2006 provides no definition of the corporate opportunity that a director should not exploit for the purpose of either the no-conflict duty or the no-profit duty. The law of corporate opportunity still relies on the traditional case-law approach.

The no-profit principle prohibits directors from exploiting any commercial opportunity which comes to them by reason of and in the course of their directorship. The rule was established by the House of Lords in the *Regal*[558] and *Boardman* cases.[559] In the recent Court of Appeal case of *Sharma v Sharma*, it was made clear that a director's exploitation of 'opportunities which come to his attention through his role as director' constitutes a breach of his or her fiduciary and statutory duty.[560] Although directors may use corporate property or information when exploiting a corporate opportunity, the application of the no-profit principle essentially captures the use of a fiduciary position and not necessarily the use of corporate property or information.[561] In *O'Donnell v Shanahan* the Court of Appeal denied the 'scope-of-business' test in relation to the application of the no-profit principle.[562] This means that the application of the no-profit principle should not be constrained by the scope of the company's business. Insofar as the no profit principle applies, all business opportunities accrue to the company regardless of company's scope of business.

The no-conflict principle prohibits directors from exploiting any commercial opportunity where their personal interests conflict or may possibly conflict with their duties to the company. In terms of section 175 of CA2006, the exploitation of opportunity is a common manifestation of breach of the no-conflict duty.[563] In generally, directors have a common-law duty to act in the interests of the company[564] and a statutory duty to act to promote the success of the company.[565] In the case of corporate opportunity, the specific duty of directors is a duty to

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558 *Regal (Hastings)* (n 397).
559 *Boardman* (n 403).
560 *Sharma v Sharma* (n 450) [52].
561 *Boardman v Phipps* (n 403). Also see *Bhullar* (n 408) 253.
562 *O'Donnell v Shanahan* [2009] EWCA Civ 751 [70]. This case is widely criticised as rejection of the 'line of business' test in identifying a corporate opportunity. See Deirdre Ahern, 'Guiding Principles for Directorial Conflicts of Interest: Re Allied Business and Financial Consultants Ltd; O'Donnell v Shanahan' (2011) 74 Modern Law Review 596. Ernest Lim, 'Directors' Fiduciary Duties: A New Analytical Framework' (2013) 129 Law Quarterly Review 242. However, a closer look at the case judgement reveals that the court intended to exclude the 'line of business' test for the purpose of the no-profit principle, but not the no-conflict principle.
563 Companies Act 2006 s 175(2).
564 See *Ultraframe* (n 418) [1292]-[1295].
565 Companies Act 2006 s 172.

report or present a commercial opportunity to the company (or pursue it on behalf of the company).[566] In this way the no-conflict principle prohibits directors from finding themselves in a situation in which their self-interest in the personal exploitation of the opportunity conflicts, or may possibly conflict, with their duty to offer the opportunity to the company. Apparently, to determine breach or non-breach of the no-conflict principle, the central issue is under what circumstances directors faced with a commercial opportunity are duty bound to refer that opportunity to the company.

The UK corporate opportunity doctrine adopts a broad and fact-dependent approach to directors' duty to pass a business opportunity on to their company. In *Cooley*, it was stated that directors have a duty to present a commercial opportunity to their company, if the company has been positively pursuing the opportunity.[567] The facts in *Cooley* revealed an obvious conflict of interest. In *Bhullar*, it was held that the directors had a duty to inform their company of the opportunity to acquire land adjacent to land already owned by the company as the opportunity 'would have been commercially attractive to the company'.[568] *Bhullar* has been challenged as adopting too broad an approach by 'treat[ing] anything of economic value to the company as a corporate opportunity'.[569] However, in *Bhullar* there was indeed a special link between the opportunity and the company. In this regard, 'opportunities that are geographically proximate to the corporate premises' should be strictly interpreted.[570] An opportunity simply adjacent to the company's headquarters would not necessarily be 'commercially attractive' to the company.[571]

Under the UK's no-conflict regime and corporate-opportunity doctrine, it can happen that a director's personal interest in exploiting a commercial opportunity cannot possibly conflict with his or her duty to the company.[572] In such a situation the director has no duty to refer the opportunity to the company. The UK corporate-opportunity doctrine provides no clear guidance on this situation although there have been some sporadic insights in cases and in theory. In *Wilkinson v West Coast Capital*[573] Warren J conceded that 'a company with a wide objects clause could, in theory, diversify its business in limitless ways', and discussed

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566 *Bhullar* (n 408); *Cooley* (n 407) 451; *O'Donnell v Shanahan* (n 562) [70].
567 *Cooley* (n 407).
568 *Bhullar* (n 408).
569 Dan Prentice and Jenny Payne, 'The Corporate Opportunity Doctrine' (2004) 120 Law Quarterly Review 198, 202.
570 ibid.
571 Kershaw (n 557) 556-557.
572 Companies Act 2006 s 175(4).
573 *Wilkinson v West Coast Capital* [2005] All ER (D) 346, [2005] EWHC 3009 (Ch).

hypothetically that ‘a director of a company selling fashion clothing for women could hardly be in breach of the “no conflict” rule if he took a stake in a company distributing farm machinery’ since there would ‘simply be no “real sensible possibility” of conflict’.[574] A commentator has argued that ‘bona fide, fully informed and unbiased rejection’ by the board of a corporate opportunity should be deemed as no possibility of conflict.[575] However, in *Wilkinson*, Warren J held that in cases of board rejection it is ‘a very difficult question’ whether the director could take the opportunity without breaching fiduciary principles.[576] Warren J also affirmed this issue as ‘not clear’ in UK corporate-opportunity law. In my view, in light of the broad and fact-dependent approach adopted by UK law to directors’ duty to present a commercial opportunity to the company, UK courts would naturally be reluctant and cautious to laid out contradictory rules as regards situations where a director has no duty to pass an opportunity on to the company.

The UK corporate-opportunity doctrine applies to both the no-conflict principle and no-profit principle to hold directors liable for exploiting a corporate opportunity.[577] To determine a breach of the corporate-opportunity doctrine – that either no-conflict principle or no-profit principle applies – is sufficient for UK courts to hold a defendant director liable. On the other hand, courts can find a director not to be in breach of the corporate opportunity doctrine only if neither the no-conflict nor the no-profit principles has been breached. In early cases, for example in *Regal*,[578] UK courts applied only the no-profit principle to capture the breach of the corporate opportunity doctrine. In modern cases of corporate opportunity, however, the courts typically analyse and apply both the no-conflict and the no-profit principles.[579] In post-2006 corporate opportunity cases, UK courts apply the no-conflict and no-profit principles as part of their interpretation of statutory duties. However, as there is some uncertainty as to the relation between statutory duties and common-law principles, the courts either cite both

[574] ibid [253].
[575] Lim (n 562) 246-252.
[576] *Wilkinson* (n 573) [302].
[577] There are some debates about the relationship between the no-conflict principle and the no-profit principle in theory and in case law. See 2.3.1 for detailed discussions. This parts deals with the application of the two principles in the corporate opportunity doctrine based on UK case authorities.
[578] *Regal (Hastings)* (n 397).
[579] The practice started from *Boardman*, while *Cooley* (n 407) and *Bhullar v Bhullar* (n 408) apply the no-conflict only because no-profit doesn’t govern private capacity. According to *Ultraframe* (n 418), insofar as case law reveals principled analysis, the corporate opportunity doctrine is duly based on both no conflict and no profit principles. See *Ultraframe* (n 418) [1355] per Lewison J.

sections 175 and 176 and apply the no-conflict and no-profit principles,[580] or cite section 175 and apply the no-conflict and no-profit principles as two limbs of the no-conflict duty.[581]

Despite the overlap in the ambit of the no-conflict and no-profit principles, as a practical matter the two principles have a somewhat different role in identifying a breach of the corporate-opportunity doctrine. If a business opportunity arose by reason and in the course of the directorship, the no-profit principle would be of more direct and obvious use than the no-conflict principle. In theory, in cases of breach of the no-profit principle, the application of the no-conflict principle would usually deliver the same solution.[582] However, as discussed above, the application of the no-conflict principle could be more complex and situation-specific. Nevertheless, if a commercial opportunity came to the director in his or her private capacity – as in *Bhullar*[583] courts should nevertheless apply the no-conflict principle as the no-profit principle simply does not apply in such situations.[584]

The UK corporate-opportunity doctrine adopts a rigorous prohibition of exploiting a corporate opportunity which falls under either the no-conflict principle or the no-profit principle. The strict prohibition of exploitation of corporate opportunity originates from the strict nature of the fiduciary principles.[585] Section 175(2) of CA2006 provides that 'it is immaterial whether the company could take advantage of the opportunity'.[586] Case law provides various situations in which the company may not take advantage of the opportunity. In both *Regal (Hastings)*[587] and *Boardman*,[588] it was held that facts as to the company's financial inability,[589] or whether it could have profited,[590] or whether the company has in fact been damaged or benefited are irrelevant to the prohibition on directors from exploiting the corporate opportunity thereof. In *ICD v Cooley*, the fact that the third party would not have wanted to deal with the company was held to be irrelevant,[591] while in *Bhullar*, it was held that even if the board had decided

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580 See *Towers* (n 450).
581 *Sharma v Sharma* (n 450), the section 175 duty is summarised as a 'director is in breach of his fiduciary or statutory duty if he exploits for his personal gain (a) opportunities which come to his attention through his role as director or (b) any other opportunities which he could and should exploit for the benefit of the company.'
582 Gelter and Helleringer (n 557) 121.
583 *Bhullar* (n 408).
584 *Wilkinson* (n 573) [252]. 'It is important to note that the 'no conflict' rule can apply to a fiduciary in some situations where he neither makes a profit from trust property nor from his fiduciary position.'
585 See 2.3.1.1 for detailed discussions of the strictness of fiduciary principles and the relevant rationales.
586 Companies Act 2006 s 175 (2).
587 *Regal (Hastings)* (n 397).
588 *Boardman* (n 403).
589 ibid [747] per Lord Hudson.
590 ibid [752] per Lord Guest.
591 *Cooley* (n 407).

not to pursue that particular type of business was immaterial.[592] Significantly, the default directors' good faith is also irrelevant to the prohibition on exploiting a corporate opportunity.[593] In short, once the breach of the no-profit or no-conflict principle has been established, UK courts allow no factors or considerations as a defence by the director.

3.3.4 Interested Transaction Regulation

Modern regulation of interested transactions in the UK company law in principle permits directors to be involved in such transactions. The UK's regulation of interested transactions falls outside of the ambit of the fiduciary no-conflict principle – ie, a director has no duty to avoid interested transactions with the company.[594] In both the law and economics research, interested transactions are rationalised by not only the conflict-of-interest theory – as the predominant theory – but also the efficient-transactions theory.[595] The departure of interested transaction regulation from the regime of the fiduciary doctrine can be explained by the efficient-transactions theory which views interested transactions as beneficial for the company.[596] Nevertheless, the fundamental purpose of interested transaction regulation is still to regulate the problematic conflict of the director's self-interest and his or her duty to the company. Most significantly, the UK's regulation of interested transactions features a 'fairly lenient default rule' – a statutory duty of interested directors to disclose their interest in a transaction or arrangement with the company.[597] Further, as part of the UK law on interested transactions, companies are permitted to deviate from the duty to disclose and require more than simple disclosure through their articles of associations.[598] Moreover, shareholders may always approve, either *ex ante* or *ex post*, interested transactions in situations that would otherwise amount to fiduciary breach.[599]

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592 *Bhullar* (n 408).

593 Also see *Bray v Ford* (n 276) 51 per Lord Herschell; *Ex Parte James* (n 276) 345 per Lord Eldon LC; *Regal (Hastings)* (n 397) 144 per Lord Wright.

594 Companies Act 2006 s 175 (3). Ss 175 and 177 of the Companies Act 2006 have been confirmed to be 'mutually exclusive' in *McKillen v Misland (Cyprus) Investments Ltd* [2012] EWHC 2343 (Ch), [583]-[584] per David Richards J.

595 Elizabeth Gordon, Elaine Henry and Darius Palia, 'Related Party Transaction and Corporate Governance' (2004) 9 Advances in Financial Economics 1.

596 Michael D Ryngaert and Shawn Thomas, 'Related Party Transactions: Their Origins and Wealth Effects' (2007) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=970689 accessed 12 December 2021.

597 Gower and Worthington (n 300) 516.

598 Companies Act 2006 s 180(4)(b).

599 ibid s 180(4)(a).

As the UK's default regulation of interested transactions, CA2006 imposes a duty on interested directors to disclose their interest in a transaction or arrangement with the company to their fellow board members. The purpose of such duty to disclose is to keep the other directors fully informed of relevant conflicts in the transaction so that they can take measures to safeguard the company's position.[600] In this regard, sections 177 and 182 of CA2006 provide, respectively, for an interested director's duty to make a pre-transaction declaration, and the duty to make an in-transaction declaration, although the statutory requirements for the two do not differ significantly. First, a director has a duty to disclose any interested transaction in whatever form. In terms of sections 177 and 182 of CA2006, a director has a duty to disclose when he or she is 'in any way, directly or indirectly, interested' in a transaction or arrangement with the company.[601] The duty to disclose thus arises not only in direct self-dealings where a director deals with the company as the other party to the transaction, but also in transactions with the company in which a director only has an indirect interest through persons connected to him or her. CA2006 provides a detailed definition of such persons which includes family members, bodies corporate, trustees, partners, and firms.[602] It is to be noted, however, that an indirect interest will not be automatically established simply because a director's connected persons are interested in a transaction or arrangement with the company, although under such circumstances disclosure is 'advisable as a matter of caution'.[603] For purposes of sections 177 and 182, interested transactions can be contracts or non-contractual arrangements.[604] Entering into such interested transactions or arrangements does not of itself necessarily require board approval and transactions entered into by managers or officers on behalf of the company also count.[605]

Second, an interested director is obliged to disclose his or her interest in an interested transaction to the other directors on the board of the company. More specifically, being interested in a transaction or arrangement with the company, the interested director should disclose the nature and extent of that interest to fellow board members,[606] to enable them to

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600 Gower and Worthington (n 300) 518.
601 Companies Act 2006 ss 177(1) and 182(1).
602 ibid s 252. Ss 253, 254 and 255 of CA2006 further define members of a director's family, a body corporate connected with a director, and a body corporate controlled by a director.
603 Lloyd Tamlyn and Marcus Haywood, 'Duty to Declare Interest in Transaction or Arrangement' in Simon Mortimore (ed), *Company Directors: Duties, Liabilities, and Remedies* (3rd edn, OUP 2017) 388. In case law sometimes even a nominal interest requires disclosure.
604 See *Financial Conduct Authority v Capital Alternatives Ltd* [2014] EWHC 144 (Ch) [51].
605 See *Nepture (Vehicle Washing Equipment) Ltd v Fitzgerald* [1996] Ch 274.
606 Companies Act 2006 s 177(1). It is the common practice in case law to require disclose regarding the nature and extent of interests. See *Imperial Mercantile* (n 383) 194.

see 'what his interest is and how far it goes'.[607] The CA2006 allows an interested director's prior-transaction declaration can take any form,[608] but an in-transaction declaration may be made only at a meeting of the directors, by notice in writing or by general notice.[609] Furthermore, CA2006 requires that the relevant declaration of interest in transactions should be accurate and complete, and interested directors are obliged to make a further declaration in cases where the earlier declaration has proved to be, or becomes, inaccurate or incomplete.[610] For example, an in-transaction declaration made in a form other than the three optional methods allowed, renders the declaration inaccurate or incomplete and requires a further declaration.[611] Common law traditionally requires the disclosure of all the material facts and information relevant to an interested transaction.[612] The standards of conduct to which courts may hold interested directors are, therefore, to be found in common-law cases.[613]

Third, under some circumstances, despite of having an interest in a transaction or arrangement with the company, the interested director may not be obliged to make either a prior-transaction or an in-transaction declaration. One obvious situation is when an interested director is completely unaware of either the transaction or any of his or her interest in it,[614] which is clearly possible in light of the broad scope of indirect interest that a director may have as discussed above. However, CA2006 makes it clear that a director would be 'treated as being aware of matters of which he ought reasonably to be aware'.[615] As explained by the Solicitor-General, the application of 'an objective test' here is explained by the view that directors have certain 'substantial obligations'.[616] Similarly, a second situation in which an interested director need not disclose is when the other directors are already aware of the transaction and the interested director's interest in it.[617] In this regard, the other directors are also 'treated as aware of anything of which they ought reasonably to be aware'.[618] Clearly, the extent of the other directors' awareness required should accord with the extent of an interested director's duty of

[607] *Movitext Ltd v Bulfield* [1988] BCLC 104, 121 per Vinelott J.
[608] Companies Act 2006 s 177(2). The section provides no mandatory requirement, which means that even oral disclosure in private occasions also counts.
[609] ibid s 182(2). Detailed requirements about the notice in writing and the general notice are specified in s 184 and s 185 of CA2006 respectively.
[610] ibid s 177(3) and 182(3).
[611] ibid s 182(3).
[612] See *Dunne v English* (1874) LR 18 Eq 524, 533-535; *Costa Rica Railway Co v Forwood* [1901] 1 Ch 746 CA, 761.
[613] Robin MacDonald, 'The Companies Act 2006 and the directors' duty to disclose' (2011) 23(3) International Company and Commercial Law Review 96, 97.
[614] Companies Act 2006 ss 177(5) and 182(5).
[615] ibid.
[616] Hansard HC Standing Committee D, col 628 (11 July 2006).
[617] Companies Act 2006 s 177(6).
[618] ibid ss 177(6) and 182(6).

disclosure as discussed above. The interested director, however, still has a duty to disclose whatever is not known by the other directors.

Another situation in which an interested director is not obliged to disclose interest is when 'it cannot reasonably be regarded as likely to give rise to a conflict of interest'.[619] Since neither section 177 nor section 182 provides any detail regarding this 'not-possibly-conflict' situation, UK courts must interpret and apply the provision on a case-by-case basis. 'Given the importance which the law has traditionally ascribed to the need to avoid conflict of interest', such not-possibly-conflict situation would better be interpreted in a narrow sense so that even remotely possible conflict should be disclosed.[620] Fundamentally, a not-possibly-conflict situation should mean that there is no breach of the fiduciary no-conflict principle when applying the principle to the facts of a particular case. The CA2006 provides these express exclusions in order to save courts the trouble of discussing purely technical breaches in relation to self-dealing disclosure.[621]

The key differences between the duty to make a prior-transaction declaration in section 177 and the duty to make in-transaction declaration in section 182 concern their timing and the legal consequences of their breach. The declaration required by section 177 should be made *ex ante*, ie before the company enters into the transaction or arrangement.[622] The significance of the *ex ante* disclosure is that it allows the company to 'decide whether to enter into the transaction, on what terms and with what safeguards'.[623] In contrast, the declaration required by section 182 is made once the company has already entered into the transaction or arrangement, and in cases where someone becomes a director or a director becomes aware of the transaction or his or her interest at a late stage, or where a director has failed to make a prior-transaction disclosure.[624] The section 182 declaration therefore supplements the prior-transaction declaration. In addition to the requirement that in-transaction declaration should be made 'as soon as is reasonably practicable',[625] more importantly, failure to make the in-transaction declaration leads to legal liability. As explained by the Lord Goldsmith in Grand Committee, the division of prior-transaction declaration and in-transaction declaration is

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619 ibid. Also see *Cowan de Groot Properties Ltd v Eagle Trust plc* [1991] BCLC 1045.
620 Tamlyn and Haywood (n 603) 393.
621 ibid 392.
622 Companies Act 2006 s 177(4). See also *Burns v The Financial Conduct Authority* [2014] UKUT 0509 (TCC) [78].
623 Lord Goldsmith, Hansard, HL Grand Committee, col 334 (9 February 2006).
624 Companies Act 2006 s 182.
625 ibid s 182(4).

because the failure of the former ‘cannot affect the validity of the transaction or give rise to any other consequences’, while the failure of the later will render the transaction voidable and entitle the company’s right to ‘claim financial redress’.[626] However, commentators argue that there is no logical distinction between the remedies available for breach of the two duties of disclosure.[627]

Nevertheless, in light of the statutory division of prior-transaction and in-transaction declarations as well as the complex situations involving compliance or non-compliance with section 177 and/or section 182, legal liability, and the remedies available are not straightforward. First, if section 177 is observed, the relevant interested transaction would not be ‘liable to be set aside by virtue of any common law or equitable principle requiring the consent or approval of [shareholders]’.[628] Compliance with section 177 means that there has been no breach of the duty of loyalty, and salvages an interested transaction from any legal consequence resulting from a breach of the fiduciary no-conflict principle.[629] In common law, rescission of the contract or transaction is traditionally the only remedy available for breach of the interested transaction rule,[630] as the UK courts view the director’s profit from self-dealings as ‘unquantifiable’ and are unwilling to fix a new contract price for the parties to the transaction.[631] Similarly, if a director is not obliged to make a prior-transaction disclosure, and has duly made a section 182 disclosure, the transaction concerned would also be valid.

Second, non-compliance with section 177 and subsequent compliance with section 182 results in the relevant interested transaction being avoidable.[632] The failure to comply with the general duty to disclose in section 177 triggers liability for breach of the duty of loyalty in common law. Third, if a director is not obliged to make a prior-transaction disclosure and then fails to make an in-transaction disclosure, the transaction would be valid but the director would be guilt of a criminal offence for which he or she would be liable to a fine.[633] It should be noted here that because the duty in section 182 is not one of the director’s general duties, relevant common-law remedies imported by CA2006 specifically for breaches of those general duties,

[626] HL GC Day4, Hansard HL 678, 9/2/06, col 338.
[627] Worthington and Sealy (n 186) 446.
[628] Companies Act 2006 s 180(1).
[629] Tuch (n 393) 982-983.
[630] It means, if rescission is no longer possible in reality, the court will decline to intervene.
[631] Gower and Worthington (n 300) 522.
[632] Companies Act 2006 s 178(1). According to this section, non-compliance of section 177 basically leads to the consequences of breaching the common law no-conflict principle.
[633] ibid s 183(1).

do not apply to non-compliance with section 182.[634] Fourth, failure to comply with either section 177 or section 182 renders the relevant interested transaction avoidable and the director liable to a fine.

Concluding Remarks

This chapter examines the UK model of corporate fiduciary duties in terms of its historical development, who owes fiduciary duties to whom, and fiduciary duties and rules under current law. The evolving history of UK's corporate fiduciary law paints a vivid picture of how the law closely relates to the equity jurisdiction and the case law tradition, both hallmarks of common-law systems. The earliest version of UK law of fiduciary duties served as a most important source for legal transplantation by US states which allow them to first set out their law of corporate fiduciary duties. It was therefore not only the starting point of the long development of US corporate fiduciary law, but also the starting point of how UK and US law diverge. Moreover, the current UK company law provides a codified version of fiduciary duties which carries unparalleled weight for China's transplantation.

There have been three main stages in the evolution of corporate fiduciary duties in the UK culminating in the current model. In ancient times, Chancery Courts applied the fiduciary doctrine in the corporate context so establishing the fiduciary status of corporate directors and rendering them subject to fiduciary duties. From the mid-nineteenth century to today, the doctrine of corporate opportunity has developed within the framework of the no-conflict and no-profit prohibitions, whilst the law on interested transactions was drawn from the shareholder authorisation mechanism embodied in fiduciary principles. The enactment of CA2006 codified existing fiduciary principles and rules as statutory duties.

United Kingdom company law adopts a flexible and fact-based approach to directors. It identifies three categories of director: *de jure* directors; *de facto* directors; and shadow directors. In the case of shadow directors, UK courts in effect adopt a fact-based approach to fiduciary relationships rendering this field of law unsettled. In UK company law directors owe fiduciary duties to the company not to individual shareholders or stakeholders. Company law in the UK is characteristic of a traditional fiduciary model of fiduciary duties. Corporate directors owe

[634] ibid s 178. Gower and Worthington (n 300) 524.

no-conflict and no-profit fiduciary duties, and the UK's corporate-opportunity doctrine prohibits a director from exploiting a commercial opportunity whenever the no-conflict or no-profit principles apply. Directors must make both prior- and in-transaction declarations under the law on interested transactions. This duty to disclose reflects shareholders' expectations of directorial behaviour by UK companies and has been established by the long history leading up to the enactment of CA2006. United Kingdom law offers a classic model of corporate fiduciary duties in a common-law country on which the equity tradition has a profound impact.

Chapter 4: The United States' Model of Corporate Fiduciary Duties

Introduction

This chapter discusses the US corporate fiduciary duties in common-law system which has served as a major source of China's legal transplant. It focuses specifically on Delaware corporate law as an exemplary model of US jurisprudence. Corporations in the US are generally subject to the corporate law of the state in which they are incorporated. Each of the US states is a separate legal jurisdiction with its own corporate law. Corporate governance, including the fiduciary duties of corporate fiduciaries, is generally a matter of state law. Strictly speaking there is no such thing as a US model of fiduciary duties. However, because of common inter-state legal borrowing the law of some states can be influential. One of these is Delaware, the market leader in the field of corporate law where the vast majority of Fortune 500 companies and US publicly traded companies are incorporated.

This chapter examines fiduciary duties in Delaware corporate law with a view to answering the following questions: (1) How has the Delaware law of corporate fiduciary duties evolved to establish the content and contours of its current model? (2) What are the fiduciary relationships under the Delaware corporate law – ie, who owes fiduciary duties to whom? and (3) What are the principal rules and key features of the current Delaware model of corporate fiduciary duties? The three main questions are discussed and answered in Part I, Part II and Part III respectively followed by a conclusion. By answering these questions an holistic picture of the Delaware model of corporate fiduciary duties is drawn as a leading model of corporate fiduciary duties among common-law systems on which the current fiduciary duties in Chinese company law are said to be based.

4.1 Fiduciary Duties in US/Delaware Corporate Law: Historical Developments

Originating in the fiduciary doctrine of English equity, the UK and US law of corporate fiduciary duties has evolved into different models of law since the first reported case in 1742.[635] The current model of corporate fiduciary duties in Delaware is the product of continuous evolution spanning the long history of both the US and Delaware. Tracing developments from

[635] The *Charitable Corporation* (n 302).

pre-Delaware corporate fiduciary law in the US, this part explores how the content and structure of corporate fiduciary duties have evolved to form the current Delaware model. Based on doctrinal evolution and social context, this part divides the historical development of corporate fiduciary law into four stages. The first stage addresses pre-Delaware corporate fiduciary law which subsequently became law in Delaware. The emphasis here is on the transplantation of fiduciary law and its divergence from English law. The second stage involves how Delaware law established its corporate fiduciary duties by innovative inter-state legal borrowing. In the third stage we discuss the evolution of Delaware corporate fiduciary law in light of the 'takeover trend' of the 1980s. The fourth stage considers developments in Delaware's fiduciary law since 2000.

4.1.1 The Evolution of Corporate Fiduciary Duties in the US: Prior to the 1920s

This part explores the developments of corporate fiduciary duties in the US before the 1920s when Delaware secured its status as market leader and started its own history of corporate fiduciary law. Specifically, this part focuses on what became part of Delaware law at a later stage when the courts set out corporate fiduciary duties by 'legal borrowing' from leading cases in other US jurisdictions. Most significantly, both the interested transaction regulation and the corporate opportunity doctrine characteristic of the US position had by-and-large already been established during this pre-Delaware period in the development of corporate fiduciary law.[636] One prominent feature of this pre-Delaware stage is legal transplantation from English law and other US states. The legal transplantation of English fiduciary and corporate law can in many respects be seen clearly in the earliest US corporate fiduciary law jurisprudence. On the other hand, whist the inheritance of relevant UK law was unequivocal, the divergence of US corporate fiduciary law from English law had also started shortly after, or possibly even during the legal transplant process. In this regard, the divergence of the US and UK corporate fiduciary law was mainly the product of this pre-Delaware legal development. Furthermore, the US federal structure ensured that legal transplantation also took place between US states. As illustrated in this part, the inter-state legal borrowing was common in the early development of US corporate fiduciary law. A significant factor in this pre-Delaware development of US

[636] Since Delaware duty of care law was basically a home-made product at a later stage, Delaware law borrowed mainly the interested transaction regulation and corporate opportunity doctrine from this early development of corporate fiduciary law in the US.

corporate fiduciary law was the adaption of the law during the process of inter-state legal borrowings.

4.1.1.1 The Pre-Delaware Development of Interested Transaction Regulation

The evolution of interested transaction regulation in the US has long been classed as a mystery due to its complexity and intricacy.[637] In the late nineteenth century US law established its initial interested transaction regulation by transplanting English law although it diverged from its English equivalent from the outset. The key divergence from English law was its involvement of the fairness standard review. The paths to a fairness standard review of interested transactions in US corporate fiduciary law typically included the 'New Jersey' and 'New York' models from which Delaware corporate law borrowed heavily at a later stage.[638] One path to fairness review was New Jersey's remedial approach. New Jersey courts established the self-dealing rule to regulate interested transactions by borrowing from English corporate law. In the 1875 case of *Stewart v Lehigh Valley Railroad Company*,[639] dealing with an interested transaction between a state-charted canal company and one of its directors, the New Jersey Court of Errors and Appeals directly relied on the leading English corporate self-dealing case of *Aberdeen Railway*[640] to establish a self-dealing rule effectively identical to that adopted in *Aberdeen Railway*. In *Stewart* the company purchased iron railway chairs from a partnership with one of its partners as the company's chairman of the directors. Based on the no-conflict principle and its strict application, the court held that an interested transaction is voidable at the option of the company regardless of whether or not it was fair to the company.[641] The court explicitly rejected the argument that the interested director had abstained from participating as director in entering into the contract, and held that 'he ought to have participated, and in the interest of the stockholders' in any transaction entered into by the corporation.[642] This self-dealing rule as regards interested transactions in both *Aberdeen Railway* and *Stewart* had been widely adopted by highly regarded US courts by the 1880s.[643]

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[637] See Harold Marsh Jr, 'Are Directors Trustees? Conflict of Interest and Corporate Morality' (1966) 22 Business Lawyer 35; Norwood P Beveridge Jr, 'The Corporate Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction' (1992) 41 DePaul Law Review 655. Marsh and Beveridge give completely different accounts of the evolution of interested transaction law in the US.
[638] Kershaw (n 382) 326-328.
[639] *Stewart v Lehigh Valley Railroad Company* 38 NJL 505 (1875).
[640] *Aberdeen Railway* (n 276). For a detailed discussion of this case, see 3.1.2.
[641] *Stewart* (n 639) 522-523.
[642] ibid 522-523.
[643] Marsh (n 637) 36.

On the other hand, when New Jersey courts endeavoured to explore the remedial implications of the self-dealing rule, New Jersey's interested transaction law departed from English law taking the path of fairness standard review. Shortly after *Stewart,* in the 1879 case of *Gardner v Butler,*[644] the New Jersey Court of Errors and Appeals extended the self-dealing rule for interested transactions to a remedial fairness review. In *Gardner* a state-charted corporation entered into an agreement outsourcing the company's paper trading business to a partnership in which the company's managing director and several other directors were partners.[645] When the case was brought to court, the services had been provided by the partnership in accordance with the agreement. The court first affirmed the rule of strict voidability in *Stewart* as 'well settled' law, and then explored the remedial implications of the rule in cases where the contract had been executed.[646] According to the court, rather than rendering the contract invalid the court would review what the interested directors had retained from the executed transaction: if they had retained only that to which they were justly and reasonably entitled ‒ ie, the transaction was fair ‒ the court would uphold the transaction; However, if the interested directors had retained anything more, they would be liable to account for any profit.[647] Therefore, for any executed interested transaction, the court in effect conducted a fairness standard review of the transaction.

This remedial fairness review in *Gardner v Butler* as part of the New Jersey's interested transaction law thus resulted from the operation of law. When faced with a case where the interested contract has been performed, and to unravel the contract is thus not an option, the court must identify the remedy available to the corporation. In such circumstances the appropriate equitable remedy would generally be an accounting for profits. However, where the court saw 'amount' as profit in excess of market price or adequate consideration a fairness review of the executed contract could be required. In relation to executed interested contracts the strict self-dealing rule therefore becomes a fairness standard review. As a result of the operation of law, *Gardner's* approach to fairness review as the remedial extension of the self-dealing rule is entirely consistent with the strict rule not a rejection of it.[648] In subsequent cases, *Stewart* and *Gardner* were frequently cited together as a complete indication of the New Jersey law. New Jersey's interested transaction regulation could at this stage be summarised as a

644 *Gardner v Butler* 30 NJEq 702 (1879).
645 ibid.
646 ibid 721.
647 ibid 724-725.
648 Kershaw (n 382) 335.

general self-dealing rule coupled with a remedial fairness standard review of executed transactions. Although a strict rule plus a remedial fairness review can be the functional equivalent of a generic fairness standard, New Jersey courts did not establish this functional connection until the 1960s.[649]

Another route to fairness standard review of interested transactions in late nineteenth century US corporate law was the New York dichotomous approach. Transplanted from both English corporate law and non-corporate fiduciary law rules, New York corporate law established its interested transaction regulation comprising both a rule of strict voidability and a rule of fairness. A signal case for the rule of strict voidability in the New York corporate law was *Munson v Syracuse, Geneva Corning Railway Company* in 1886 which dealt with a petition for specific performance of a contract between a corporation and its director.[650] The New York Court of Appeals cited *Aberdeen Railway* observing that that case was 'in many of its features similar to the present one'.[651] The law applied in *Munson v Syracuse* was also in many respects similar to that in *Aberdeen Railway* – interested transactions are voidable at the election of the corporation or its shareholders regardless of its actual fairness. Notably, in *Munson v Syracuse* the interested contract had been approved by the board comprising one interested director and nine directors without an interest. It was because the interested director had participated in the approval of the transaction and because the court was concerned that '[t]he law cannot accurately measure the influence of a trustee with his associates',[652] that the court applied the rule of strict voidability. Had the interested director avoided any part in the approval of the transaction, under the New York corporate law at that time the rule of fairness standard would have applied.

New York's rule of fairness standard as regards interested transactions was represented by the 1895 case of *Sage v Culver*.[653] Here the New York Court of Appeals cited as authority, but did not discuss, *Gibson v Jeyes*,[654] an English equity case involving a transaction between a solicitor and his client, and adopted the rule of fairness standard similar to that in *Gibson v*

[649] See *Eliasberg v Standard Oil Company* 92 A2d 862 (1952). In the case, New Jersey court cited the Delaware case of *Gottlieb v Heyden Chem Corp* 83 A2d 595 (1951) to endorse the shift of law.
[650] *Munson v Syracuse, Geneva Corning Railway Company* 8 NE 355 (1886).
[651] ibid 359.
[652] ibid 358.
[653] *Sage v Culver* 41 NE 513 (NY 1896).
[654] *Gibson v Jeyes* 6 Ves Jun 268 (1801). In the case it was held that a solicitor could not purchase property from his client if the property involved the relationship of solicitor and client, unless the solicitor had obtained his client's fully informed consent. However, if the solicitor could prove that the transaction was fair to the client, the fully informed consent would be deemed to have been obtained by the solicitor when dealing with the client.

Jeyes. In *Sage v Culver* the court saw the interested transaction as a breach of the no-conflict principle and held that the interested director was bound to 'show that the [transaction] was fair and that no undue advantage has been taken by him of his position…'.[655] The rule was consequently that the court would uphold an interested transaction if the interested director could prove its fairness to the corporation. This fairness standard rule clearly differed from and seemingly contravened the rule of strict voidability in *Munson v Syracuse* – although the court failed to explain its choice of this rule over the rule in *Munson v Syracuse* which had been decided by the same court several years earlier.

Although it was not explicitly stated in the judgment, the rule of fairness standard applied when the interested director had *not* participated in entering into the transaction – ie, the corporation was represented by disinterested directors.[656] Many other New York cases from this period also adopted the view that the rule of fairness standard applied if the interested director had not participated in the conclusion of the transaction,[657] while in post-*Munson v Syracuse* cases that adopted a rule of strict voidability, the New York courts were at pains to stress the participation of the interested directors.[658] The co-existence of *Munson v Syracuse* and *Sage v Culver* means that New York corporate law never applied a generally applicable voidability standard such as the self-dealing rule in *Aberdeen Railway* or *Stewart*. In effect, the strict-voidability rule in *Munson v Syracuse* differed from that in *Aberdeen Railway* or in *Stewart*. In the latter two cases, the strict rule applied even if the interested director had not participated in the board action as the courts in both cases held that the interested director was obliged to participate by giving the company 'the full benefit of his knowledge and skill.'[659] In contrast, the New York model of interested transaction regulation is clearly based on the premise that the law permits interested directors not to be part of the board action provided that the company is duly represented by disinterested directors.

It can thus be seen that New York's interested transaction regulation diverged from English corporate law insofar as it also borrowed the rule of fairness standard from non-corporate

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[655] *Sage v Culver* (n 653) 514.
[656] Kershaw (n 382) 342.
[657] See *Strobel v Brownell* 40 NYS 702, 705 (1895); *Globe Woolen Company v Utica Gas & Electric Company* 136 NYS 16 (1912). Unlike *Sage v Culver* (n 653) being readily traceable to the English fiduciary doctrine by citing *Gibson v Jeyes* (n 654) these cases were not clearly traceable to English law.
[658] Kershaw (n 382) 353.
[659] *Aberdeen Railway* (n 276) 253. The court rejected the possibility of the interested director dealing with the company in his or her personal capacity and explained that whether the self-dealing director was only one of a body of directors or the sole director could 'make no difference in principle' as it was the director's 'duty to give to his co-directors, and through them to the company, the full benefit of all the knowledge and skill which he could bring to bear on the subject.'

fiduciary law. New York courts were open to the submission that a fiduciary rule other than the self-dealing rule adopted in *Aberdeen Railway*, could also apply to corporate interested transactions.[660] When faced with the interested transaction issue in the corporate context, New York courts naturally drew on fiduciary rules addressing analogous interested dealings in other types of fiduciary relationship, in particular the trust relationship. However, as a company is not a 'perfect fit' within the trust analogy, the relationships of trust, trustee, and beneficiary must be translated into those of corporation, board, director, and shareholder.[661] This allows space for borrowing not only the self-dealing rule, but also the fair-dealing approach from trust law. In *Aberdeen Railway* a director's dealings with the company were analogous to a trustee's dealing with him- or herself regarding trust property, and the trust law's approach to self-dealing was thus borrowed.

In a separate line of English trust-law cases in which a trustee enters into a contract with the beneficiary without involving trust property, equity courts provided that the transaction is subject to a fair-dealing requirement.[662] Such fair-dealing rule also applies to interested transactions between agent and principal or between attorney and client.[663] Through this lens, a transaction between a director and the corporation could also be analogised to a transaction between a trustee (in his or her personal capacity) and the beneficiary, or between an attorney and his or her client, on condition that the interested director has not represented both him- or herself and his or her corporation in concluding the transaction. New York corporate law therefore translated corporate interested transactions from both the trustee-trust property lens and the trustee-beneficiary lens and adopted both the rule of strict voidability and the rule of fairness standard, the application of which depended on whether the interested director had participated in the negotiation and voting process of the transaction.

The subsequent development of the New York interested transaction regulation reveals that the rule of strict voidability increasingly lost its place. There was, however, no clear reasoning in New York case law to explain this shift and courts did not deem it necessary to consider the influence of an interested director on his or her boardroom associates.[664] As discussed above, concern regarding influence was the basis for the courts' application of the strict rule where an

660 Kershaw (n 382) 314.
661 ibid 327.
662 See *Ex Parte Lacey* (n 281).
663 See McGhee *et al* (n 187) 7-022.
664 See Marsh (n 637) 40-42.

interested director had participated in the transaction. If this concern was no longer sustained in the courts, it became unnecessary to differentiate between the participation or otherwise of the interested director. All that was required was for the company to be represented by any disinterested director. In consequence, the rule of fairness standard prevailed, while the rule of strict voidability gradually lost its place in New York law. One the other hand, the rule of strict voidability still applied in cases where there was no disinterested director who could properly represent the corporation in concluding an interested transaction. This New York pattern of interested-transaction law was subsequently borrowed by Delaware courts in the 1920s.

4.1.1.2 The Pre-Delaware Development of the Corporate Opportunity Doctrine

In the late nineteenth century, US law established its corporate opportunity doctrine by transplanting the fiduciary doctrine from English equity. [665] The divergence of US corporate opportunity law from English law resulted from subsequent developments in cases in the context of both property and the no-conflict principles.

The foundations for the US corporate opportunity doctrine were laid in late nineteenth century New York cases.[666] One foundation was the fiduciary no-conflict principle. In the 1874 case of *Blake v Buffalo Creek Railroad Company*,[667] the corporation (which built railroads) constructed trestle work and laid railway tracks on premises owned by the City of Buffalo. Two of the corporation's directors – one of whom was employed specifically to secure rights of way for its railroads – took out a personal lease on the premises involved. The two directors thereafter transferred the lease to a third director of the corporation who, when the company refused to pay the rent demanded, destroyed the trestle work, tore up the tracks on the premises, and brought an action to restrain the company from using the premises.[668] The New York Court of Appeals adopted the no-conflict principle articulated in earlier New York cases which drew directly from the fiduciary-law authorities in English equity.[669] Applying the no-conflict principle, the court found that the directors in question should not have taken a lease of the

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[665] US law applied fiduciary principles directly to establish and develop its corporate opportunity doctrine rather than transplanting from UK's corporate law. In fact, the leading cases on the corporate opportunity doctrine in UK's company law were decided much later in the mid-twentieth century. See *Regal (Hastings)* (n 397).

[666] Kershaw (n 382) 430-435.

[667] *Blake v Buffalo Creek Railroad Company* 11 Sickels 485 (1874).

[668] ibid.

[669] See *Van Epps v Van Epps* 9 Paige Ch 237 (1841) and *Torrey v Bank of Orleans* 9 Paige Ch 649 (1842). In these cases, New York courts cited English fiduciary doctrine cases, in particular the jurisprudence of Lord Eldon and its progeny, including *Keech v Sandford* (n 186), *Ex Parte Lacey* (n 281) and *Ex Parte James* (n 276).

premises as they were bound to acquire the right of way which the corporation needed to perform its functions, for the corporation.[670] The court therefore restrained the plaintiff director from asserting any rights under the lease and declared the lease of the premise subject to a constructive trust. This case is a typical application of the no-conflict principle: the directors' self-interest conflicted with their duty to the company – ie, the duty to acquire the right of way for the company.

Another foundation of the corporate opportunity doctrine found in late nineteenth century New York cases is the fiduciary no-profit principle and its application in the renewal of leases by fiduciaries. In the 1889 case of *Robinson v Jewett*,[671] the president of a corporation renewed the lease of premises already under lease to the corporation in his name. He then assigned the lease to the corporation in consideration of a profit share. In his suit to claim those profits the court held that the new lease was held in trust for the corporation and that his claim for profit share was not supported. Relying on early New York and English fiduciary authorities, the court borrowed the English fiduciary law as regards 'the tenant's right of renewal' to deal with the issue of the renewal of a lease in the corporate context.[672] According to the court, between the landlord and the tenant the latter's right cannot 'strictly be denominated a right or estate'; it is merely a 'hope or expectation'. However, between the tenant and third persons the law recognises this interest as a 'valuable property right' and the renewal as a 'reasonable expectancy' on the part of the tenant.[673] It was a rule of equity that, applying the no-profit principle, a trustee or partner was prohibited from renewing the lease on premises leased by the beneficiary/co-partner for his or her own benefit. If he or she were to do so the lease would fall to the benefit of the beneficiary/principal. The Court of Appeals of New York held that the rule was 'appropriately applied to a trustee of a corporation'.[674] The renewal of leases is a classic application of the no-profit principle – the director's unauthorised profit from the lease arose by reason of his or her fiduciary capacity in relation to the company's right of renewal, rather than in his or her private capacity.

Clearly drawing on New York jurisprudence, subsequent developments of the corporate opportunity doctrine in the US followed the route of the property and no-conflict cases from

[670] *Blake v Buffalo Creek* (n 667).
[671] *Robinson v Jewett* 71 Sickels 40; 22 NE 224 (1889).
[672] *Phyfe v Wardell & Woolley* (1835) 5 Paige Ch 268 following *Keech v Sandford* (n 186).
[673] *Robinson v Jewett* (n 671) 227.
[674] ibid.

which Delaware law subsequently borrowed. In the context of property, although US courts applied the no-conflict principle preventing the conflict between a fiduciary's self-interest and his or her duty to the corporation, the duty to the corporation was confined in a quasi-property-right manner. In other words, unless there was some property-like connection between the opportunity and the corporation, directors or officers would have no duty to acquire the property[675] for the corporation, and thus the fiduciary could take advantage of the opportunity without breaching his or her fiduciary duty. The corporate opportunity doctrine in these property cases therefore diverged from the fiduciary doctrine and established a quasi-property-right approach to corporate opportunities.

Two cases formed the structural and substantive basis of the US corporate opportunity doctrine as regards property. In the 1900 case of *Lagarde v Anniston Lime & Stone Co*,[676] the corporation – which quarried limestone and manufactured lime – in its endeavour to acquire ownership of lands and easements regarding a limestone quarry, managed to acquire a one-third interest in the lands and easements. It entered into a contingent contract to purchase a second third interest (in relation to which the corporation also took a lease) and failed to purchase the remaining third interest (for which the corporation had negotiated various times). Subsequently, directors of the corporation purchased both the second third and the remaining third of the land in their own name. The court held that the second parcel was held in trust for the corporation but that the third parcel could be taken by the directors.[677] In applying the no-conflict principle, the court followed a narrowed approach to the duties owed by directors to their corporation. Drawing on *Blake v Buffalo Creek* and *Robinson v Jewett*, the court held that there are three circumstances under which a director should be prohibited from taking an opportunity to acquire a property. First, where the corporation already has an interest in the opportunity; second, the corporation has an expectation arising from an existing right to the opportunity; third, by the director taking the opportunity the corporation's purpose will be frustrated in some way.[678] The court then observed that in terms of the lease and the contract to sell the second one third-interest, the corporation 'had rights in that interest' and the directors could not purchase that parcel. In contrast, as regards the third parcel the corporation had 'no property or right' as the fact that the corporation had been 'negotiating for and endeavouring

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[675] In the property lens of corporate opportunity cases, case facts typically concern an opportunity to acquire certain property or property rights, such as the lease of land, the renewal of lease, the acquisition of lands or mines.
[676] *Lagarde v Anniston Lime & Stone Co* 126 Ala 496 (1900).
[677] ibid.
[678] ibid.

to purchase' that interest generated 'no expectancy of value'.[679] The court therefore held that the director's taking of the third interest did not breach his duty to the corporation and there had consequently been no breach of the no-conflict principle.

In *Lagarde* the court synthesised the fiduciary principles and their application in *Blake v Buffalo Creek* and *Robinson v Jewett* to establish corporate-opportunity law distinct from the fiduciary doctrine. While *Lagarde* still applied the no-conflict principle it confined a director's duty to the corporation through three criteria. The first and second criteria drawn from *Robinson v Jewett*, originated in the context of the right of renewal to which the no-profit principle had been applied and which were used in *Lagarde* to limit the application of the no-conflict principle. The third criterion was drawn from the facts in *Blake v Buffalo Creek* to which the no-conflict principle had been applied. In *Lagarde* the overlapping frameworks of no-conflict and no-profit principles for addressing the problem of taking a corporate opportunity set out in *Blake v Buffalo Creek* and *Robinson v Jewett* were borrowed and adapted not as principled frameworks, but as 'unrooted conceptual fragments of law'.[680] The court was clearly unaware of the fiduciary concept's origins in English equity on which earlier New York cases had been based.[681] The innovative adaptation of New York jurisprudence in *Lagarde* in effect drastically shifted the corporate opportunity doctrine away from the fiduciary doctrine.

In 1909, in the case of *Zeckendorf v Steinfeld,*[682] the Supreme Court of the Territory of Arizona explored the financial-capacity defence to property under the corporate-opportunity doctrine. In *Zeckendorf* a manager of a corporation who dominated its corporate affairs was challenged for acquiring, in his own name, title to a mining claim known as the 'English Group' which surrounded the property known as 'Old Boot Mine' operated by the corporation.[683] According to the court an officer or director may not purchase and hold the property as his or her own. The court restated the law in *Lagarde* in which a director's duty to the corporation was circumscribed by three criteria. However, instead of analysing whether the manager owned a duty to purchase the English Group for the corporation based on these three criteria, the court highlighted the fact that the corporation was 'indebted… in an amount exceeding its capitalization, with no available resources which could be utilized to effect a purchase of the

[679] ibid 431.
[680] Kershaw (n 382) 435.
[681] For the third parcel, with either the no-conflict or the no-profit principle applied, it would constitute a taking of corporate opportunity.
[682] *Zeckendorf v Steinfeld* 12 Ariz 245 (1909).
[683] ibid. The holding of both the 'English group' and the 'Old Boot Mine' can increase the value of either of the two mines.

English Group'.[684] According to the court, an officer or director of a corporation is under no duty to 'loan money or to purchase out of his own funds property for the use of the corporation'.[685] The court then concluded that the manager's acquisition of the property for himself violated no duty he owed to the corporation. It is thus the law in *Zeckendorf* that if a corporation is in a state of indebtedness with no available resources to purchase a property, a director or officer has no duty to purchase the property for the corporation. In this regard, *Zeckendorf* relaxed the strict feature of no-conflict principle embedded in the fiduciary doctrine – albeit without any significant explanation.[686]

Subsequent to *Lagarde* and *Zeckendorf*, the quasi-property-right approach to corporate opportunity was widely adopted in other US states. In the 1933 Mississippi case of *Pioneer Oil & Gas Co v Anderson*,[687] while a corporation was negotiating for an oil and gas lease one of its directors entered into the lease in his own name. The Supreme Court of Mississippi repeated verbatim, but without citation, the law set out in *Lagarde* and held that the corporation had no interest or expectation in relation to the oil and gas lease, and hence there had been no breach of fiduciary duty. The court made it clear that the mere fact that a corporation is negotiating for the acquisition of certain property 'did not give it such an interest and expectancy therein'.[688] Further, in the 1935 Colorado case of *Colorado & Utah Coal Co v Harris*[689] with similar facts and approach as *Pioneer*, the court specifically excluded two situations as capable of establishing a legitimate expectation: one where the director gained all his or her knowledge of the property through his or her connection with the corporation; and the other where the corporation had been 'negotiating for and endeavouring to purchase' the property.[690] For the court, 'something more' is required to establish the legitimate expectation.[691] The adequate property-like connection between the corporation and the opportunity to acquire certain property is therefore a demanding one.

This 'demanding requirement' reveals the quasi-property-right approach to corporate opportunities in this line of cases. The connection entails a legitimate interest and expectation

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684 ibid 262.
685 ibid 262-263.
686 See 2.3.1.1 for a detailed discussions of the strict application of fiduciary principles.
687 *Pioneer Oil & Gas Co v Anderson* 151 So 161 (1933).
688 ibid.
689 *Colorado & Utah Coal Co v Harris* 49 P2d 429 (1935).
690 ibid. This case in effect ruled out the application of the no-profit principle in the property-lens corporate opportunity doctrine.
691 ibid.

beyond mere business negotiation, a criterion that originally came from the application of fiduciary principles in relation to the property right and the right of renewal. In this regard, the notion of the opportunity belonging to the corporation is of extraordinary nature and extent on the basis of 'justifiable property claims and entitlements'.[692] The quasi-property-right approach which requires a nexus between the corporation and the opportunity is based on policy considerations and local context. According to the court in *Colorado*, because the corporation had been 'investigating numerous other coal properties', if a legitimate expectation can be established through mere negotiations the corporation would have a 'virtual monopoly' on all coals fields. This would forever exclude directors and officers from the mining business.[693] To exclude corporate fiduciaries from the mining sphere on strict fiduciary principles was not advisable in view of the local context. This trilogy of cases was heard in those US states which were the foci of the nineteenth-century land and mineral distribution and in which the idea of distributing unowned land and minerals featured prominently in the minds of local people and the courts.[694] This peculiar local context resulted in the distinctive notion of corporate opportunities which proved influential in the development of the broader US corporate opportunity law.

While US courts still applied the fiduciary no-conflict principle, under the no-conflict aspect of corporate opportunity doctrine, they limited the fiduciary's duty to the corporation on the basis of the corporation's practical situation. More specifically, the no-conflict approach to the corporate opportunity doctrine in effect excluded situations in which the corporation was unable or unwilling to take advantage of certain opportunities. And in those cases, directors or officers would have no duty to acquire the opportunity for the corporation and could do so for themselves without breaching their fiduciary duties. In *Murray v Vanderbilt*[695] an early case dating from 1863, the president of a corporation carried out the corporation's business in his own name following the failure and insolvency of the corporation. The liquidator challenged him to account to the corporation for the profits made. The New York County Supreme Court held that 'no duty rested upon the agent to run the line for the company after the authority and ability of the company to do so had terminated'.[696] It appears that, for this court, the application of the no-conflict principle was moulded taking the financial capacity of the corporation into

[692] Kershaw (n 382) 454.
[693] *Colorado* (n 689).
[694] Kershaw (n 382) 443.
[695] *Murray v Vanderbilt* 39 Barb 140 (1863).
[696] ibid.

consideration. That is, if the corporation was incapable of taking advantage of a specific opportunity, directors or officers would have no duty to acquire the opportunity for the corporation.

Subsequently, in this context of the corporate opportunity doctrine, the willingness of the corporation to take up certain opportunities was also a consideration in applying the no-conflict principle. In the 1885 Maine case of *Sandy River RR v Stubbs*,[697] while a railroad corporation was unwilling to accept the price and thus declined to purchase a piece of land necessary for its right of way, station, water-tank, and woodshed, one of its directors, with the consent of the other six directors, subsequently purchased a larger piece of land which included the aforesaid land. Drawing on early New York trust cases and English equity authorities,[698] the court held that the director had not acquired for himself 'any interest adverse to his company in any sense contemplated by the rules of equity governing trustee'.[699] For the court '[t]here was no opportunity for a breach of trust' as the other six directors had rejected the opportunity before the defendant director seized it for himself.[700] The rejection by the board indicated the unwillingness of the corporation to take up the opportunity. If the corporation was unwilling to take certain opportunity, directors or officers would have no duty to acquire the opportunity for the corporation and there would be no breach of the no-conflict principle. Again, as in *Murray v Vanderbilt*, practical factors moulded the application of the no-conflict principle.

Significantly, the 1923 case of *Lancaster Loose Leaf Tobacco Co v Robinson*[701] ascribed the line of business of a corporation to its willingness to take certain opportunities and established the 'line-of-business' test for corporate opportunities. In *Lancaster* a director of a tobacco warehouse company who purchased and sold tobacco at a substantial profit was challenged by the corporation claiming accounting for profits. The Kentucky Court of Appeals stated the no-conflict and the no-profit principles to be 'well recognized and fundamental principles'.[702] As the director 'engaged in a venture in a line of business never engaged in by the corporation' whose 'policy had been not to engage in it', the court found that there could be no 'antagonism whatsoever between his interests as an individual and his duty as an officer of the

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697 *Sandy River RR v Stubbs* 77 Me 594 (1885).
698 *Murray v. Vanderbilt* (n 695).
699 *Sandy River* (n 697).
700 ibid.
701 *Lancaster Loose Leaf Tobacco Co v Robinson* 250 SW 997 (1923).
702 ibid 998-999. In the case, the court phrased the no-conflict principle in both ways: a fiduciary should 'never be permitted to place himself where his personal interests are antagonistic to those of the corporation'; a fiduciary should not 'plac[e] himself in such antagonism whatever between his interests as an individual and his duty as an officer of the corporation'.

corporation'.[703] Drawing on *Jasper v Appalachian Gas Company*,[704] the court found *no* difference between 'a corporation which is insolvent and therefore unable to carry out a venture undertaken by one of its officers,' and 'a corporation capable of carrying out the venture, but because of its business policy [was] unwilling to undertake it'.[705] The court therefore linked the line of business of a corporation with its willingness to take certain opportunities. The court explained that the policy consideration behind the judgment is that to deny to a fiduciary the right to do business in a line in which the corporation has never engaged would 'be the carrying of the principle contended for to an unauthorized extent' and would prevent the fiduciary from doing business 'in any line or in any endeavour'.[706]

It thus can be seen that through this no-conflict lens of the corporate opportunity doctrine, the application of the no-conflict principle was moulded by practical considerations regarding the corporation's ability or willingness to take up certain opportunities. On the one hand, this no-conflict corporate opportunity doctrine, other than from the fiduciary doctrine transplanted from English equity, in effect relaxed the strict application of fiduciary principles. The strict application of fiduciary principles embedded in English equity clearly rejected the consideration of practical factors as a preventative element.[707] Courts in the US relaxed the strict no-conflict principle without offering any proper justification or explanation which possibly points to a lack of understanding of the strict nature of fiduciary principles. The courts based this on considerations of fairness, although this too was expressly excluded from the strict application of fiduciary principles. If they are adequately familiar with the strictness of fiduciary principles, US courts might take pains to justify the loosening of such strictness even based on fairness considerations. On the other hand, these no-conflict cases introduced the 'financial-capacity' criteria and the 'line-of-business' test which were then adopted by courts in many US states and thus influenced US corporate-opportunity law profoundly.

4.1.2 The Evolution of Corporate Fiduciary Duties in Delaware: 1920s-1970s

Delaware established its primacy as a market leader in corporate law from the 1920s when it also began to include fiduciary duties in its corporate law. Previously there had been no

[703] ibid 999.
[704] *Jasper v Appalachian Gas Company* 153 SW 50 (1913). This case applied the law in *Murray v Vanderbilt* (n 695).
[705] *Lancaster Loose Leaf* (n 701) 1000.
[706] ibid.
[707] See 2.3.1.1.

corporate fiduciary law in Delaware.[708] In the long history of Delaware's corporate law has since developed, in the main, through case law. More specifically, the law of fiduciary duties has been gradually shaped by a discrete number the Delaware Supreme Court decisions and a plethora of Delaware Court of Chancery decisions. This notwithstanding, the Delaware General Corporation Law (DGCL) as statutory law intervened at several historical points effecting drastic shifts in the development of corporate fiduciary duties. During the period from the 1920s to the 1970s Delaware courts established the embryonic content and structure of its corporate fiduciary duties. Delaware's duty of loyalty – borrowed from other US state jurisdictions – brought with it pre-Delaware developments in corporate fiduciary law which subsequently came to characterise the state's approach to fiduciary duties. Delaware's duty-of-care law, as a purely autochthonous 'product', has yet to be established despite sporadic cases in the field.

In early cases, Delaware courts established interested transaction regulation and the corporate opportunity doctrine by borrowing from other US jurisdictions. Notably, the Delaware courts not only 'borrowed' proactively and creatively from multiple models of law in other US states, they also introduced innovative changes in the process. During the 1920s Delaware courts adopted the existing New-Jersey and New-York model rules to regulate interested transactions. In the case of *Lofland v Cahall*,[709] directors of a corporation, through board resolution – or even on occasion without a resolution – paid themselves compensation or capital stock for their services rendered outside the scope of their duties. This was subsequently challenged in court. Having established that the directors had provided no extra services to the corporation and the compensation and shares were 'purely as a gift', the Supreme Court of Delaware held that the action of paying compensation and issuing capital stock was constructively fraudulent and voidable at the election of the corporation.[710] Citing *Du Pont v Du Pont*,[711] a Delaware District Court judgment applying New Jersey law,[712] the court held that if a fiduciary 'acts for himself in matters where his interest conflicts with his duty, the law holds the transaction constructively

[708] Kershaw (n 382) 361. Delaware became a market leader in corporate law even before it had any case law on corporate fiduciary duties.
[709] *Lofland v Cahall* 13 Del Ch 384 (Del 1922).
[710] ibid.
[711] *Du Pont v Du Pont* (DC) 242 Fed 98.
[712] It is to be noted that in the first stance, the Delaware Court of Chancery also applied the New Jersey's remedial approach to the fairness review citing relevant case law.

fraudulent and voidable at the election of the corporation.'[713] It appears that New Jersey law on interested transactions was borrowed and adopted in the case.

However, in *Lofland* the court also explained repeatedly that the transaction 'was constructively fraudulent because there was no one competent to value their service, meaning, of course, no one personally disinterested.'[714] According to the court, a contract to pay compensation or issue shares of stock 'must be made with directors, or other proper corporate officers who have no personal interest, directly or indirectly, in the contract, and who are competent to represent the company in the transaction'.[715] This implies that if there is one proper director or officer to represent the corporation, the rule of strict voidability would not apply. Moreover, the court noted that, as a general principle of law and equity, '[d]irectors of a corporation are trustees for the stockholders, and their acts are governed by the rules applicable to such a relation, which exact of them the utmost good faith and fair dealing, especially where their individual interests are concerned'.[716] It thus appears that the New York model of interested transaction regulation was adopted by Delaware.

In 1938, in the Supreme Court of Delaware case of *Keenan v Eshleman,*[717] directors of a corporation but acting as officers of a different corporation, used the payment of management fees (by the board in which a majority of the directors were interested) from the former corporation to the latter corporation to pay themselves double salaries and bonuses. Citing *Lofland*, the court re-stated the same fair-dealing requirement.[718] Further, citing *Geddes v Anaconda Copper Mining Co*,[719] a US Supreme Court case which adopted a fairness standard, the court held that the interested directors 'assumed the burden of showing the entire fairness of the transaction'.[720] However, the court denied that there was any express or implied contract for the payment of monthly management fees and, consequently, no interested transaction. The court identified the relevant actions of the directors and officers as 'a fraudulent misapplication of the funds of the corporation' and found the actions voidable at the election of the corporation. *Keenan v Eshleman* therefore considered but did not apply the law on interested transactions.

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[713] *Lofland* (n 709) 400.
[714] ibid 400.
[715] ibid 391.
[716] ibid 389.
[717] *Keenan v Eshleman* 23 Del Ch 234 (Del 1938).
[718] *Lofland* (n 709) 389.
[719] *Geddes v Anaconda Copper Mining Co* 254 US 590, 41 S Ct 209, 65 L Ed 425. In this case the fairness standard rule came from the US Supreme Court case which it followed, and which adopts a New Jersey model by citing relevant case authorities.
[720] *Keenan v Eshleman* (n 717).

The judgment did, however, endorse that during this period Delaware law adopted the fairness standard borrowed from both the New York and New Jersey models.

Most significantly, Delaware's corporate opportunity doctrine together with its duty of loyalty were established in the landmark decision of *Guth v Loft, Inc*[721] delivered by the Delaware Supreme Court. In this case, Loft was a corporation whose main business was manufacturing syrup and running retail stores that sold, inter alia, soft drinks. Guth, the president and dominant director of Loft, acquired a controlling interest in Pepsi Cola at a time when Loft was considering – under his direction – replacing Coca Cola with an alternative cola provider.[722] Subsequently, Guth also used Loft's financial and personnel resources to develop the Pepsi business and brand. In consequence, Loft brought an action against Guth claiming that the Pepsi opportunity and resulting profits accrued to Loft. *Guth v Loft* is of vital importance in Delaware corporate law because it not only set out Delaware's corporate opportunity doctrine but also introduced the general duty of loyalty. *Guth* defined, in unyielding terms, the fiduciary duty of loyalty and the no-conflict principle it embodies. 'The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.'[723] Moreover, the court correctly pointed out that while '[t]he standard of loyalty is measured by no fixed scale…the rule of corporate opportunity is merely one of the manifestations of the general [no-conflict] rule'.[724] In this way *Guth* introduced in the Delaware corporate law the general fiduciary doctrine which applies the no-conflict principle to determine the breach or non-breach of the duty of loyalty.

In *Guth* the Delaware court also established the corporate opportunity doctrine by borrowing and collating existing corporate opportunity laws from other US states. In this case, citing relevant cases such as *Colorado*, *Lagarde*, *Pioneer*, *Sandy River*, and *Lancaster Loose Leaf*, the Delaware court undertook inter-state borrowing from both the property and the no-conflict approaches to the corporate-opportunity doctrine. The court then held that:

> If there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-

[721] *Guth* (n 276).
[722] ibid.
[723] ibid 510.
[724] ibid.

> interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.[725]

The court thereby laid out Delaware's corporate opportunity doctrine, known as the 'Guth Rule', borrowing the 'line of business' and the 'financial capacity' criteria from the no-conflict lens cases and the 'interest or expectancy' test from the property-lens cases.

Furthermore, in *Guth* the court made some proactive and innovative coalescence in borrowing from pre-Delaware corporate-opportunity law. First, the Delaware court established a proprietary pattern of the corporate opportunity doctrine in which the no-conflict principle no longer works as a framework. As discussed, in both the property and the no-conflict cases, the no-conflict principle was generally applied, though the fiduciary's duty to the corporation was either confined to where there was a quasi-property-right connection between the corporation and the opportunity or the corporation was constrained by its inability or unwillingness to take advantage of the opportunity. In *Guth*, instead of adopting the no-conflict framework and confining the duty to the corporation, Delaware law established a proprietary framework using four criteria to determine whether an opportunity belongs to the corporation.[726] There was thus no longer general application of the no-conflict principle but a proprietary pattern of law which defined a 'corporate' opportunity by four criteria. Second, the Delaware court re-defined the 'interest or expectancy' test as part of the Guth Rule. Originally, in *Lagarde*, the 'interest or expectancy' test required a property-like link between the corporation and the opportunity. Besides, as part of the *Lagarde* law, there was a further criterion which operated in tandem with the 'interest or expectancy' test and required that the opportunity must be essential to the purpose of the corporation.[727] In *Guth*, however, the 'interest or expectancy' test was re-defined to reflect the essential nature of an opportunity related to the business of the corporation.

Delaware's corporate opportunity doctrine has not changed significantly since *Guth*. In 1956 a corporate opportunity case, *Johnston v Greene*,[728] came before the Delaware Supreme Court with a more complex set of facts. The challenged director was involved in the management of various similar businesses and received the offer of an opportunity in his private capacity. The court found that the key corporation concerned did not have a well-defined line of business and

[725] ibid 511.
[726] Kershaw (n 382) 457.
[727] *Lagarde* (n 676).
[728] *Johnston v Greene* 121 A2d 919 (Del 1956)

held that if an officer receives an offer in his or her personal capacity, it must be shown that the opportunity is either directly or closely related to the corporation's business or a business in which the corporation has a specific interest or expectation. The court also referred to the role of 'fairness' in establishing the interest and stated that 'whether an opportunity is corporate or personal depends on the facts—upon the existence of special circumstances that would make it unfair for the director or officer to take the opportunity for himself'.[729] *Johnston v Greene* developed the Delaware corporate opportunity doctrine by clarifying the criteria in the Guth Rule as well as their application in a fact-based analysis based on considerations of 'fairness'.

In 1967 a significant milestone in the evolution of Delaware's interested transaction regulation was the enactment of the 'safe harbour' statute. Section 144 was adopted in 1967 as part of an overall revision of the DGCL. Section 144(a) provides that no interested contract or transaction shall be void or voidable solely for the reason of its 'interested' nature, or solely because the interested director or officer participates in the meeting which authorises the transaction, or solely because any such director's or officer's votes are counted for such purpose, provided that the transaction has been duly approved by the majority of disinterested directors or shareholders, or is fair to the corporation.[730] This section sets out three avenues by which to rescue interested transactions from *per se* voidability under the common law. This *per se* voidability originated in two different lines of common-law cases. One involved the shareholders' power to nullify interested transactions as part of interested transaction regulation. As discussed above, Delaware adopted both the New York and New Jersey models of interested transaction regulation, either of which embodies the element of *per se* voidability of the transaction. Under the New York model, if the transaction was entered into by all interested directors with no director or officer duly representing the corporation, the transaction is voidable. Under the New Jersey model, despite having the remedial fairness review, the generic rule itself was a rule of voidability. In both cases, the shareholders were to some extent empowered to nullify interested transactions.[731] Section 144(a) was therefore aimed at addressing this *per se* voidability by subjecting interest transactions to the fairness standard only.

[729] ibid 924.
[730] Del Gen Corp Law s 144(a).
[731] See *Stewart* (n 639) and *Gardner* (n 644).

In another line of cases, a contract or transaction in which a majority of voting directors had an interest was generally presumed to be void. There is a general common-law rule that 'the votes of interested directors will not be counted in determining whether proposed action has received the affirmative vote of a majority of the [board]'.[732] In that case, the proposed action as regards an interested transaction might fail to meet the quorum requirement for board authorisation and the transaction could thus be voided by the courts.[733] Based on this line of cases, an otherwise fair transaction could be declared void for lack of due board authorisation. There was consequently a measure of tension between this common-law approach and the approach which applied the fairness standard to interested transactions. Section 144 therefore also aimed to address this tension by subjecting interest transactions only to the fairness standard. Consequently, in terms of section 144(a), the problem of *per se* voidability arises only if the transaction is not fair to the corporation, which accords with the common-law interested transaction regulation.

It should be noted that the role and application of section 144(a) are limited to the avoidance of *per se* voidability of interested transactions and that the section addresses neither the validation of the transactions nor the breach or non-breach of fiduciary duties by interested directors or officers.[734] 'The effect of the statute is not necessarily to validate the transaction but simply to put it on the same footing as any other corporate transaction'.[735] In other words, section 144 merely prevents interested transactions from being invalidated due solely to any director's or officer's interest rendering the transactions subject to the common law as regards interested transaction regulation and breach of fiduciary duty – ie, the fairness standard. On the other hand, because section 144 uses the disinterested board or shareholder approval as avenues to rescue interested transactions from *per se* voidability, it in effect brings interested transactions into the realm of the common-law business judgment rule.[736] Because the compliance with section 144(a) requirements as regards the disinterested board or shareholder approval happens to be the type of action required for invoking the business judgment rule. The business judgment rule protects interested transactions which have been approved by the disinterested board or shareholder from the fairness review by Delaware courts. In this regard,

[732] *Kerbs v Cal E Airways Inc* 90 A2d 652, 658 (Del 1952).
[733] ibid.
[734] Blake Rohrbacher, John Mark Zeberkiewicz and Thomas A Uebler, 'Finding Safe Harbor: Clarifying the Limited Application of Section 144' (2008) 33 Delaware Journal of Corporate Law 719.
[735] Samuel Arsht and Walter K Stapleton, 'Delaware's New General Corporation Law: Substantive Changes' (1967) 23(1) Business Lawyer 75, 82. Both authors were involved in the 1967 DGCL drafting process.
[736] See 4.3.1 for a detailed discussion of the business judgment rule and its relation to the fiduciary duties.

the disinterested board or shareholder approval has become the safe harbour procedure in Delaware's interested transaction law since the enactment of section 144(a).

During the 1960s and 1970s, there were also sporadic cases on the directorial duty of care decided in Delaware courts, although the jurisprudence in this area of the law crystalised only in mid-1980s.[737] In one line of cases, Delaware courts recognised that the accountability was appropriate for relevant process care failures however, the legal basis for this liability falling to the directors is not persuasive.[738] The courts highlighted the duty to exercise corporate power in good faith, and regarded informational and procedural flaws in directors' decision making as proxies for bad faith.[739] One case in point was what is commonly regarded as the first Delaware duty of care case, *Graham v Allis-Chalmers Manufacturing Company*[740] in 1963. The directors of a corporation were charged with failure to prevent anti-trust violations by certain corporation employees and were challenged to be liable 'by reason of their gross inattention to the common law duty of actively supervising and managing the corporate affairs.'[741] Similarly, in other duty of care cases during this period Delaware courts also reviewed the exercise of directorial power rather than addressing directorial care in the decision-making process.[742] In another line of cases, directors were simply presumed to have behaved reasonably and apparent instances of negligence triggered an inquiry into the duty of loyalty breach by the Delaware courts. As a result, the duty of care was no longer enforceable as a stand-alone duty.[743]

4.1.3 The Evolution of Corporate Fiduciary Duties in Delaware: 1980s-1990s

During the 1980s and1990s both the content and structure of Delaware's corporate fiduciary duties shifted in the wake of new developments in both the law and society. The most significant development during this period was the 'takeover boom' of in the 1980s. Takeover disputes began to appear frequently in Delaware courts after the US Supreme Court invalidated

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737 Kershaw (n 382) 198; Stephen J Lubben and Alana J Darnell, 'Delaware's Duty of Care' (2006) 31 Delaware Journal of Corporate Law 589, 590.
738 See, eg, *Bennett v Propp* 187 A2d 405 (Del 1962).
739 See *Gimbel v Signal Companies Inc* 316 A2d 599 (Del Supr 1974).
740 *Graham v Allis-Chalmers Manufacturing Company* 41 Del Ch 78 (1963).
741 ibid 84.
742 See, eg, *Penn Mart Realty Co v Becker* 298 A2d 349 (1972); *Sinclair Oil Corp v Levien* 280 A2d 717, 722 (1971); *Getty Oil Co v Skelly Oil Co* 267A2d 883, 887 (1970).
743 Edward Rock and Michael Wachter, 'Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants Symposium: Van Gorkom and the Corporate Board: Problem, Solution, or Placebo' (2001) 96 Northwestern University Law Review 651.

virtually all state statutes regulating| tender offers on the ground that the internal affairs of corporations were properly the domain of the state of incorporation.[744] The development of Delaware corporate fiduciary law at this stage was therefore characterised by the hostile takeover phenomenon. Responding this trend in a proactive or even over-reactive manner, Delaware law shifted significantly in several aspects of fiduciary duties. As regards the duty of loyalty, Delaware courts for the first time defined the standard of 'entire fairness' in their judicial review of interested transactions and in effect settled Delaware's interested transaction regulation. However, the most significant development in Delaware's corporate fiduciary law during this period was in the field of the duty of care. As a home-grown product, Delaware's duty of care was established and quickly shifted in 1980s on the tide of the takeover boom. The drastic shifts in law on the duty of care subsequently led to increasing prominence of the so-called 'duty of good faith' during this period.

In the context of takeover trend, the Delaware Supreme Court delivered judgment in the case of *Weinberger v UOP Inc* which refined the judicial-fairness review of interested transactions. Although Delaware law had long adopted the fairness standard review of interested transactions, *Weinberger* was the first case in which its courts explained the standard of 'entire fairness' in detail. In *Weinberger* the Delaware Supreme Court held that the fairness standard includes both fair dealing and fair price as two basic concepts.[745] AAs discussed, in pre- and early Delaware law on interested transaction, the fairness standard required only a fair price – ie, that the corporation receive reasonable consideration in the transaction.[746] It is fair to assume that *Weinberger* introduced the fair-dealing requirement into the fairness standard. It appears that the introduction of the fair-dealing test made the fairness standard more demanding. However, as pointed out in the case, the requirements of fair dealing and fair price 'must be examined as a whole since the question is one of entire fairness.'[747] Indeed, if there is no fair dealing in a given transaction there can hardly be a fair price and vice versa. *Weinberger* thus provided a defined and refined fairness standard. Since *Weinberger* Delaware law on interested transactions has remained largely settled.

In light of the takeover trend, the most significant development in Delaware corporate fiduciary law has been in the field of the duty of care. Prior to the 1980s, the duty of care received little

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744 See *Edgar v MITE Corp* 457 US 624 (1982).
745 *Weinberger v UOP Inc* 457 A2d 701, 711 (Del 1983).
746 See 4.1.1 and 4.1.2.
747 *Weinberger* (n 745) 711.

or no attention in Delaware. In 1985, the Delaware Supreme Court delivered a most controversial decision in the history of the duty of care, *Smith v Van Gorkom*,[748] in which the board of directors engaged in a rather sloppy decision to approve a proposed cash-out merger of Trans Union Corporation into its wholly owned subsidiary. The board decision was taken during a two-hour meeting without seeking an opinion on fairness from the company's financial advisors. The court adopted the standard of gross negligence to review the board's conduct and held that the board had been grossly negligent in agreeing to the merger without being fully informed. In so doing it breached the duty of care.[749] The *Van Gorkom* decision was unique, significant, and influential in the evolution of duty of care jurisprudence. It was the first case in which the duty of care was enforced as an independent duty, and importantly, although the Delaware Supreme Court applied 'gross negligence' as the standard of review, the directors' conduct in this case arguably constitutes only a degree of negligence. United States commentators regard the decision in *Van Gorkom* to have been strongly influenced by the takeover trend prevailing at the time.[750]

The takeover trend post new problems for judicial review of director conduct by the Delaware courts. For example, in a hostile takeover the management of the targeted corporation is at huge risk of being dismissed once the takeover has been completed as the completion of a hostile takeover generally takes place against the backdrop of a tense relationship between incumbent directors and shareholders.[751] Even in friendly acquisitions the decisions of the boards targeted for acquisition regarding a negotiated takeover may be made not solely in the economic interests of the shareholders. The directors taking the decision also have an interest in maintaining their offices, salaries, and benefits once the takeover has been completed.[752] Furthermore, the cooperation of the target board is a prerequisite for a successful takeover transaction in that US corporation directors have considerable power in negotiated takeovers. Thus, bidders are motivated to offer the management side benefits, including employment contracts, substantial severance payments, and compensation arrangements.[753] These

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[748] *Smith v Van Gorkom* 488 A2d 858 (Del 1985).
[749] ibid 893.
[750] See William T Allen, 'The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under US. Corporate Law' in Klaus J Hopt *et al* (eds), *Comparative Corporate Governance: State of the Art and Emerging Research* (OUP 1998) 307, 321-324
[751] See Stephen Bainbridge, *Mergers & Acquisitions* (3rd edn, West Academic Publishing 2012) Chapter 3.
[752] See *Paramount Communications Inc v Time Inc* [1989 Transfer Binder] Fed Sec L Rep (CCH) (Del Ch 1989).
[753] Stephen Bainbridge, 'Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions' (1990) 75 Minnesota Law Review 239, 273-274.

considerations led to the Delaware Supreme Court adopting a harsher approach to the duty of care as part of its new takeover jurisprudence.

The *Van Gorkom* decision raised considerable concern in the boardrooms of Delaware corporations, which attracted the intervention of the DGCL on public-policy considerations. As a result of the *Van Gorkom* judgment all the directors, both internal and external, were faced with draconian monetary liability most of which was ultimately paid by the corporation's insurers, which consequently caused a directors and officers insurance liability crisis.[754] Moreover, the *Van Gorkom* decision caused huge concern about personal liability among directors of Delaware corporations. In the following year the Delaware legislature responded by enacting section 102(b)(7) of DGCL which allows Delaware corporations to include a charter provision exonerating directors from monetary liability for gross negligence.[755] Soon, most Delaware corporations had incorporated charter amendments or restated certificates of incorporation to include the section 102(b)(7) provisions.

For some time after the enactment of section 102(b)(7) there was uncertainty as to the operation of the section in practice. In 1999, in *Emerald Partners v Berlin*,[756] the Delaware Supreme Court clarified that the section 102(b)(7) provisions in the charter of the corporation were 'in the nature of an affirmative defense'. This articulation in *Emerald* led to confusion because, theoretically, it appeared to require directors to prove that there had been no breach of the duty of loyalty and good faith even where the plaintiffs had failed to allege such breaches. This was later resolved in *Malpiede v Townson*[757] in which the Delaware Supreme Court stated that a sole duty of care claim is dismissible if a section102(b)(7) provision is properly invoked. *Malpiede* can be seen as judicial cognisance of practical reality – that a trial is unnecessary if a section 102(b)(7) provision will exculpate the defendant directors from the payment of monetary damages for breach of the duty of care. This explanation in *Malpiede*, together with the ubiquity of section102(b)(7), in effect rendered the duty of care component of Delaware corporate fiduciary duties largely unenforceable.

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[754] Roberta Romano, 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 Emory Law Journal 1155.
[755] DEL CODE ANN. tit. 8, § 102(b)(7) (2008) (enacted 1986). Section 102(b)(7) is designed to have the remedial effect that directors would not incur monetary liability, while the court may still set aside a transaction which is the product of directors' gross negligence.
[756] *Emerald Partners v Berlin* 787 A2d 85 (Del 2001).
[757] *Malpiede v Townson* 780 A2d 1075 (Del 2001).

In light of the shifts in the duty of care during the mid-1980s, the duty of 'good faith' gained prominence in Delaware corporate fiduciary law. This, in turn, gave rise to the notion of a triad of fiduciary duties in Delaware cases during the 1990s. Given the ubiquity of section 102(b)(7) in Delaware corporations and the largely unenforceable duty of care, claims of the breach of the duty of 'good faith' became a key channel for breaches of fiduciary duties in the Delaware courts. If the plaintiffs could successfully plead lack of good faith, the case could not be dismissed by invoking section 102(b)(7) of the DGCL.[758] Consequently, in litigation during the 1990s, plaintiffs' lawyers started to include arguments pleading the defendants lack of good faith, which compelled Delaware courts to consider how to deal with the good faith claims.[759] This led in 1993 to the judgment in *Cede & Co v Technicolor Inc* in which the Delaware Supreme Court first referred to a 'triad of fiduciary duties' – loyalty, due care, and good faith.[760] To be clear, the court did no more than state the existence of this triad without offering any explanation. Following *Technicolor*, this notion of triad of fiduciary duties was taken up in some Chancery court cases.[761] Although the phrase 'triad of fiduciary duties' suggests an independent duty of good faith, the triad was never actualised in practice – not even in *Technicolor* itself.[762] Furthermore, in spite of its gaining prominence in the 1990s, little guidance as to what good faith entails had been provided by Delaware courts at this stage.[763]

4.1.4 The Evolution of Corporate Fiduciary Duties in Delaware: Since 2000

The beginning of twenty-first century witnessed further dynamic developments in Delaware's corporate fiduciary law. Although the traditional fields of fiduciary duties of loyalty and care was well-settled by this stage, Delaware law set out to explore some new areas of corporate fiduciary duties.

One prominent development was to permit contracting-out of the corporate-opportunity doctrine. Historically, the contracting around or out of the doctrine was not permitted as the duty of loyalty was considered a mandatory component of corporate law.[764] On the other hand,

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758 See *Malpiede* (n 757) 1092-1096 for further explanation.
759 Claire A Hill and Brett H McDonnell, '*Stone v Ritter* and the Expanding Duty of Loyalty' (2007) 76 Fordham Law Review 1769, 1773-1774.
760 *Cede & Co v Technicolor Inc* 634 A2d 345, 361 (Del 1993).
761 Leo Strine *et al*, 'Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law' (2010) 98 Georgetown Law Journal 629, 685.
762 ibid 673-684.
763 Hill and McDonnell (760) 1773-1774.
764 Jeffrey N Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 Columbia Law Review 1549, 1593.

as Delaware law provided no clear prohibition on contracting-out a few corporations experimented with corporate opportunity waivers which led to the signal case of *Siegman Tri-Star Pictures Inc* decided by Delaware Chancery Court in 1989.[765] In this case, the court found that the corporate opportunity waiver 'arguably would contravene Delaware law because, under the articulated terms of Tri-Star's certificate of incorporation, some scenarios can be envisioned as violating section 102(b)(7) of DGCL.[766] *Siegman* thereby confirmed contracting-out of the duty of loyalty through an amendment of corporate constitutions was not permitted. However, the 1990s ushered in a wave of market-mediated innovations, including partial IPOs, equity carve-outs, venture capital, and private equity which resulted in corporate structures featuring ownership-board-industry overlap among affiliated entities.[767] These types of corporate structure led to the conundrum of allocating corporate opportunities between the parent corporation and its subsidiaries or among affiliated entities. The challenges were evidenced in the courts by two leading cases – *Thorpe v CERBCO Inc*[768] and *In re Digex, Inc*,[769] both of which involved corporate opportunity claims asserting that the parent corporation had usurped a corporate opportunity involving an acquisition by its controlled subsidiary. These cases revealed the potential value in and necessity of allowing the pre-arranged division of corporate opportunities in the modern business context and served as the driving force for legal reform.[770] As a consequence, a shift in the corporate opportunity doctrine emerged on the cusp of the twenty-first century.

In 2000, the Delaware Assembly amended the DGCL by adding subsection (17) to section 122 which essentially permitted contracting-out of the corporate opportunity doctrine.[771] In light of the nature of section 122, the power to renounce corporate opportunities is categorised as an inherent power of Delaware corporations and can be effected in the certificate of incorporation or by action of the board.[772] It is to be noted, however, that this power is confined to 'specified classes or categories of' business opportunities'.[773] As explained in the legislative synopsis, the purpose of the subsection (17) is to 'eliminate uncertainty regarding the power of a

765 Gabriel Rauterberg and Eric Talley, 'Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers' (2017) 117 Columbia Law Review 1075, 1090-1091.
766 *Siegman Tri-Star Pictures Inc* No 9477, 1989 WL 48746 (Del Ch 1989) 7-8.
767 Rauterberg and Talley (n 766) 1093.
768 *Thorpe v CERBCO Inc* 676 A2d 436 (Del 1996).
769 *In re Digex Inc* 789 A2d 1176 (Del Ch 2000).
770 Rauterberg and Talley (n 766) 1094-1095.
771 72 Del Laws 619 (2000).
772 Del Code Ann Tit 8 § 122 (2017).
773 ibid § 122(17) (2017).

corporation to renounce corporate opportunities in advance raised in *Siegman*.'[774] Since the promulgation of section 122(17) it has been invoked in only one Delaware case and triggered several commentaries.[775] This notwithstanding, other states have followed Delaware's example and amended their statues accordingly – although New York and California are not among them.[776]

Another post-2000 development in Delaware corporate fiduciary law has been the emergence of the doctrine of good faith. In the *Disney* cases, acknowledging that 'the duty to act in good faith is, up to this point[,] relatively uncharted', the Delaware courts formulated the standards for good or bad faith for the first time.[777] The key formulation, applied by both the Delaware Chancery and Supreme Court, is that 'the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith'.[778] Thereby, although still somewhat vague, the *Disney* cases have offered a general standard of good faith and its application in addressing complex scenarios.[779] Relatedly, Delaware courts redefined the nature of good faith as a subsidiary element of duty of loyalty rather than one of triad of fiduciary duties. In its 2006 decision in *Stone v Ritter*, the Delaware Supreme Court pointed out that the 'phraseology…describing the lack of good faith as a "necessary condition to liability" is deliberate', and clarified that the imposition of liability in a good-faith case does not arise directly from the failure to act in good faith. Rather, it is based on the failure constituting a breach of duty of loyalty, of which good faith is a 'subsidiary element' or 'condition'.[780] The Delaware Supreme Court further explored some implications of this doctrinal clarification. For one, although 'colloquially' described as one of triads of fiduciary duties, it is settled that good faith is not an independent fiduciary duty.[781] For another, the scope of the duty of loyalty has been extended beyond 'financial or other cognizable fiduciary conflict of interest' to include good faith.[782] *Stone v Ritter* thereby settled the position of good faith in the legal framework of fiduciary duties under Delaware corporate law.

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774 Senate Bill 363: Original Synopsis, Del Gen Assembly.
775 Rauterberg and Talley (n 766) 1098.
776 ibid 1101.
777 *In re Walt Disney Co Derivative Litigation* 907 Asd 693 (Del Ch 2005), aff'd 906 A2d 27 (Del 2006).
778 *In re Walt Disney Co Derivative Litig* 906 A2d 27, 62 (Del 2006) (quoting the Chancery Court opinion).
779 Hill and McDonnell (n 760) 1775.
780 *Stone v Ritter* (n 293) 369-370.
781 ibid 370.
782 ibid.

4.2 Fiduciary Relationships in Delaware Corporate Law

Under Delaware corporate law there is a fiduciary relationship between directors and officers and the corporation and shareholders. This part first discusses the fiduciary status of corporate directors and officers with emphasis on the relatively unclear Delaware law on officers. It then explores the legal implications for the corporation and shareholders to whom fiduciary duties are owed.

4.2.1 Directors and Officers Owe Fiduciary Duties

The most important set of fiduciary relationships in Delaware corporate law is that between corporate directors and officers who owe fiduciary duties to the corporation and its shareholders. In *Guth v Loft*, the Delaware Supreme Court stated that 'corporate officers and directors…stand in a fiduciary relation to the corporation and its stockholders.'[783] Delaware law is clear that corporate directors and officers are fiduciaries and owe fiduciary duties. This has been confirmed in numerous subsequent cases. On the other hand, Delaware law offers little or no legal or conceptual basis to justify this fiduciary status. Despite being recognised as settled law, that directors and officers are fiduciaries or that they owe fiduciary duties are virtually assertions in Delaware cases. As has been shown, US law established the fiduciary status of directors and officers very early on by simple analogy with trustees or agents rather than on the basis of sound legal analysis or reasoning.[784] It was nevertheless one of early ways in which courts in common-law jurisdictions identified those traditional types of fiduciary relationship.

In general, Delaware corporate law adopts a status-based approach identifying whoever occupies the position of director or officer serves as a corporate fiduciary. In terms of section 102(b)(7) of the DGCL, a director is whoever, pursuant to a provision in the certificate of incorporation of a corporation, exercises or performs any of the powers or duties otherwise conferred or imposed upon the board of directors by the DGCL.[785] Despite its lack of conceptual basis in Delaware law, corporate directors' *sui generis* status as fiduciaries is widely

[783] *Guth* (n 276) 510.
[784] Tamar Frankel, *Fiduciary Law* (OUP 2011) 65-68.
[785] Del Gen Corp Law s 102(b)(7).

accepted.[786] There have been many statutory provisions and a rich body of case law establishing the set of rules with regard to the fiduciary duties of directors. This is discussed further below.

In sharp contrast, in Delaware law the fiduciary status and duties of corporate officers are far from clear or well-established. Remarkably, there is little statutory or case law specifically addressing the fiduciary duties and liability of non-director officers in Delaware.[787] First, the scope of corporate officers as fiduciaries is not specified in Delaware law. In fact, Delaware courts have never dealt with this issue of defined officers to establish whether they are subject to fiduciary duties,[788] although Delaware statutes do contain some provisions defining officers for other purposes. Section 142(a) of the DGCL merely provides that every corporation shall 'have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws'.[789] This means that officers are as specified in the corporation's bylaws or board resolutions. Clearly, this provision offers no meaningful definition or scope of the officers in a Delaware corporation. More specifically, providing for personal jurisdiction over officers by Delaware courts, Delaware's Courts and Judicial Procedure Code defines 'officer' as someone who:

> (1) Is or was the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful;
>
> (2) Is or was identified in the corporation's public filings with the United States Securities and Exchange Commission because such person is or was 1 of the most highly compensated executive officers of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful; or
>
> (3) Has, by written agreement with the corporation, consented to be identified as an officer for purposes of this section.[790]

786 Lyman PQ Johnson and David Millon, 'Recalling Why Corporate Officers Are Fiduciaries' (2005) 46 William and Mary Law Review 1597, 1620-1622.
787 Stephen M Bainbridge *et al*, *Can Delaware Be Dethroned? Evaluating Delaware's Dominance of Corporate Law* (CUP 2018) 185-190.
788 Kevin McCarthy, *Corporate Officer Liability and the Applicable Standard of Review-Under Delaware Law and Agency Law* (2017) available at http://digitalcommons.law.msu.edu/king/256 accessed 11 November 2020.
789 Del Gen Corp Law s 142(a).
790 DEL CODE ANN tit 10, 3114(b) (West 2015).

This definition is more helpful as the commonly used titles of officers are listed and flexible standards are specified. It can be seen that officers in general refer to the senior management of the corporation but not lower-level managers. To clarify, in that this provision deals with an entirely different legal issue, it is of no direct assistance in establishing officers as fiduciaries. It does, however, clarify the common titles of officers acknowledged by Delaware law.

Nevertheless, the statutory provisions above can offer some insight into who are deemed as officers in Delaware courts. It can be fairly assumed that an officer who is duly specified in the corporation's bylaws or board resolutions by any of the titles of president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, or chief accounting officer could be presumed in Delaware litigation to be a corporate fiduciary who owe fiduciary duties. Fundamentally, the fiduciary status of officers arises because they stand in a fiduciary relationship to the corporation. To determine relevant personnel as officers, a title is not dispositive.[791] On the other hand, it is fair to contend that the common titles of officers imply *per se* fiduciary status unless otherwise decided in the courts. Conceptually, who are officers as fiduciaries can only be properly explained on the existence of fiduciary relationships, but Delaware law does not provide such rationalisation and commentators have yet come up with a consensual theory to explain the fiduciary relationship. Consequently, the fiduciary status of any officer without a common title can only be determined by the courts.

Further, corporate officers' fiduciary duties remain murky under Delaware law. In *Gantler v Stephens*,[792] the Delaware Supreme Court for the first time dealt specifically with non-director officers' fiduciary duties. The court held that officers of Delaware corporations owe fiduciary duties of loyalty and care, and that the fiduciary duties of officers are identical to those of directors.[793] Therefore, as confirmed in *Gantler v Stephens*, fiduciary duties and relevant rules under Delaware corporate law generally apply to both directors and officers. However, in light of the dearth of law on officers' fiduciary duties some legal issues remain unsettled. Important questions in this regard include whether the business judgement rule applies to officers, and whether gross negligence or simple negligence is the requisite standard for an officer's duty of care. The debate between two sets of US commentators captures the plausible alternatives to

[791] Gilchrist Sparks and Lawrence A Hamermesh, 'Common Law Duties of Non-Director Corporate Officers' (1992) 48 The Business Lawyer 215.
[792] *Gantler v Stephens* 965 A2d 695 (Del 2009).
[793] ibid 708-09.

these questions.[794] As either side of the arguments can be grounded on theories and policy considerations, they are open to be decided by the courts in future cases.

It is to be noted that in Delaware's jurisprudence addressing claims against corporate officers are rare. For example, between 2004 and 2014 only 86 Delaware state court judgments involved claims against corporate officers.[795] As regards breaches of fiduciary duties the cases typically dealt with duty-of-loyalty claims in situations involving the appropriation of corporate opportunities, excessive executive compensation, and exploitation of corporate assets.[796] Most recently, the only significant judgment on officer fiduciary duties is the 2015 judgment in the *Dole Food* case which also involved the duty-of-loyalty type failures by corporate officers in a management buy-out context.[797] By way of contrast, there have been hundreds of cases addressing fiduciary duty claims against corporate directors during the same period. Clearly, the limited extent of litigation in Delaware courts has led, at least in part, to the dearth of law in this field.

Various reasons can be given for this perplexing dearth of Delaware law on the fiduciary status and duties of corporate officers. First, the Delaware Chancery Court did not have personal jurisdiction over non-director officers before 1 January 2004.[798] Second, and concomitantly, thirty years ago there were a limited number of non-director officers in Delaware corporations, whist the rise of independent directors in the 1980s and 1990s plus the increasing legal mandates in this regard, led to fewer director-officers specifically in public companies.[799] Third, boards of directors tend to resolve officer misconduct by non-litigious means or contractual settlements such as salary reduction, demotion, or outright termination, which tend to make formal litigation a rarity.[800] Fourth, legal professionals practising Delaware corporate law lack sufficient expertise in officers' fiduciary duties. Delaware lawyers have historically

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794 Lyman PQ Johnson, 'Corporate Officers and the Business Judgment Rule' (2005) 60 The Business Lawyer 439; Lawrence A Hamermesh and A Gilchrist Sparks, 'Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson' (2005) 60 The Business Lawyer 865.

795 Megan Wischmeier Shaner, 'Officer Accountability' (2016) 32 Georgia State University Law Review 357, 380-388.

796 ibid.

797 *In re Dole Food Inc Stockholder Litig* 2015 WL 5052214 (Del Ch 2015).

798 William B Chandler and Leo E Strine, 'The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State' (2003) 152 University of Pennsylvania Law Review 953. Delaware's Courts and Judicial Procedure Code was revised, as effective on 1 January 2004, to give personal jurisdiction over non-director officers. See DEL CODE ANN tit 10, 3114(b) (West 2015).

799 Jeffrey N Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices' (2007) 59 Stanford Law Review 1465.

800 Bainbridge *et al* (n 788). Officer misconduct in a solvent Delaware corporation can only be remedied by stockholders though derivative suits.

failed to appreciate the fiduciary status and duties of corporate officers.[801] Also legal counsel – both in-house and external – typically devote less effort to advising officers of their fiduciary duties than they do in the case of external directors.[802]

4.2.2 Fiduciary Duties are owed to the Corporation and Shareholders

In Delaware corporate law directors and officers owe their fiduciary duties to the corporation and its shareholders. It is well-established law in Delaware that directors and officers stand in a fiduciary relation to, and thus owe fiduciary duties to the corporation and its shareholders – although the courts commonly state this without much justification or reasoning.[803] To begin with, directors and officers owe fiduciary duties to the shareholders of the corporation. The basic rationale for this is that the separation of ownership and control in a corporation makes the relationship between corporate management and shareholders fiduciary. Historically, in US corporation law fiduciary duties were initially introduced in the corporate context by analogy to trust law and should obviously be owed to the shareholders – ie, the ownership beneficiaries of the corporation.[804] In modern case law this rationale still applies. For example, the Delaware Supreme Court explains that because Delaware corporate law provides for the separation of control and ownership, fiduciary duties are imposed to regulate directors' conduct when they act to manage the business of the corporation for the benefit of its shareholder owners.[805]

Fiduciary duties can be owed to all shareholders collectively or to individual shareholders. In most circumstances, fiduciary duties are owed to all shareholders collectively, which equates with the fiduciary duties being owed to the corporation. Commonly, breach of fiduciary duties by directors or officers in their management of the corporation affects all shareholders indirectly, while the corporation suffers the loss directly. Fiduciary duties are owed directly to shareholders when their breach only affects individual shareholders as opposed to the corporation. In such cases, shareholders may seek to enforce the relevant fiduciary duties in the courts in their own right. These are shareholders' direct suits in contrast to derivative suits.

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801 Lyman Johnson and Dennis Garvis, 'Are Corporate Officers Advised About Fiduciary Duties?' (2009) 64 The Business Lawyer 1105.
802 ibid.
803 See *Mills Acquisition Co v MacMillan Inc* 559 A2d 1261, 1280 (Del 1989) ('[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders'…); *N Am Catholic Educ Programming Found Inc v Gheewalla* 930 A2d 92, 99 (Del 2007). ('It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders.').
804 Joseph T Walsh, 'The Fiduciary Foundation of Corporate Law' (2002) 27 The Journal of Corporation Law 333, 335.
805 *Gheewalla* (n 803) 101.

In this regard, the Delaware courts set out the standard that a director-suit applies when individual shareholders rather than the corporation have suffered the alleged harm and would receive the benefit of any recovery or other remedy.[806]

On the other hand, under Delaware corporate law directors and officers do not owe fiduciary duties to stakeholders. Stakeholders refer to the constituencies in a corporation other than shareholders – eg, creditors, suppliers, customers, employees, and perhaps even the community in which the corporation operates. Delaware law is clear that fiduciary duties are not owed to these stakeholders. Fundamentally, this is because directors and officers do not stand in a fiduciary relationship to stakeholders and so there is no justification for their protection. Further and relatedly, stakeholder interests are sufficiently protected by other legal means, in particular by contract. In short, in contrast to the gap-filling role of fiduciary duties in the protection of shareholders against managerial opportunism, other constituencies can protect themselves by retaining negative control over the firm's operation by negotiating the right to veto management decisions in their contracts with the corporation. They can also protect themselves against the firm's post-contractual opportunism by judicial gap-filling in interpreting those contracts.[807] For example, under Delaware law fiduciary duties are not owed to creditors even if the corporation is insolvent. The courts reason that creditors of an insolvent corporation may not assert claims for breach of fiduciary duties as they are protected by contract terms, fraudulent conveyancing law, and other laws, while fiduciary duties exist to protect shareholders.[808]

However, directors and officers *may* take stakeholder interests into account when making business decisions. This relates to the classic stakeholder debate about whether corporate management should only serve the interests of the shareholders by maximising profits or should also consider the interests of other stakeholders. Adolf Berle of Columbia Law School and Merrick Dodd of Harvard engaged in a classic scholarly debate on this issue in the 1930s. Berle argued that 'managerial powers are held in trust for stockholders as sole beneficiaries of the corporate enterprise'.[809] In response, Dodd contended that 'the business corporation as an

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[806] *Tooley v Donaldson, Lufkin & Jenrette* 845 A2d 1031 (Del 2004).
[807] Jonathan R Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 Stetson Law Review 23.
[808] *Gheewalla* (n 803). See also Frederick Tung, 'The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors' (2008) 57 Emory Law Journal 809. The author argues that creditor should be protected by contracts only.
[809] Adolf A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 Harvard Law Review 1049.

economic institution…has a social service as well as a profit-making function'.[810] Years later, Berle conceded that Dodd's contention turned out to be a social and juridical fact.[811] But the debate continues with scholars even proposing that fiduciary duties should be owed to stakeholders. Law in general, and Delaware law in particular, has, however, not as yet ventured this far.

In Delaware corporate law the courts have indicated that in the context of control decisions directors are permitted to consider stakeholder interests subject to limitations as regards shareholder interests. In *Unocal Corp v Mesa Petroleum Co* the Delaware Supreme Court held that in responding to a takeover bid a board may consider, among other things, 'the impact on "constituencies" other than shareholders'.[812] Subsequently, in *Revlon Inc v MacAndrews & Forbes Holdings Inc*, the Delaware Supreme Court confirmed that board *may* take various stakeholder interests into account, at least when there is no ongoing auction for the firm in process, provided that the action taken in the interests of stakeholders satisfies the requirement that 'there be some rationally related benefit accruing to the stockholders'.[813] *Revlon* also provided that once the decision to sell the corporation has been taken, directors can consider only the interests of shareholders.[814] It can therefore be seen that under Delaware law directors' consideration of stakeholder interests is strictly confined and limited. Delaware cases in this regard were decided in the context of the takeover trend of the 1980s and 1990s as a defensive measure to protect corporations from takeovers.

As directors and officers do not owe fiduciary duties to stakeholders, how is one to understand that they may consider stakeholder interests in their corporate decision making? That directors may consider stakeholder interests in business decisions is by nature an exercise of management discretion. Even if the law in some other US jurisdictions requires the board to consider stakeholder interests, this form of management duty constitutes 'morally significant non-fiduciary obligations'.[815] Management discretion or duty and fiduciary duties are essentially different forms of duty.[816] On the other hand, in light of the function of fiduciary duties in protecting the due performance of management functions, permitting stakeholder

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[810] Merrick Dodd, 'For Whom Are Corporate Managers Trustees?' (1932) 45 Harvard Law Review 1145.
[811] Adolf A Berle, *The 20th Century Capitalist Revolution* (Harcourt, Brace 1954).
[812] *Unocal Corp v Mesa Petroleum Co* 493 A2d 946 (Del 1985).
[813] *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A2d 173, 176-182 (Del 1986).
[814] ibid 182.
[815] Kenneth E Goodpaster, 'Business Ethics and Stakeholder Analysis' (1991) 1 Business Ethics Quarterly 53, 67.
[816] Although some scholars propose that corporate fiduciaries should owe the duty of care to stakeholders, none of them suggest the duty of loyalty in the same regard. However, the duty of loyalty is the core of fiduciary duty.

interests to be taken into account can in effect broaden the scope of the fiduciary concept. Conceptually, breach of fiduciary duty should be analysed on the basis of the fiduciary's non-fiduciary duty.[817] To reiterate: for corporate fiduciaries to take stakeholder interests into account is not a breach of fiduciary duties. Management discretion or duty to consider stakeholder interest is a business judgement call which falls within the ambit and protection of the business judgement rule.

4.3 Fiduciary Duties in Delaware Corporate Law: A Dual-Standard Model

Generally speaking, under Delaware corporate law corporate directors and officers must fulfil the fiduciary duties of loyalty (which includes good faith) and care to the corporation and its shareholders. To lay the foundation, this part first discusses the close relation between fiduciary duties and the 'business judgement rule' from a framework perspective. It addresses the duty of loyalty and the duty of care as current Delaware law of fiduciary duties. Thirdly, Delaware corporate fiduciary law is modelled on the basis of its prominent and unique characteristics. Finally, this part analyses local context – both in the US as a whole and in Delaware corporate fiduciary law – in support of the smooth functioning of the Delaware model of corporate fiduciary duties.

4.3.1 Fiduciary Duties and the Business Judgement Rule

Delaware's common-law of corporations centres around the notion of the business judgement rule. It is presumed that corporate fiduciaries act in accordance with their fiduciary duties when making business decisions. In *Aronson v Lewis* the Delaware Supreme Court defined the business judgement rule as 'a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'.[818] This is commonly referred to as the standard of judicial review in Delaware courts when reviewing corporate decision making.[819] However, in practical terms the business judgement rule is more a policy of non-review to protect

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[817] See 2.3.1.
[818] *Aronson v Lewis* 473 A2d 805, 812 (Del 1984).
[819] See, eg, Stephen M Bainbridge, *Corporate Law and Economics* (Foundation Press 2002) 243. Delaware courts adopt three basic standards of review as regards corporate decisions: the business judgment rule, the enhanced scrutiny and the entire fairness standard.

corporate decisions from judicial review.[820] As a deferential standard of review, Delaware courts will generally refrain from unreasonably imposing their views on the affairs of a corporation provided that the board's decision can be 'attributed to some rational corporate purpose'.[821] Consequently, Delaware courts only review a business decision for breach of fiduciary duties; if there has been no breach of fiduciary duties, the business judgement rule can be rebutted only if the business decision is entirely irrational or amounts to waste.[822] Deferring to the board's business decisions as well as shielding directors and officers from liability for decision making, the business judgement rule affords corporate fiduciaries unique protection.

Under Delaware corporate law the business judgement rule bears a close relation to fiduciary duties. As regards the duty of loyalty, the rule serves as the foundation for certain neutral decision-maker approvals as a safe harbour for corporate fiduciaries in certain common conflicting situations. The underlying rationale is that neutral decision makers can make valid corporate decisions on interested transactions and corporate opportunities which are in the best interest of the corporation.[823] These corporate decisions which meet the relevant requirements are subject to the business judgement rule. The safe harbour protection under the business judgement rule is therefore a strong incentive for fiduciaries to make full disclosure and seek neutral decision maker approval. Under the business judgement regime, Delaware law addresses interested transactions and corporate opportunities by crafting a legal incentive system. In this regard the business judgement rule introduces safe harbour procedures to the fiduciary duty regime – ie, neutral decision maker approval. For example, before the introduction of disinterested board or shareholder approval as safe harbour protection for interested transactions, the common-law regulation of interested transactions followed only the fairness standard. But under the business judgement rule detailed requirements for neutral decision maker approval have developed and constitute important fiduciary standards of behaviour for directors and officers.

In Delaware corporate law, however, the business judgement rule relates to the fiduciary duty of care in a more complex and intrinsic manner. In essence, the concept of duty of care under

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820 Stephen M Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vanderbilt Law Review 83, 89-90.

821 *Technicolor* (n 760) 361.

822 See *Brehm v Eisner* 746 A2d 244, 264 (Del 2000).

823 See *Oberly v Kirby* 592 A2d 445, 467 (Del 1991).

Delaware corporate law refers to the duty resting on corporate fiduciaries to duly inform themselves before making a business decision. When developing the business judgement rule Delaware courts identified a set of standards of behaviour for directors' and officers' duty of care. Furthermore, when deciding whether the business judgement rule should apply, Delaware courts have established the standard of review for breach of duty of care. In other words, under the business judgement regime Delaware law has established not only standards of behaviour and review as regards the duty of care, but also the divergence of these two standards. Essentially, the entire body of Delaware's duty of care law originated from the business judgement regime.

It thus can be seen that in light of the centrality of the business judgement rule in Delaware corporate law, the fiduciary duty regime is closely and intrinsically related to the business judgement regime. This results in not only Delaware's unique framework for fiduciary duties but also the distinctive features of the Delaware model of corporate fiduciary duties.

4.3.2 Fiduciary Duty of Loyalty

Delaware law defined a corporate director or officer's fiduciary duty of loyalty in unyielding terms in the landmark case of *Guth v Loft*:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests….A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[824]

Delaware corporate law thus requires a corporate officer or director's 'undivided and unselfish' duty of loyalty to the corporation and its shareholders and adopts the fiduciary no-conflict principle.

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[824] *Guth* (n 276) 514.

In the field of the duty of loyalty, Delaware law has developed specific doctrines and standards to regulate some common situations where a corporate fiduciary's duty of loyalty can be called into question – in particular, interested transactions and usurping corporate opportunity. On the other hand, the actions of corporate fiduciaries which do not fall afoul of the law on interested transactions or corporate opportunity, may still be a violation of the broader and more fundamental fiduciary duty of loyalty as defined in *Guth.* The fiduciary doctrine still functions independently to capture rare or newly emergent situations involving breach of the no-conflict principle and the duty of loyalty.

4.3.2.1 Interested Transaction Regulation

A common manifestation of conflicts of interest today is interested transactions between a corporation and its corporate fiduciaries or between corporations sharing fiduciaries. Modern regulation of interested transactions in Delaware and other US jurisdictions generally permits such transactions. Delaware's regulation of interested transactions follows an alternative *ex ante* approval by disinterested board members or shareholders together with the default *ex post* fairness review. It also provides a safe harbour for interested transactions by means of disinterested board or shareholder authorisation. Ultimately, if an interested transaction is brought before the Delaware courts in a conflict-of-interest challenge, the courts will apply the 'entire fairness' standard of review.

The analysis of Delaware interested transaction regulation typically starts from the section 144(a) of the DGCL:[825]

> (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:
>
> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction

[825] Before the introduction of the s 144(a), the common-law regulation of interested transactions applied only to the entire fairness review. See 4.1.2.

> by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
>
> (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
>
> (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.'[826]

Section 144(a) first specifies common types of interested transaction under Delaware corporate law. It governs interested transactions between the corporation and its directors or officers, and between the corporation and another enterprise in which the corporation's directors or officers are also directors or officers or have a financial interest.[827] While interested transactions with directors or officers on both sides are generally more easily identified, Delaware courts adopt an nuanced analysis on a case-by-case basis to establish an interested transaction in which directors or officers have a financial interest.[828]

More importantly, section 144(a) of the DGCL outlines preliminary requirements as regards the disinterested board or shareholder approval as well as the fairness standard as regards interested transactions. To be clear, this section 144(a) merely functions to protect interested transactions against *per se* voidability based solely on the taint of a conflict of interest, whilst it neither validates interested transactions nor determines the breach/non-breach of fiduciary duty.[829] On the other hand, because section 144(a) sets out three avenues for disinterested board approval, shareholder approval, and the fairness standard to rescue interested transactions, it links to the common-law business judgement rule as well as the common-law fairness standard, which in effect constitute the Delaware law on interested transactions. Section 144(a) links to the common-law fairness standard in that it provides that an interested transaction is not void or voidable if it is fair to the corporation.[830] In other words, only if the transaction is unfair to the corporation is it invalid. This fairness requirement clearly reflects the common-law regulation of interested transactions, ie the fairness standard. Similarly, section 144(a) sets requirements for disinterested board or shareholder approval which closely

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826 Del Gen Corp Law § 144(a).
827 Del Gen Corp Law § 144(a). See also *Marciano v Nakash* 535 A2d 400, 405 (Del 1987).
828 *Oberly v Kirby* (n 823) 468.
829 Rohrbacher, Zeberkiewicz and Uebler (n 734).
830 Del Gen Corp Law § 144(a)(3).

resemble those of the common-law business judgement rule. As previously indicated, 'the common law of corporations also was centered on the idea of the business judgement rule and its approach to interested transactions looked much like that codified in section 144.'[831] In consequence, compliance with those requirements in section 144(a) results in the invocation of the business judgement rule.

Due to the functioning of the common-law business judgement rule, the alternative *ex ante* approval by disinterested board or shareholders serves as a safe-harbour procedure in Delaware's interested transaction law. The underlying rationale is that a 'neutral decision-making body', ie, the disinterested board or shareholders, may take a corporate decision on the interested transaction in the best interest of the corporation.[832] 'By those methods, respect for the business judgment of the board can be maintained with integrity, because the law has taken into account the conflict and required that the business judgment be either proposed by the disinterested directors or ratified by the stockholders it affects.'[833] Under the business judgement rule, if an interested transaction has been duly authorised by the disinterested board or shareholders, Delaware courts will defer to the business judgement and not review the transaction in any great detail. This protection under the business judgement rule clearly incentivises corporate fiduciaries to disclose interested transactions and seek disinterested director or shareholder approval. Therefore, in the business judgement regime, Delaware law addresses interested transactions by crafting a legal incentive system.

a. Interested Transactions: Disinterested Board Approval

In order to obtain the benefit of 'business judgement rule' protection interested directors or officers should demonstrate compliance with relevant requirements and seek due approval from the disinterested directors or shareholders. While section 144(a) outlines preliminary requirements, the common-law business judgement rule provides more specific standards of conduct stemming from judicial scrutiny in Delaware courts. The centrality of both statutory and common-law requirements is to ensure the neutrality of decision makers when approving

[831] *In re Cox Communications Inc Shareholders Litigation* 879 A2d 604, 615 (Del Ch 2005).
[832] *Oberly v Kirby* (n 823) 467.
[833] *Cox Communications* (n 831) 614.

interested transactions. Only if the neutrality of relevant decision makers is ensured can the safe-harbour protection of business judgement rule be justified.

Under Delaware corporate law, one element of the safe-harbour protection of interested transactions is the *ex ante* approval by a disinterested board. First, interested directors or officers should disclose the material facts regarding their relationship or interest in the contract or transaction to the board unless the board is aware of the material facts. The term 'material' is interpreted by Delaware court to mean 'relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decision-making'.[834] The extent of the disclosure must enable the disinterested directors to exercise their duty of care duly when deciding to enter into the interested transaction. In *Smith v Van Gorkom*,[835] the Delaware Supreme Court explained the duty of care in this sense as the duty 'to act in an informed and deliberate manner in determining whether to approve [a transaction] before submitting [it] to the stockholders'.[836] More specifically, the duty requires that disinterested directors be adequately informed of the material facts regarding the nature of the conflict and appraise themselves of all reasonably available material information concerning the transaction at issue.[837] As discussed above, in pursuit of the benefit of business judgement rule, disinterested directors should abide by their fiduciary duties in approving a given interested transaction. Delaware law thereby uses the disinterested directors' duty of care as the yardstick for the interested directors or officers' duty to disclose. As an important part of their fiduciary standards of behaviour in interested transactions, interested directors or officers should take affirmative actions to disclose the material facts required. Failure to disclose the material facts results in neither due approval by the disinterested board, nor will it exclude the judicial fairness review as discussed below.

Second, independent directors with no interest in the transaction qualify as 'legitimate decision makers'; while an interested director or officer is one who stands on both sides or who has a personal stake in the transaction which is not shared by the stockholders generally.[838] Disinterested directors are those who do not qualify as interested directors. As is clear from *Oberly v Kirby*, a director's significant stock ownership interest does make him or her

[834] *Tokyo Inc v Benihana Inc* 891 A2d 150, 179 (Del Ch 2005) aff'd 906 A2d 114 (Del 2006).
[835] 488 A.2d 858 (Del 1985).
[836] *Van Gorkom* (n 748) 873.
[837] ibid 872.
[838] See *Aronson v Lewis* (n 818) 812.

‘interested’, ‘unless the director somehow contrives to favor his own interests over those of other stockholders’.[839] As explained by the court, disinterested directors are the appropriate officials to approve interested transactions as they ‘have no incentive to act disloyally and should be only concerned with advancing the interests of the corporation’.[840] For this rationale to be tenable, disinterested directors clearly need to be genuinely independent of the interested directors or officers concerned. Unlike the *ex ante* definition of independent directors in certain corporate legislation, independent disinterested directors are here defined on an *ad hoc* basis with reference to a specific interested transaction.[841]

The ‘independence’ requirement is less clear a standard. Delaware law defines the independence of disinterested directors in an abstract and imprecise way and prefers a case-by-case inquiry.[842] As defined in *Aronson v Lewis*, ‘independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences’.[843] In essence, independence requires that disinterested directors exercise their own judgement and decision without being swayed or influenced by interested directors or officers.[844] Based on so abstract a definition of independence which turns on the exclusion of influence, Delaware courts conduct an inquiry into the independence or otherwise of disinterested directors in each particular case. On the other hand, in *Technicolor* the court pointed to certain ways in which to restrict possible influence by interested directors or officers. These include, but are not limited to, ‘recusal of the interested director(s) from participation in board meeting’, ‘resignation from the board by the interested director(s)’, and ‘establishment of a committee of disinterest independent directors to review the proposal’.[845] In order for disinterested directors to be independent, these options have been affirmed as acceptable standards of behaviour by interested directors or officers. By affirming such methods, the Delaware business judgement rule requires in essence that interested directors or officers avoid participating in the negotiation and approval of relevant interested transactions.[846] It can consequently be seen that fiduciary standards of behaviour under the business judgement rule

[839] *Oberly v Kirby* (n 823) 468.
[840] *Cook v Oolie* 2000 Del Ch LEXIS 89, 44, 2000 WL 710199, 13 (Del Ch May 24, 2000).
[841] Lisa M Fairfax, ‘The Uneasy Case for the Inside Director’ (2010) 96 Iowa Law Review 127, 134-135.
[842] Donald C Clarke, ‘Three Concepts of the Independent Director’ (2007) 32 Delaware Journal of Corporate Law 73, 105.
[843] *Aronson v Lewis* (n 818) 816.
[844] Clarke (n 843) 102-108.
[845] *Technicolor* (n 760) 366 n.35.
[846] In the evolution of common law regulation of interested transactions, the non-participation of interested directors once served as the pre-condition for the rule of fairness standard to be applied. Later development of law didn’t bother to differ participation or non-participation and applied a general rule of fairness standard. Here, the participation of interested directors became relevant again for the application of business judgement rule.

also require interested directors or officers to avoid any participation in the conclusion of the interested transaction.

Third, the interested transaction should be authorised in good faith by a majority of the disinterested directors. The legitimate body to approve an interested transaction is the disinterested majority board or a committee of disinterested directors. The requirements of section 144(a) differ from those under the business judgement rule.[847] In terms of section 144(a), as a quorum is not required even if a majority of the board are interested in a given transaction, the transaction can still be approved by a majority of the remaining disinterested directors.[848] However, under the business judgement rule if a majority of the board are interested, the interested transaction can only be duly authorised by the majority of a committee of disinterested directors – without this the transaction would be subject to shareholder approval.[849] Furthermore, Delaware law highlights that disinterested directors should act in 'good faith' when considering and approving an interested transaction. In the Delaware Court of Chancery's 2005 *Disney* opinion, the 'good faith' of the disinterested directors was interpreted as their being 'mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies'.[850] The requirement of good faith is necessary in that 'ensuring director compliance with the fiduciary duties of care and loyalty (as we have traditionally defined those duties) may be insufficient'.[851] Because the situation where a director may decide to reward a college does not fall in the ambit of the duty of loyalty which excludes a fiduciary's self-interest or the duty of care which requires a fiduciary to be duly informed. According to the court, failure to act in good faith means that 'a majority of the independent directors were aware of the conflict and all material facts, ...but acted to reward a colleague rather than for the benefit of the shareholders'.[852] As with the disinterested directors' independence requirement, this requirement of good faith aims further to ensure their neutrality in authorising an interested transaction.

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[847] Rohrbacher, Zeberkiewicz and Uebler (n 734) 737-738.
[848] Stephen A Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Officers* vol 1 (6th edn, Wolters Kluwer) 819.
[849] See, eg, *Krasner v Moffett* 826 A 2d 277, 287 (Del 2003) where it is stated that 'when the majority of a board of directors is the ultimate decisionmaker and a majority of the board is interested in the transaction the presumption of the business judgment rule is rebutted'.
[850] *In re Walt Disney Co Derivative Litigation* 907 A 2d 693, 756 (Del Ch 2005).
[851] ibid.
[852] ibid 756.

Compliance with the above requirements invokes the business judgement rule and therefore generally insulates an interested transaction and the corporate action involved from a judicial fairness review. Indeed, it is unclear from the Delaware statute whether courts can still conduct a fairness review of interested transactions which have been duly approved by disinterested directors.[853] Delaware courts are nevertheless entitled to conduct a fairness review of duly approved interested transactions,[854] but in deference to the business judgement of disinterested directors they will not generally do so. The judicial fairness review should serve as a last resort in interested transaction regulation to be applied only in absence of qualified and neutral decision makers. Considering the frequency of interested transactions in modern business reality, the judicial fairness review should not be over-extended for fear of an unnecessary use of judicial resources.[855] The operation of the concept of a neutral decision maker renders the judicial review of the interested transaction 'ineffective in the aggregate'.[856] On the other hand the breach of fiduciary standards of behaviour in interested transactions results in impunity for the interested directors or officers. Non-compliance with safe harbour procedures as regards disinterested board approval merely opens the transaction to a judicial fairness review – which the transaction may well survive. Fundamentally, compliance or no-compliance with safe-harbour procedures is not directly linked to the breach or non-breach of fiduciary duties which can only be decided by a judicial fairness review.

b. Interested Transactions: Disinterested Shareholder Approval

Under Delaware corporate law the other safe harbour protection of interested transactions is the *ex ante* disinterested shareholder approval. General speaking, the requirements for shareholder approval of interested transactions resemble those of disinterested board approval in many respects – an interested transaction may be duly approved by a majority of the shareholders entitled to vote, acting in good faith, and on an informed basis. The interested director or officer standards of behaviour also involve the disclosure of relevant material facts as well as abstention from participation. The legitimate decision makers who may approve an interested transaction, however, are the majority of disinterested shareholders – albeit that this

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[853] Victor Brudney, 'Revisiting the Import of Shareholder Consent for Corporate Fiduciary Loyalty Obligations' (2000) 25 The Journal of Corporation Law 209.
[854] Radin (n 849) 819-820.
[855] Julian Velasco, 'Structural Bias and the Need for Substantive Review' (2004) 82 Washington University Law Quarterly 821, 839.
[856] Kenneth B Davis Jr, 'Judicial Review of Fiduciary Decisionmaking - Some Theoretical Perspectives' (1985) 80 Northwestern University Law Review 1, 35.

is not explicitly required by section 144(a)(2).[857] As explained, the good faith requirement for shareholder approval in section 144(a)(2) is regarded as adequately addressing self-benefit or independence.[858] In other words, provided that the board abides by its duty of disclosure, including any conflicts of interest, the requisite vote of all shareholders – interested and disinterested alike – is subject to the 'good faith' requirement. Nevertheless, the requirement otherwise comes from the common law in that it only gives effect of ratification to the interested transaction approval by a majority of the disinterested shareholders.[859]

The legal effect of disinterested shareholder approval of interested transactions resembles that of disinterested board approval – ie, it triggers the business judgement rule. Similarly, non-compliance with safe harbour procedures in disinterested shareholder approval also subjects the transaction to a judicial fairness review.

c. Interested Transactions: Entirely Fair to the Corporation

Delaware law adopts a default *ex post* judicial review of 'entire fairness' to enforce the fiduciary duty of loyalty in situations of interested transactions rigorously. In Delaware's interested transaction regulation, the fairness standard is the fundamental standard of conduct by corporate fiduciaries and also the standard of review applied by the courts. As a fiduciary standard of conduct, the fairness standard requires corporate directors or officers to deal fairly when embarking on interested transactions. As a standard of judicial review, it requires Delaware courts to review the fairness of interested transactions for breach of fiduciary duty. In this regard the fairness analysis entails judicial scrutiny. On the other hand, in light of the functioning of the safe harbour approvals, the application of the judicial fairness review is generally confined to cases which either lack approval by the disinterested board or shareholders, or/and the approval itself is flawed.[860] In Delaware cases such situations include but are not limited to: (i) failure by interested directors to disclose their interest in a transaction to the entire board;[861] (ii) failure by interested directors to abstain from any participation in the approval of a transaction;[862] (iii) where interested directors constitute a majority of the board;

[857] Del Gen Corp Law § 144(a)(2).
[858] Ernest L Folk, Review of the Delaware General Corporate Law 67 (1967), 21.
[859] See *Solomon v Armstrong* 52747 A 2d 1098 (Del Ch 1999); *In re Cox Commc'ns, Inc Sholders Litig* 879 A 2d 604, 615 (Del Ch 2005).
[860] Radin (n 849).
[861] See *Tokyo Inc v Benihana Inc* (n 834) 180-81.
[862] See *Weinberger* (n 745) 710.

or (iv) where interested directors control or dominate the board as a whole.[863] In these cases, because there is a clear duty-of-loyalty issue on the part of the interested directors or officers, Delaware courts will bypass the business judgement rule and require the directors to show that the challenged transaction was entirely fair to the corporation and its shareholders.

Delaware law formulates the fairness standard in a demanding and exacting manner which has both procedural and substantive elements – fair dealing and fair price. In *Weinberger v UOP* the Delaware Supreme Court articulated the standard of 'entire fairness' as follows:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.[864]

The fair-dealing test in effect requires an arm's-length bargaining process. In *Weinberger* the court reviewed the interested-transaction process and compared it to a transaction structured on an arm's-length basis with all relevant factors considered as a whole, such as the time schedule, the negotiation structure, the approval meeting, etc.[865] The procedural replication of the circumstances of neutral bargaining is aimed at ensuring an equally fair outcome.[866] The fair-price test relates to the financial aspects of interested transactions. Notably, both tests are objectively construed, while the good faith of the directors in interested transactions is neither sufficient nor strictly relevant. 'Not even an honest belief that the transaction was entirely fair will sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board's beliefs.'[867] These two tests are intrinsically connected and interrelated. It however remains necessary to distinguish the two as failure to acknowledge their individuality can weaken the 'entire fairness' test.[868]

[863] See *Cinerama Inc v Technicolor Inc* 663 A2d 1156, 1168 (Del 1995).
[864] *Weinberger* (n 745) 711.
[865] ibid 711-712.
[866] Lawrence E Mitchell, 'Fairness and Trust in Corporate Law' (1993) 43 Duke Law Journal 425, 454.
[867] *Gesoff v IIC Indus Inc* 902 A2d 1130, 1145 (Del Ch 2006).
[868] Mitchell (n 867) 455.

In a case challenging an interested transaction the burden of proof vests in the defendant interested directors or officers to establish the 'entire fairness' of the transaction to the satisfaction of court.[869] If they fail to show that the interested transaction is the product of fair dealing and reflects a fair price, the court will take the initiative to review the transaction substantially. Ultimately, if an interested transaction survives the judicial fairness review both the transaction and the corporate action involved is valid and the interested directors or officers have not breached their fiduciary duties. However, a failure of the interested transaction to survive the judicial fairness review means that a fiduciary duty has been breached.

4.3.2.2 Corporate Opportunity Doctrine

The common-law doctrine of corporate opportunity has long been recognised as the core of the fiduciary duty of loyalty. Delaware's corporate opportunity doctrine prohibits corporate fiduciaries from taking up a corporate opportunity without first having presented it to the corporation. The law adopts a proprietary pattern of corporate opportunity by applying a set of criteria to determine whether the corporation is rightfully entitled to the opportunity.[870] Moreover, when dealing with corporate opportunity Delaware law also allows for disinterested board rejection of a certain opportunity which then triggers safe harbour protection for corporate fiduciaries who may elect to act on the opportunity.

In *Guth v Loft* the Delaware Supreme Court set out the corporate opportunity doctrine known as the 'Guth Rule'.[871] In *Broz v Cellular Information Systems Inc* the Supreme Court summarised the law in *Guth* and its progeny succinctly listing the four criteria applicable under Delaware's corporate opportunity doctrine to identify a 'corporate' opportunity:

> (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.[872]

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[869] Radin (n 849) 849.
[870] Kershaw (n 557) 540-541. See 4.1.1 for the emergency and evolution of a quasi-property-right approach to corporate opportunity doctrine and 4.1.2 for Delaware's adoption as well as adaption of such approach in its corporate opportunity doctrine. US states commonly take such a proprietary pattern of corporate opportunity doctrine, while they use variants of criteria and of the interpretation and application of those criteria.
[871] *Guth* (n 276) 511.
[872] *Broz v Cellular Information Systems Inc* 673A2d 148, 155 (Del 1996).

If an opportunity satisfies all four criteria it is an opportunity which rightfully belongs to the corporation and the usurping of such a 'corporate' opportunity by corporate fiduciaries constitutes a violation of the corporate opportunity doctrine and a breach of duty of loyalty. These criteria warrant closer attention.

Firstly, the courts apply a 'line of business' test which requires that the opportunity fall within the corporation's line of business. This test is, however, not clearly defined in Delaware law. *Guth* provides some guidance on the test pointing out that the 'real issue' is whether the opportunity 'was so closely associated with the existing business activities of [a corporation], and so essential thereto, as to bring the transaction within that class of cases where the acquisition of the property would throw the corporate officer purchasing it into competition with his company'.[873] This is a restrictive definition of the 'line of business' test which emphasises its close and essential relation to the current business of the corporation. Despite this interpretation, the meaning of the 'line of business' test remains imprecise – although one must acknowledge that by its nature the notion of line of business is not open to precise definition. As was conceded in *Guth*: 'The phrase [line of business] is not within the field of precise definition, nor is it one that can be bounded by a set formula' – in short, it has 'a flexible meaning.'[874] Indeed, lines of business are things intrinsically vague, and the test for line of business is 'not a mere exercise in conceptual classification' but rather 'a rough and ready inquiry into economic efficiency'.[875] Delaware courts therefore adopt a case-by-case inquiry to determine whether a given opportunity is in the line of business of the corporation. It is 'a factual question to be decided by reasonable inference from objective facts'.[876]

Secondly, Delaware law adopts a 'interest or expectancy' test which requires that the corporation must have an interest or expectation in the opportunity. Here too, Delaware courts have provided faint guidelines as regards this 'interest or expectancy' test which tend to be situation-specific in their application. In its essence, the 'interest or expectancy' test requires certain connection between an opportunity and the corporation.[877] *Johnston v Greene* made it clear that '[f]or the corporation to have an actual or expectant interest in any specific property,

[873] *Guth* (n 276) 513. Notably, Delaware courts commonly refer an opportunity as 'property' because of the quasi-property-right approach taken in Delaware's corporate opportunity doctrine.
[874] ibid 514.
[875] Robert C Clark, *Corporate Law* (Little Brown 1986) 227.
[876] *Guth* (n 276) 513.
[877] In the earliest cases the 'interest or expectancy' test refers to certain quasi-property rights or contractual rights of the corporation. At a later stage, Delaware and some other US jurisdictions which adopt the 'interest or expectancy' test in their corporate opportunity doctrine modified its meaning. See 4.1.1 and 4.1.2 for detailed discussion.

there must be some tie between that property and the nature of the corporate business'.[878] Delaware's 'interest or expectancy' test thus links an opportunity to the business of the corporation. In *Guth* the courts provided a more detailed description of the opportunity in this sense as:

> [A]n activity as to which [the corporation] has fundamental knowledge, practical experience and ability to pursue, which, logically and naturally, is adaptable to its business…and is one that is consonant with its reasonable needs and aspirations for expansion.[879]

Being itself vaguely defined, 'some tie' appears to require that the corporation has the resources and a need to take advantage of the opportunity. For example, in *Broz* the court held that the corporation had no cognisable interest or expectation in the purchase of a cellular telephone service licence because it was actively divesting its cellular licence holdings and its business plan involved no new acquisitions.[880]

Delaware law therefore adopts a 'line of business' test combined with an 'interest or expectancy' test – both in relation to the business of the corporation – to identify a corporate opportunity. The two tests characterise those opportunities which are so closely associated with and so essential to the business of a corporation, and which the corporation has both resources and the need to make use of that should be deemed by law as inherently tied to the corporation. In this regard, Delaware has its own restricted corporate opportunity doctrine. From an economic perspective, the adoption of the twin tests is justified on the reasonable expectations of shareholders. In economic terms this means that if shareholders had envisioned the contingencies and contemplated the possibilities as regards the appropriation of corporate opportunity which subsequently materialised, they would have contracted against some of them – ie, those inherently tied to the corporation.[881] Delaware law thus affirms shareholders' rational expectations to prevent directors or officers from taking on new projects within the corporation's line of business in which the corporation also has an interest or expectation. The restrictive concept of corporate opportunity under Delaware corporate law can also be explained in terms of the policy concern that, at least in the case of non-management directors,

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[878] *Johnston v Greene* (n 728) 924. This interpretation is the widely agreed meaning of the 'interest or expectancy' test in Delaware law.
[879] *Guth* (n 276) 514.
[880] *Broz* (n 872) 156.
[881] Brudney and Clark (n 252) 1010.

entrepreneurs may be less inclined serve as directors.[882] In the business world, as entrepreneurs are commonly involved in complex business activities, it is inevitable that they will be exposed to multiple forms of business opportunity. If the business opportunity doctrine is too broadly formulated it could be difficult to attract qualified candidates as external directors.

The third criterion requires that the corporation is financially able to exploit the opportunity in question. This criterion indicates that Delaware law acknowledges the financial inability of a corporation as an affirmative defence for a corporate fiduciary who takes advantage of the offer. There are a series of cases in Delaware courts which permit directors or officers to pursue an opportunity which the corporation cannot exploit due to financial constraints.[883] The 'inability' defence also takes other forms as affirmed by courts in other US jurisdictions – eg, external legal constraints or refusal by the third parties to deal with the corporation,[884] but these do not apply in Delaware.

The underlying rationale for 'inability' defences is fairness. From an economic perspective this indicates that courts have adjusted the law to meet shareholders' rational expectations on the basis of fairness.[885] It is fair to assume that a corporation should not be entitled to an opportunity which it is, as a practical and factual matter, incapable of exploiting. Similarly, it seems unfair to prohibit directors or officers from taking an opportunity which the corporation genuinely cannot afford to exploit. For corporate fiduciaries to purse the opportunity under such circumstances should pose no real threat to their duty of loyalty. Indeed, based on deterrence as a policy consideration the inclusion of the financial-inability defence in the Delaware corporate opportunity doctrine can be fairly criticised as offering inadequate fiduciary protection,[886] its inclusion in Delaware's law is a purely policy decision.

Fourth, by taking the opportunity for his or her own benefit the corporate fiduciary will be in a position inimical to his or her duties to the corporation. This criterion is in fact a reflection and

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882 See Lowry and Edmunds (n 280).
883 See *Odyssey Partners LP v Fleming Cos* 735 A2d 386, 412 (Del Ch 1999); *Carlson v Hallinan* 925 A2d 506, 520 (Del Ch 2006).
884 Eric Talley, 'Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine' (1998) 108 Yale Law Journal 277, 291.
885 Brudney and Clark (n 252) 1020.
886 See *Northeast Harbor Golf Club Inc v Harris* 661 A2d 1146 (Me 1995) and 725 A2d 1018 (Me 1999). In the case, the Supreme Judicial Court of Maine analysed and declined to adopt the Delaware corporate opportunity doctrine stating that 'the injection of financial ability into the equation will unduly favour the inside director or executive who has command of the facts relating to the finance of the corporation. Reliance on financial ability will also act as a disincentive to corporate execute to solve corporate financing and other problems.'

restatement of the no-conflict principle preventing the conflict between the fiduciary's self-interest and his or her duty to the corporation[887] In Delaware case judgments this criterion receives neither priority nor significance in the judges' analysis.[888] As noted, the identification of this criterion appears to depend automatically on the satisfaction or non-satisfaction of the other three criteria without much reasoning.[889] Because Delaware corporate opportunity doctrine adopts the proprietary approach, the functioning of the other three criteria makes this no-conflict criterion less important, if not irrelevant. In its conceptual origin, the no-conflict criterion is a principle of broad and general use intended to capture any breach of duty of loyalty. The other three criteria were adopted by US courts in the legal developments to constrain, in the context of corporate opportunity, a fiduciary's duty to the corporation as well as the general application of the no-conflict principle. As accurately pointed out, the other three criteria have been formulated to 'moderate the potentially harsh consequence of the strict adherence' to the no-conflict principle.[890] In this regard, the satisfaction or non-satisfaction of the other three criteria naturally determines the breach of non-breach of the duty to the corporation as well as the no-conflict principle.

In Delaware courts, the above four criteria together determine whether a specific opportunity rightfully belongs to the corporation and if a corporate fiduciary has violated the corporate opportunity doctrine. In cases subsequent to *Broz*, the legal reasoning typically proceeds as an individual appraisal of the four criteria based on a careful examination of the case facts. 'No one factor is dispositive and all factors must be taken into account insofar as they are applicable.'[891] To constitute a violation of the corporate opportunity doctrine all four criteria must to be satisfied in a given case and if any criterion is not met the opportunity in question does not accrue to the corporation and the fiduciary commits no breach of the duty of loyalty if he or she acts on it. The four criteria therefore assist Delaware courts to balance equities when deciding an individual case.[892] Furthermore, in Delaware corporate opportunity doctrine the criteria serve as guidelines for individual fiduciaries to decide whether they can properly take up a certain opportunity. As affirmed in *Broz*, if after analysing the situation *ex ante* a

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[887] It is worth mention that in *Guth* (n 276), the no-conflict principle was inaccurately stated as the conflict of the corporate fiduciary's self-interest and the interest of the corporation. Later in *Broz* (n 872), the Delaware Supreme Court stated the criteria in a way reflecting the no-conflict principle accurately.
[888] See *Schreiber v Byan* 396 A2d 512, 519 (Del 1978). The no-conflict criterion was not even discussed or considered in this case. In *Broz* (n 872), the determination of no-conflict criterion clearly is a direct function of the prior three criteria.
[889] Kershaw (n 382) 542.
[890] Theresa A Gabaldon and Christopher L Sagers, *Business Organizations* (2nd edn, Wolters Kluwer 2019) 611.
[891] *Broz* (n 872).
[892] ibid.

corporate fiduciary believes that the opportunity is not one rightfully belonging to the corporation, he or she can take it for him- or herself.[893] However, as discussed above, Delaware courts only provide vaguely-defined criteria and prefer to apply them in a situation-specific approach in individual cases. In light of what we have seen above, Delaware's corporate opportunity doctrine can hardly be seen to offer predictable guidelines for directors and officers.

Consequently, in the context of corporate opportunity, Delaware law also crafts a legal incentive system and provides safe harbour procedures. As regards corporate opportunity, the safe harbour procedures involve directors or officers' full disclosure and the disinterested board's proper rejection of an opportunity.[894] In seeking due rejection of an opportunity by the disinterested board, directors or officers should comply with requirements similar to this applicable to interested transactions. More specifically, a director or officer must disclose all relevant material facts regarding the opportunity to the board. Once the fully informed, disinterested, and independent directors decide by majority acting in good faith to reject the opportunity, the interested director or officer may take up the opportunity without violating the corporate-opportunity doctrine. As stated in *Broz,* 'presenting the opportunity to the board creates a kind of "safe harbour" for the director, which removes the spectre of a *post hoc* judicial determination that the director or officer has improperly usurped a corporate opportunity.'[895] The safe harbour effect here also originates in the business judgement regime and clearly serves as an incentive for directors or officers to seek board rejection particularly in complex circumstances.

Ultimately, if violation of the corporate-opportunity doctrine is found by the courts they will grant the corporation both legal and equitable remedies. To summarise: the violation generally occurs when a corporate fiduciary pursues an opportunity in his or her personal capacity which satisfies the four Delaware criteria but fails to comply with safe harbour procedures and obtain due approval. When a director or officer violates the corporate opportunity doctrine, equitable remedies available to the corporation include injunctive relief (if feasible), disgorgement of the fiduciary's gains, or even punitive damages. Most commonly, disgorgement of the fiduciary's verifiable gains is claimed. In most corporate opportunity cases relevant monetary remedies

[893] ibid. This is also the case even if the fiduciary becomes aware of the opportunity in his or her official capacity. See *Field v Allyn* 457 A2d 1089 (Del Ch 1983).
[894] See *Kaplan v Fenton* 278 A2d 834 (Del 1971).
[895] *Broz* (n 872).

tend to be gains-based rather than harm-based.[896] As noted in *Guth*, the corporation can choose to claim all of the fiduciary's benefits for itself, or the court may impose a constructive trust in favour of the corporation on the property, interests, and profits acquired by the fiduciary by virtue of his or her taking advantage of the corporate opportunity.[897] Clearly, such equitable remedy can be distinctly advantageous when the disgorged profits of the fiduciary exceed the corporation's loss or where the corporation is unable to prove loss.

4.3.3 Fiduciary Duty of Care

Under Delaware corporate law the fiduciary duty of care refers to corporate fiduciaries' duty duly to inform themselves before making a business decision. As stated in *Van Gorkom*, '[a] director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders'.[898] From a conceptual perspective, Delaware's duty of care governs corporate fiduciaries' exercise of decision-making power.[899] Specifically, Delaware's common-law fiduciary duty of care requires corporate fiduciaries to exercise a reasonably informed business judgement in the process of corporate decision making. In *Aronson v Lewis* the Supreme Court of Delaware specified the duty of care of which directors and officers should have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'[900]

Delaware's post-*Aronson v Lewis* case law provides specific standards with regard to this duty of care. First, Delaware courts undertake a factual inquiry to determine whether the board has been duly informed in the decision making, while the specific scope of 'all material information reasonably available' can differ from case to case. In practice a variety of factors may be involved, for example access to certain information or knowledge, the availability of relevant professional advice, and the extent and quality of information.[901] In *Smith v Van Gorkom*,[902] which dealt with a proposed leveraged buyout (LBO), the board failed to inform itself of the

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896 Talley (n 885).
897 *Guth* (n 276) 514.
898 *Van Gorkom* (n 748)
899 In its conceptual origins, the duty of care is not a fiduciary duty. Under Delaware's business judgement rule framework, duty of care is nevertheless defined by law as a fiduciary duty. See 2.3.2 for detailed discussion. Also see Christopher M Bruner, 'Is the Corporate Director's Duty of Care a "Fiduciary" Duty? Does It Matter?' (2013) 48 Wake Forest Law Review 1027, 1038-1043.
900 *Aronson v Lewis* (n 818) 812.
901 William M Lafferty, Lisa A Schmidt and Donald J Wolfe, 'A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law' (2012) 116(3) Pennsylvania State Law Review 837, 842.
902 *Van Gorkom* (n 748)

terms of the offer, obtain an independent fairness opinion on the merger agreement from its financial advisor, or even the specific negotiations between the CEO/president and the bidder before it decided to accept the merger agreement during a two-hour meeting. This information was regarded as 'material information' by the Delaware court.

Second, as an affirmative duty, Delaware's duty of care requires directors and officers to take proactive measures to inform themselves about decision making. 'Representation of the financial interests of [the corporation] imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type...' as explained in *Van Gorkom*.[903] Instead of passively accepting information, directors and officers are obliged critically and actively to assess the information presented to the board.[904] Third, Delaware's duty of care focuses on the directors or officers' decision-making process.[905] In *Brehm v Eisner* it is made clear that '[d]ue care in the decision-making context is *process* due care only'.[906] This means that, as a general matter, Delaware courts will not review the substantive quality of a decision made by the board,[907] because judges generally lack the expertise to conduct a substantive review.[908] Clearly, such a 'procedural' due care requirement accords with the core of the business judgement rule. Notably, in Delaware cases, certain factors have been recognised by the courts as relevant in determining directors or officers' fulfilment of their duty of care. These include whether they: (i) are notified of the purpose of the meeting as well as the essentials of the matters to be considered;[909] (ii) are informed of all developments regarding the issue to be considered;[910] (iii) consult extensively with competent legal and financial advisors;[911] (iv) review proactively relevant or key documents;[912] (v) make reasonable inquiry and receive a knowledgeable critique of the proposal;[913] and (vi) take

903 ibid 872.
904 Lafferty, Schmidt and Wolfe (n 901) 842.
905 William T Allen *et al*, 'Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law' (2001) 26 Delaware Journal of Corporate Law 859, 890-893; Lyman Johnson, The Modest Business Judgment Rule' (2000) 55 Business Lawyer 625, 632-633.
906 *Brehm v Eisner* (n 822) 264.
907 Stephen J Lubben and Alana J Darnell, 'Delaware's Duty of Care' (2006) 31 Delaware Journal of Corporate Law 589, 592.
908 Stephen Bainbridge, *Corporate Law* (2nd edn, Foundation Press 2009) 103.
909 See *Van Gorkom* (n 748) 882-884.
910 ibid 884-885.
911 See *Muoio & Co LLC v Hallmark Entertainment Investment Co* No 4729-CC, 2011 WL 863007, 13-14 (Del Ch 2011).
912 *Van Gorkom* (n 748) 882-884.
913 See *Moran v Household International Inc* 500 A2d 1346, 1356 (Del 1985).

sufficient time under the circumstances and act in a deliberative manner in considering a given decision.[914]

By contrast, Delaware adopts 'gross negligence' as the standard of review for alleged breaches of the duty of care. In *Aronson v Lewis* the Delaware Supreme Court made it clear that '[w]hile the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgement rule director liability is predicated upon concepts of gross negligence'.[915] Unless directors have been grossly negligent in a specific decision-making process, they are protected by the invocation of the business judgement rule.[916]Specifically, Delaware courts interpret 'gross negligence' as 'reckless indifference to or a deliberate disregard of the stockholders' or decisions which are outside the 'bounds of reason'.[917] In Delaware cases, this standard of gross negligence is actually akin to the notions of recklessness or irrationality and is very difficult for a plaintiff to prove.[918]

Delaware's common-law duty of care therefore adopts varying standards of behaviour and review. In *Brehm v Eisner* the Delaware Supreme Court clearly confirmed that Delaware law preserves the divergence between the standard of behaviour and the standard of review in *all* aspects of the duty of care.[919] To be sure, arguments can be made for setting the standard of review at the same level as the standard of conduct, considering the fact that the divergence would in effect leave shareholder no remedy for a certain degree of board sloppiness. However, the divergence of standards of conduct and review can be justified on considerations of fairness in which Delaware law has taken a policy judgement. [920] Directors or officers virtually always make business decisions with limited or incomplete information, while business decisions inherently involve a certain degree of assessment and risk-taking. In the business world negative results nevertheless occur even if the prior assessment appears positive. Furthermore, courts are ill-equipped to determine *ex post* whether a business decision was reasonable in specific circumstances. The possibility of the 'wisdom of hindsight' may also play a role here with those faced with a *fait accompli* claiming that the outcome 'could have been correctly

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914 See *McMullin v Beran* 765 A2d 910, 921-22 (Del 2000).
915 *Aronson v Lewis* (n 818) 812.
916 See 4.3.1 for detailed discussion of the business judgement rule as well as its relation to the fiduciary duties under Delaware corporate law.
917 *Rabkin v Philip A Hunt Chemical Corporation* 547 A2d 964, 970 (Del Ch 1986).
918 William Allen *et al*, 'Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem' (2002) 96 Northwestern University Law Review 449, 453.
919 *Brehm v Eisner* (n 822).
920 Allen *et al* (n 920) 451.

predicted beforehand'.[921] In consequence it is clearly unfair and impractical for the courts to review the business decisions of directors or officers on the basis of reasonableness and impose liability accordingly. [922] The divergence of standards also carries public policy value in that the corporation and shareholders can be motivated to review the corporate fiduciary's decision-making process.[923] Faced with the harsh reality of day-to-day business, the economic value of a risky business decision may be far greater than a less risky option, but to hold business decisions to 'reasonableness' as standard of behaviour will in all likelihood discourage directors or officers from taking business decisions which are risky yet economically desirable. It is clearly not in the best interests of the corporation and its shareholders for directors to be unduly risk averse. In this regard, the protected space offered by divergence of standards of behaviour and review serves to motivate directors to take business decisions which, although risky, are likely to benefit the corporation.

Delaware law allows corporations to limit or eliminate directors' monetary liability for breach of their duty of care. Section 102(b)(7) of the DGCL provides that a certificate of incorporation may include:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law… or (iv) for any transaction from which the director derived an improper personal benefit.[924]

This provision permits the exclusion or limitation of a director's personal liability for monetary damages arising from a breach of the fiduciary duty of care. This does not, however, apply to duty of loyalty violations, bad faith claims, and other specified conduct. The provision is the product of drastic changes to the law and in society in relation to the duty of care in mid-1980s.[925] Protection from liability for duty of care violations applies only to monetary awards in that injunctive relief is not covered by the section. The enactment of section102(b)(7) was

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[921] Hal R Arkes and Cindy A Schipani, 'Medical Malpractice v the Business Judgment Rule: Differences in Hindsight Bias' (1994) 73 Oregon Law Review 587, 588.
[922] Melvin Aron Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 Fordham Law Review 437, 443-444.
[923] ibid 444-445.
[924] DEL CODE ANN tit 8 § 102(b)(7)(2005).
[925] See 4.1.3 for a detailed discussion.

aimed at relieving monetary liability arising from a breach of the duty of care which neither the directors themselves nor the insurance market could possibly afford. Moreover, the protection from personal monetary liability offered by the section is available to directors only – corporate officers are excluded. In this regard, Delaware law has no specific provision which differentiates between directors and officers. In light of Delaware's persistent silence on the fiduciary duties of officers,[926] when it came to incorporating section 102(b)(7) into the DGCL in 1986 the legislature failed to consider its application to officers. Significantly, section 102(b)(7) in effect bars any claim for monetary damages against directors based solely on a violation of the duty of care. If a director's duty of care is challenged but the charter of the corporation includes a section 102(b)(7) elimination clause, the case will be dismissed. In *Malpiede* the Delaware Supreme Court affirmed this approach and held that plaintiffs must plead bad faith on the part of the director or that he or she breached the duty of loyalty if a motion to dismiss is to survive in the face of a section 102(b)(7) exculpatory provision in the corporation's charter.[927]

In consequence in Delaware corporate law the duty of care is today seldom if ever enforced. The business judgement rule and the gross negligence standard for judicial review protect corporate fiduciaries from liability for a breach of the duty of care save in extreme cases of gross negligence. The ubiquitous charters of most public corporations contain a section 102(b)(7) exculpation provision which further shields directors from personal monetary liability for breach of the duty of care. There have, therefore, been very few cases in the Delaware courts which have held directors liable for damages premised solely on the duty of care.[928] Since the chances of making a duty of care case in Delaware courts are very slim, claims are whenever possible based on the duty of loyalty.[929] Consequently, certain US commentators have described the duty of care as 'dead'[930] or 'broken',[931] although others still argue against its abolition.[932] However, the unenforceable duty of care can provide guidelines for corporate fiduciaries.

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926 See 4.2.1.1 for details on Delaware's long silence on officers' fiduciary duties.
927 *Malpiede* (n 757).
928 Radin (n 849).
929 Julian Velasco, 'A Defense of the Corporate Law Duty of Care' (2015) 40 The Journal of Corporation Law 647, 652-653.
930 Allen *et al* (n 920).
931 Geoffrey P Miller, 'A Modest Proposal for Fixing Delaware's Broken Duty of Care' (2010) Columbia Business Law Review 319, 321 who states that 'Delaware offers no meaningful judicial regulation of managerial decision-making'.
932 Velasco (n 931).

Concluding Remarks

This chapter takes a closer look at the Delaware model of corporate fiduciary duties. Despite their recognition as two classic models of corporate fiduciary duties within the common-law system, Delaware's model differs significantly from that of the UK model as regards the types of fiduciary relation, the content of a fiduciary duty, and the contours of fiduciary duties.

This chapter first examines the four-stage evolution of corporate fiduciary duties to be the current Delaware model. The historical developments of US/Delaware corporate fiduciary law clearly show that a legal transplantation from one common-law system to another – from the English legal system to the US legal systems – ultimately resulted in a very different model of fiduciary duties. It indicates that local adaptation made in the transplantation process can lead to substantial divergence even across similar legal systems. Moreover, what also contributed to the divergence of the US corporate fiduciary law from its English origin were those cross-state legal borrowing frequently happened prior to and at the time when Delaware established its law of corporate fiduciary duties. Since law adaptation almost inevitably happened in every cross-state legal borrowing, it led to the further divergence of US law from its English source.

This chapter then addresses the current Delaware model in terms of who owes fiduciary duties to whom as well as the main principles and rules on the duty of loyalty and duty of care. Delaware's model of corporate fiduciary duties is characteristic of its divergence in standards of behaviour for corporate fiduciaries and standards of review by Delaware courts, and of its incorporation of both fiduciary principle and the fairness standard. These characteristics are clearly not shared by the UK model which is characterised by the strict application of fiduciary principle. It thereby tells us that different social, economic, and cultural contexts indeed play a part in the process of law evolution. For instance, some commentators see the evolution of the corporate opportunity doctrine and the adoption of business judgement rule in the US as indicative of a more entrepreneurial culture than the UK and the need for the law to protect directors from unduly high risk in such an environment, whereas the UK model is closer to the old trustee model in which risk-taking was not a prominent feature.

Taken together, the divergence of the UK and Delaware models suggests that China's model could be expected to work quite differently from the UK and US, even if it, as a product of legal transplantation, formally appears to be the same. The next chapter then explores the law and enforcement of corporate fiduciary duties in China.

Chapter 5: Fiduciary Duties in Chinese Company Law

Introduction

Although the concept of fiduciary duty is widely regarded as a most elusive, resilient, and flexible concept even in its original common-law systems, the long development of corporate fiduciary duties in UK and US case law has provided China's legal transplantation with exemplary models of law for, among others, the identification of corporate fiduciaries, the determination of corporate opportunities, and the regulation of interested transactions. On the other hand, in absence of the supporting equitable fiduciary doctrine, China's transplantation of corporate fiduciary duties from common-law systems entails local adaptation not only in the process of transplanting the legislation, but also in the subsequent continuous law enforcement by Chinese courts.

The CCL2005 introduces a concept of fiduciary duty by providing in its article 148 that directors, supervisors, and senior officers owe a duty of loyalty to the company.[933] This chapter first examines the legislation of fiduciary duties in the CCL2005 as a reflection of how law reformers undertook the initial transplantation from common-law systems. The second section is based on empirical research and explores how courts in China interpret and enforce fiduciary duties. The third section analyses how fiduciary duties of the directors, supervisors, and senior officers of listed companies in China are enforced by the CSRC. This chapter thereby reveals how the legislative, judicial, administrative institutions in China rise to the challenges brought by the transplantation of corporate fiduciary duties cross legal systems.

5.1 Fiduciary Duties in the 2005 Chinese Company Law

This section discusses the law of fiduciary duties in the CCL2005 as product of the initial transplantation by law reformers in China.

[933] Companies Law of the PRC (2018 Rev) art 148.

5.1.1 Who Owe Fiduciary Duties?

Chinese company law in general adopts a status-based approach by identifying directors, supervisors, and senior officers as corporate fiduciaries who owe a duty of loyalty to the company.[934]

In Chinese company law directors are *de jure* directors who have been legally appointed to the board of a company.[935] The CCL2005 provides no clear classification of directors although article 122 requires listed companies to have independent directors on their boards.[936] Senior officers, as specified in the CCL2005, include the chief manager, vice managers, chief financial personnel, the secretary of the board of directors of a listed company, or other personnel as specified in the company's articles of association.[937] Providing that directors and senior officers owe a duty of loyalty, Chinese company law thus adopts a US-style status-based approach identifying who have been legally appointed to occupy certain positions in the company as fiduciaries.[938] This status-based approach to corporate fiduciaries adopted under the CCL2005 was adopted to avoid the flexible courts in China identifying any fiduciary falling outside of the scope of legally appointed personnel. From a comparative perspective, the UK's approach to corporate fiduciaries is, by contrast, more flexible and fact-based providing that *de jure* directors, *de facto* directors, and shadow directors owe fiduciary duties.[939]

In light of China's civil-law tradition, Chinese company law includes the board of supervisors within the corporate governance structure and so imposes a duty of loyalty on supervisors. Supervisors are those who have been legally appointed to the supervisory board of a company.[940] The office of supervisor was initially introduced in the CCL1993 with a view to supervising the conduct of directors and senior officers.[941] The supervisory power of the board of supervisors has since been significantly extended by the CCL2005.[942] Under the CCL2005 the board of supervisors exercises a series of supervisory responsibilities including, but not

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934 ibid.
935 ibid arts 44 and 108.
936 ibid art 122.
937 ibid art 216 (1). The CCL2005 allows companies to designate the scope of their senior officers through articles of association.
938 US/Delaware corporate law provides that directors and senior officers owe fiduciary duties. See 4.2.1.
939 See 3.2.1.
940 Companies Law of the PRC (2018 Rev) arts 51 and 117.
941 Anna M Han, 'China's Company Law: Practicing Capitalism in a Transitional Economy' (1996) 5(3) Pacific Rim Law & Policy Journal 457, 480-482.
942 Gang Xiao, *The Evolution of China's Capital Markets* (CITIC Press 2020) 106.

limited to, examining the financial affairs of the company, supervising the conduct of directors and senior officers, and the institution of a lawsuit against them where necessary.[943] The inclusion of the board-of-supervisors regime in Chinese corporate governance is based on German company law which also reflects the countries' civil-law traditions.[944] German company law has followed a dual-board model and recognised the supervisory board regime since 1861 in the General German Commercial Code (*Allgemeines Deutsches Handelsgesetzbuch*, ADHGB).[945] German company law has established a series of mechanisms to ensure that the supervisory board is able to oversee the management of the corporation, for example, the supervisory board's right to be fully and correctly informed on all business matters by the board of directors and senior managers.[946]

Chinese company law also follows German company law in identifying supervisors as corporate fiduciaries. According to article 116 of the German Stock Corporation Act 1965 (*Aktiengesetz* 1965), the duty of loyalty imposed on directors should apply equally to supervisory board members of German corporations.[947] Chinese law has, consequently, also borrowed from German company law in imposing fiduciary duties on supervisors. However, the issue here is whether supervisors stand in a fiduciary relationship to the company identical or similar to that between directors or senior officers and the company. Although civil-law countries introduced the supervisory board to represent the interests of stakeholders such as employees – eg, in Germany, the One-Third Participation Act 2004 (*Drittelbeteiligungsgesetz*) requires one-third employee representation on the supervisory board.[948] Essentially, supervisors also act in the interests of the company when performing their responsibilities. They indeed stand in a fiduciary relationship to the company irrespective of whether that relationship is identical to that between a director or a senior officer and the company.

5.1.2 The General Duty of Loyalty

As a part of its Chapter 6 'Qualifications and Obligations of Directors, Supervisors and Senior Officers of a Company', CCL2005 includes three articles – 148, 149 and 150 – governing

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[943] Companies Law of the PRC (2018 Rev) arts 53 and 117.
[944] Han (n 941) 457, 481.
[945] Jean J du Plessis *et al, German Corporate Governance in International and European Context* (3rd edn, Springer 2017) 106.
[946] ibid 146. See also Julian Franks and Colin Mayer, 'Ownership and Control of German Corporations' (2001) 14(4) Review of Financial Studies 943.
[947] Art 116, Stock Corporation Act of Germany (1965) (*Aktiengesetz* 1965).
[948] One-Third Participation Act of 2004 (*Drittelbeteiligungsgesetz*).

corporate fiduciaries' duty of loyalty. Article 148(1) provides, in general terms, that directors, 'supervisors, and senior officers owe a duty of loyalty […] to the company'.[949] Article 148(2) specifically requires that 'directors, supervisors and senior officers shall not, by abusing their positions and powers, take any bribe or other illegal income, or encroach on the property of the company'.[950] Article 149 then provides a list of bright-line prohibitive rules the violation of which constitutes breach of the duty of loyalty:

> Directors and senior officers are prohibited from any of the following acts:
> (1) Misappropriating the funds of the company;
> (2) Depositing the funds of the company in his/her personal name or in the name of any other individual;
> (3) Without the consent of the shareholders' meeting, shareholders' general meeting or the board of directors, loaning the funds of the company to others or using the property of the company as collateral to provide security for others in violation of the company's articles of association;
> (4) Entering into a contract or making deals with the company in violation of the company's articles of association or without the consent of the shareholders' meeting or shareholders' general meeting;
> (5) Without the consent of the shareholders' meeting or shareholders' general meeting, taking advantage of his/her powers to obtain, for the benefit of his/her own or others, any business opportunity that belongs to the company by, and engaging for himself/herself or for any other person in any business that is of the same type with that of the company that he/she serves;
> (6) Accepting, and keeping in his/her possession, commissions for the transactions between other parties and the company, and turn them into personal gains;
> (7) Disclosing corporate secrets without authorisation; or
> (8) Committing other acts in violation of his/her obligation of loyalty to the company.
> The income gained by the director or senior management person from any of the acts listed in the preceding Paragraph shall belong to the company.[951]

It can be seen from the above provisions that Chinese company law introduces an overarching duty of loyalty. Article 148(1) imposes a general duty of loyalty on corporate fiduciaries. Then article 149 makes it clear that directors and senior officers are not only subjected to the specific prohibitions provided in article149 (1)-(7), but are also prohibited by article 149(8) from committing other acts in violation of their duty of loyalty as a catch-all provision.[952] Chinese company law thereby introduces a general duty of loyalty as an open-ended, situation-specific duty. It suggests that it is open to Chinese courts to go beyond those proscriptive rules and adopt a flexible approach in deciding a breach of the duty of loyalty. Article 149 of Chinese

949 Companies Law of the PRC (2018 Rev) art 148(1).
950 ibid art 148(2).
951 ibid art 149.
952 ibid.

company law also makes the accounting for profit available as a remedy for a breach of the duty of loyalty.[953] However, the CCL2005 offers no defined meaning of the duty of loyalty. In common-law system the general duty of loyalty operates on the basis of the no-conflict and no-profit principles.[954] In the CCL2005, it seems to imply the inclusion of the no-profit principle in article 148(2) which proscribes corporate fiduciaries from accepting 'any bribe or other illegal gains by taking the advantage of their positions and powers'.[955] However, with no further provision as to the meaning or application of this proscription of illegal gains, it is uncertain whether it equates to the no-profit principle in the fiduciary and corporate law in common-law systems. More specifically, the remedy of accounting for profit under article 149 may not be available for breach of the proscription of illegal gains.

In the corporate-law context, the no-profit principle refers to the rule that a director should account to the company for any benefit obtained without the consent of the company by reason and in the course of his or her directorship.[956] In US corporate legislation, the no-profit principle is not currently in direct use as a principle, although it is included in the notion of fiduciary loyalty. In UK company law, in contrast, the no-profit principle has been codified in section 176 of CA2006 as a director's general duty not to accept benefits from third parties.[957] Preventing fiduciaries from receiving illegal gains, article 148(2) appears to have borrowed from the no-profit principle as it clearly applies to relevant gains coming from 'taking advantage of their positions and powers'. On the other hand, in article 148(2) the definition of 'illegal gains' and how they differ from the 'unauthorised profits' in the no-profit principle, is unclear. Because the notion of the no-profit principle is embedded in the equitable fiduciary doctrine, and as Chinese law does not include the fiduciary doctrine, article 148(2) uses the term 'illegal gains' to better express the nature and scope of prohibited self-profit.

In addition to the general duty of loyalty, Chinese company law introduces sub-rules specifically governing common situations involving breach of the duty of loyalty. Articles 148 (2) and 149 of the CCL 2005 set out a number of bright-line proscriptions, as manifestations of the general duty of loyalty. These include prohibitions on accepting bribes, misappropriating

[953] ibid art 149(2).
[954] See 2.3.1.1. See also 3.3.1 and 3.3.2 for the no-conflict and no-profit principles in UK company law.
[955] Companies Law of the PRC (2018 Rev) art 148(2). Relatedly, art 148(6) of the CCL2005 also prevents directors and senior officers from accepting commissions.
[956] See 3.3.1.2.
[957] See 3.1.3 and 3.3.1.2.

corporate funds, self-dealing with the company, exploiting corporate opportunities, competing with the company, and disclosure of confidential information.[958] Since Chinese company law provides a general duty of loyalty as discussed above, these prohibited acts are merely common scenarios in which the duty of loyalty may be breached and are neither exhaustive nor exclusive. This type of extensive list of proscriptions indicates that Chinese company law has adopted a common-law-style duty of loyalty.[959] The duty of loyalty in civil-law company legislation generally requires that directors, supervisors, and senior officers be loyal to the company without specific sub-rules.[960]

It is to be noted, however, that Chinese company law provides two sets of prohibitive rules which apply respectively to all corporate fiduciaries, or solely to directors and senior officers. Article 148(2) lists conduct prohibited for all corporate fiduciaries including directors, supervisors, and senior officers.[961] Although article 148(2) itself does not describe these prohibitions as situations involving the duty of loyalty, according to the official legislative interpretation of article 148(2), such behaviour indicates that a fiduciary 'betrays the trust of the company, directly or indirectly causes harm to the interests of the company and its shareholders, and seriously breaches the duty of loyalty'.[962] This means that the article 148(2) prohibitions are also manifestations of fiduciary loyalty and apply to directors, supervisors, and senior officers. In contrast, article 149 of the CCL2005 sets out fiduciary rules applicable only to directors and senior officers to the exclusion of supervisors.[963] Chinese company law therefore offers distinct lists of prohibitive rules applicable to supervisors on the one hand, and directors and senior officers on the other.

A possible explanation for this distinction is that as supervisors have supervisory responsibilities rather than managing the business of the company, they simply will not be involved in the situations of self-dealing or exploitation of corporate information and

[958] Companies Law of the PRC (2018 Rev) arts 148 and 149.
[959] Lee (n 140).
[960] ibid. See also Holger Fleischer, 'Legal Transplants in European Company Law: The Case of Fiduciary Duties' (2005) 2 European Company and Financial Law Review 378.
[961] Companies Law of the PRC (2018 Rev) art 148(2).
[962] Yanni Song and Xudong Zhao (eds) *Legislative Interpretation on the Company Law of the People's Republic of China* (Law Press 2019). This legislative interpretation is organised and led by the Legislative Affairs Commission of the Standing Committee of the NPC and written and edited by leading law scholars and practitioners in China. It represents the authoritative and official readings of the goals of legislature and the meaning of statutory provisions.
[963] Companies Law of the PRC (2018 Rev) art 149.

opportunity.[964] On the other hand, some scholars criticise this explanation and argue that excluding supervisors from article 149 may seriously expose the company to self-interested behaviour by supervisors, in particular usurping corporate opportunities.[965] Indeed, in light of the complexity of commercial reality, even if supervisors have no responsibility in managing corporate business, they inevitably have access to corporate property and information which points to an obvious flaw in the article 148(2) prohibitions. The division of fiduciary rules applicable to supervisors and directors and senior officers begs the question whether a supervisor who contravenes article 148(2) prohibitions will be guilty of a breach of the duty of loyalty. This is a question for the Chinese courts.

5.1.3 Misappropriation of Corporate Property

Chinese company law prohibits directors, supervisors, and senior officers from misappropriating any corporate property. According to article 148(2) of the CCL 2005, directors, supervisors, and senior officers may not encroach on the property of the company.[966] Articles 149(1), 149(2), and 149(6) of the CCL2005 proscribe directors and senior officers from embezzling the funds of the company, depositing the funds of the company into an account under their own names or under the name of any other individual, or taking commission on transactions between others and the company.[967] These provisions essentially prevent corporate fiduciaries from taking various measures to misappropriate corporate property. Both UK and US corporate law include a prohibition on the exploitation of corporate property and practical examples are to be found in their respective cases. The CCL2005, however, lists specific ways in which a fiduciary may misappropriate corporate property – there is no general prohibition on the misappropriation of corporate property.

Those specific manners clearly are common situations which allow a fiduciary to misappropriate corporate property in China's practice, such as depositing the funds of the company into an account under the fiduciary's own name. The legislators have specified these situations so as to provide clear guidance not only for court enforcement, but also for directors, supervisors, and senior officers of companies in China. However, as these situations provisions

964 See Junhai Liu, *Mordern Company Law* (Law Press 2015), 626.
965 See, eg, Guo Feng, 'A Study on the Legal Rules of Prohibiting Usurping Corporate Opportunities' (2010) 1 China Legal Science 96.
966 Companies Law of the PRC (2018 Rev) art 148(2).
967 ibid art 149.

of specific prohibition are not exhaustive, they cannot take the place of a general rule such as a total prohibition of the misappropriation of corporate property. This notwithstanding, any other instances of 'unlisted' misappropriating corporate property fall within the ambit of the general duty of loyalty in article 148(1) of the CCL 2005.

5.1.4 Exploitation of Corporate Opportunities

Chinese company law proscripts directors and senior officers from exploiting a corporate opportunity without shareholder approval. Article 149(5) of the CCL 2005 provides that in the absence of the consent of the shareholders' meeting or shareholders' general meeting, directors and senior officers should neither take advantage of their positions to seek and acquire, for themselves or any other person, business opportunities that accrue to the company, nor engage in business similar to that of the company for their own benefit or that of any other persons.[968] On the one hand, this article introduces the prohibition on a fiduciary exploiting a corporate opportunity without first having referred it to the company. On the other hand, it includes the prohibition on a fiduciary competing with the company by operating in the same line of business. However, the CCL2005 provides no further detail on these two prohibitions – neither why they are distinguished nor how they are to be applied. The murky co-existence of the prohibition on exploiting corporate opportunities and the prohibition on competing with the company in a single provision – article 149(5) – has raised some controversy among scholars in China over whether they are two distinct duties or in effect only one.[969]

In theory, competing with the company refers to the situation when a director or senior officer of a company directly or indirectly runs a business in competition with the business of the company through a partnership, a wholly-owned enterprise, or a company.[970] As can be seen from this definition, competing with the company can clearly coincide with exploiting corporate opportunities, particularly when a fiduciary uses an entity which operates in the same business as the company as a vehicle by which to exploits a corporate opportunity. In common-law systems, the operation of the corporate opportunity doctrine in company law is adequate to govern the situation where a fiduciary exploits a corporate business opportunity regardless

[968] ibid s 149(5).
[969] See Yousu Zhou, *The New Company Law* (Law Press 2006) 403; Xudong Zhao, *Company Law* (Higher Education Press 2003) 363; Ping Jiang and Guoguang Li, *The Understanding and Application of the New Company Law* (People's Courts Publishing 2006) 202.
[970] Shengxuan Guo, 'How to Identify the Directors of a Company Competing Industry in the Judicial Process' (2009) 27(1) Heibei Law Science 126, 128.

of whether or not he or she uses some other entity.[971] The non-compete rule is actually a product of civil law commonly encountered in the company law of civil-law countries such as Germany and Japan.[972] It is designed to address legal problems similar to those addressed by the corporate opportunity doctrine in common-law system.[973] In line with China's civil-law tradition, article 61 of the CCL1993 already included the non-compete rule which outlaws even shareholder approval to authorise or whitewash a director or senior officer's breach of the rule.[974] When introducing the common-law corporate opportunity doctrine, the CCL2005 retained the non-compete rule already provided in the CCL1993 and combined the two in its article 149(5).

Article 149(5) hardly indicates whether Chinese company law has borrowed the UK or the US pattern of corporate opportunity doctrine.[975] It provides neither the defined scope of business opportunities that belong to the company, nor how to identify a corporate opportunity. It is unclear whether Chinese company law has borrowed either the UK's status model or Delaware's proprietary model of the corporate opportunity doctrine. Moreover, as the provisions of article 148(5) are extremely simple in this regard, Chinese scholars are largely silent on the Chinese law of corporate opportunity. They rather comment on the law and theories of the corporate fiduciary doctrine in foreign legal systems such as the UK and the US.[976] In my view, despite its apparent simplicity, article 149(5) of the CCL 2005 implies that China's corporate fiduciary doctrine follows a no-profit approach. Article 149(5) specifically prevents directors and senior officers from acquiring a corporate opportunity by 'taking advantage of the convenience of their positions'.[977] This resembles the no-profit principle in UK company law which prevents directors from making a profit 'by reason or in the course of their directorship'.[978] The official interpretation of the CCL2005 explains article 149(5) on the basis that directors and senior officers, as the principal management personnel of the company, have the information about the business opportunities of the company.[979] This implies that

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971 See 3.3.3 and 4.3.2.2.
972 See Yehu Zhai, 'A study of Legal Practice of the Non-Compete Rule in Foreign Jurisdictions' (2013) 12 The Law Magazine 69, 73-74. In German corporate law, the relationship between a director and the company is an employment relationship.
973 Guo (n 970) 127. See also Lingchen Li, 'On Doctrine of Corporate Opportunity in the Juridical Thinking Pattern: Focusing on Article 149 of the Corporate Law of PRC' (2009) 6 Northern Legal Science 93.
974 1993 Chinese Company Law art 61.
975 See Feng (n 965).
976 See Tianshu Zhou, 'What Determines "Corporate Opportunities Doctrine"' (2011) 5 Law Magazine 126.
977 Companies Law of the PRC (2018 Rev) art 149(5).
978 See 3.3.2.
979 Song and Zhao (eds) (n 962) 300.

directors and senior officers are prevented from exploiting a business opportunity of which they become aware by reason or in the course of their fiduciary office. Consequently, it can be read from article 149(5) that Chinese company law applies the no-profit principle in identifying a corporate opportunity.

Despite China's seeming adoption of the no-profit approach to corporate opportunities, there is no clear trace of China borrowing the UK pattern of the corporate opportunity doctrine. The UK law applies both the no-profit and the no-conflict principles in identifying corporate opportunities.[980] Article 149(5), however, is silent as regards the no-conflict approach. There is also no indication that the CCL2005 intentionally excludes the no-conflict principle on the basis that it does not suit Chinese local context. However, in absence of the no-conflict approach, Chinese law confines the scope of corporate opportunities to those which that have come to a director by reason or in the course of directorship, while the UK corporate opportunity doctrine may also capture business opportunities explored by directors in their private capacity.[981] Chinese law thus appears to confine the scope of corporate opportunities in a too narrow and restricted manner. On the other hand, since article 149(5) embodies the non-compete rule it still may capture opportunities that came to a director or senior officer in his or her private capacity which however fall into the sphere where the non-compete rule applies. Nevertheless, in light of the simple wording of article 149(5), together with the co-existence of two different but overlapping rules, Chinese courts may some difficulty both in applying and in justifying the application of either or both the corporate opportunity doctrine and the non-compete rule in deciding corporate opportunity cases.

Other than the uncertain no-profit approach, the CCL2005 offers no further guidance on its corporate opportunity doctrine. It also does not make it clear whether the law acknowledges any defence factor justifying a fiduciary's exploitation of corporate opportunities – eg, the board's rejection of a certain business opportunity, the ability of the company to exploit an opportunity, or if the counter party declines to deal with the company. From a comparative perspective, the UK's corporate opportunity doctrine clearly rejects such defence factors, while Delaware law recognises the financial ability of the company as a factor in determining whether a business opportunity falls to the company.[982] The CCL2005's silence in this regard probably

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980 See 3.3.3.
981 ibid.
982 See 4.3.2.2.

indicates its refusal to recognise any defence factor in the law of corporate opportunity.[983] This leaves shareholder approval the only legitimate avenue for a director or senior officer to act on a corporate opportunity. China's corporate opportunity doctrine appears to adopt the UK approach in this regard. As this 'strict' approach is uncomplicated and practical, it better suits the judicial tradition in China.[984] Moreover, because the CCL2005 appears to adopt only a no-profit approach, it would be inadvisable for it to acknowledge any defence factor which would further limit the scope of corporate opportunities.

5.1.5 Interested Transaction Regulation

The CCL2005 provides prohibition as a default rule in the regulation of self-dealing transactions whose protection can be waived either by AOA authorisation or through shareholder approval or ratification. According to article 149(4) of the CCL2005, directors or senior officers should not enter into any contract or engage in any transaction with the company in violation of the company's articles of association or without the consent of the shareholders' meeting or shareholders' general meeting.[985] Chinese law thereby proscribes corporate fiduciaries' self-dealing allowing shareholders' approval to be obtained by either AOA authorisation or shareholder meetings.

It appears to have borrowed the self-dealing rule from common-law company laws which prohibit fiduciaries from dealing, directly or indirectly, with the company without shareholder approval. Furthermore, a self-dealing transaction is voidable at the option of the company or the shareholders regardless of whether or not it is fair to the company.[986] This self-dealing rule applied in both the UK and the US for a period. In UK company law the self-dealing rule was established in *Aberdeen Railway*. It, however, gradually lost relevance in regulating directors' self-dealings as most UK companies excluded its operation through their AOAs. Ultimately it lost its status as a default rule in the regulation of interested transactions as a result of the enactment of the CA2006.[987] In the US, the self-dealing rule had also been adopted by courts in most US states by late nineteenth century – eg, the New Jersey – before it was replaced by

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[983] Huaixia Hou, 'A Study on the Judicial Application of Prohibiting Usurping Company Opportunities in China' (2012) 4 Studies in Law and Business 149, 183.
[984] ibid 184.
[985] Companies Law of the PRC (2018 Rev) art 149(4).
[986] See *Aberdeen Railway* (n 276).
[987] See 3.1.2. and 3.1.3.

the rule of fairness review of interested transactions.[988] Specifically, since article 149(4) of the CCL2005 designates AOA authorisation as a vehicle for shareholder approval, it is more closely akin to the UK self-dealing rule pre-CA2006[989] in that US corporate law simply does not permit AOA authorisation of self-dealing.[990] However, since article 149(4) of the CCL2005 is unclear as to either the validity of self-dealing contracts or the relevance or irrelevance of the fairness of the transactions, it is uncertain whether the CCL2005 has fully adopted the UK model of self-dealing.

China's adoption of the self-dealing rule in principle prohibiting directors and senior officers from dealing with the company, appears to be based on its local context. In contrast to the self-dealing rule discussed above, modern regulation of interested transactions in common-law systems generally permits these transactions subject to *ex ante* disclosure or/and approval from board or shareholders or *ex post* judicial review.[991] China's conservative approach to self-dealing transactions may be based on concerns regarding the situations of most Chinese companies, in particular SOEs.[992] Self-dealing transactions can easily be used by directors and senior officers for self-benefit at the costs of corporate interests. And most Chinese boards of directors are not in the position to play the role of impartially approving these transactions. However, a question remains that how the prohibition of self-dealing can be reconciled with the necessity of self-dealing transactions in business reality. After all, in common-law countries the modern trend of allowing interested transactions basically reflects the prevalence of such transactions and their value in the corporate setting.

Similarly, China's adoption of AOA authorisation as a vehicle for shareholder approval and an exception to the general rule of prohibition may be based on local considerations. One major consideration is to meet the special need of different regulation of interested transactions in Chinese companies which are listed overseas.[993] For example, the Mandatory Provisions for the Articles of Associations of Companies to be Listed Overseas, issued in 1994 and still in effect, provides a duty of disclosure of self-dealing transactions instead of the rule of prohibition in article 149(4).[994] Permitting self-dealing transactions in the AOAs of the

[988] See 4.1.1.
[989] Note that since the CCL2005 was promulgated prior to the enactment of the CA2006 in the UK, the CCL2005 in effect borrowed the self-dealing rule directly from the UK law at that time.
[990] See Kershaw (n 382).
[991] See 3.3.4 and 4.3.2.2 for the modern regulation of interested transactions in the UK and US.
[992] Jianwei Li, *Legal Regulation on Affiliated Transactions* (Law Press 2007) 285.
[993] Lee (n 140).
[994] Mandatory Provisions for the Articles of Associations of Companies to be Listed Overseas (1994).

companies listed overseas aims to bring China into line with relevant law on interested transactions in foreign countries where these companies are listed. Apart from such exceptional considerations, it is unclear whether Chinese law expects such AOA authorisation of self-dealing transactions to be widely and generally adopted by companies in China. Article 149(4) of the CCL2005 provides no further guidance on the AOA authorisation of self-dealing transactions. It is also unclear to what extent Chinese law allows corporate AOAs to exclude the operation of the self-dealing rule. In UK common law the contracting out of the self-dealing rule by UK companies is largely unlimited, which has resulted in statutory intervention to provide a mandatory duty of disclosure by directors. In consequence, scholars in China frequently criticise AOA authorisation of self-dealing as opening the way for easy abuse aimed at evading the rule of prohibition, particularly if article 149(4) grants general permission for self-dealing transactions in the AOA of companies.[995]

Other than the seeming borrowing of the UK model of the self-dealing rule, the rule in article 149(4) of the CCL2005 is far from clear. The article is unclear on the definition or scope of self-dealing transactions which are in principle prohibited. On the face of it, article 149(4) governs the situation where a director or senior officer deals directly with the company standing as the other party in a transaction.[996] This being the case, the scope of interested transactions regulated by Chinese company law appears unduly restrictive.[997] Certain Chinese scholars thus argue that this article should be interpreted broadly to include indirect interested transactions.[998] Fundamentally, interested transactions in which a fiduciary has only an indirect interest are no less problematic than direct self-dealing transactions in that both constitute a breach of the fiduciary no-conflict principle. In UK and US company law, relevant regulatory rules apply equally to direct and indirect interested transactions. Also, as mentioned above, the law is unclear as to the validity of self-interested contracts or the shareholders' power to nullify self-dealing transactions. The relevance of the fairness or unfairness of the self-interested contracts is also unclear. Does it make any difference in Chinese company law if a self-interested contract is fair or unfair to the company? Further, the CCL2005 lacks specific guidance on the procedural requirements for the consent of shareholders.[999] Should

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[995] See Xiaojing Hu, 'The Regulation over Directors' Self-Dealing' (2010) 6 Modern Law Science 64; Li (n 992) 285.
[996] Companies Law of the PRC (2018 Rev) art 149(4). See also Hu (n 995).
[997] See also Lee (n 140) 898.
[998] Junhai Liu, *The Institutional Innovation of the New Company Law: Debates of Legislation and Explanation of Difficulties* (Law Press 2006) 399.
[999] Lee (n 140) 898.

shareholders' consent be obtained *ex ante*, or *ex post*? Should shareholders be 'fully informed' of relevant transactions to give consent? Are interested shareholders allowed to participate in relevant voting process? These issues call for further interpretation by Chinese courts.

In addition to article 149(4), the CCL2005 includes another provision that potentially also deals with the regulation of interested transactions. Article 21 of the CCL2005 provides that:

> Neither the controlling shareholder, nor the *de facto* controller, nor any of the directors, supervisors or senior officers of the company may harm the interests of the company by taking advantage of its connected relationship.
>
> Anyone who causes any loss to the company due to violating the preceding paragraph shall be liable for the compensation.[1000]

In terms of article 216 of the CCL2005, the 'connected relationship' refers to the relationship between directors, supervisors, or senior officers of a company and the enterprise directly or indirectly controlled by them, and any other relationship that may lead to the transfer of any interest of the company.[1001] As can be seen, article 21 appears also to govern interested transactions, in particular indirect interested transactions. Moreover, the wording of article 21 implies that interested transactions in which directors, supervisors, or senior officers have an interest are permitted provided that they are not detrimental to the interests of the company. The requirement of no harm to corporate interests appears to adopt a fairness standard, although the CCL2005 is unclear on this. Article 21 nevertheless provides a rule completely different from the self-dealing rule in article 149(4).

However, article 21 is not included in the ambit of the duty of loyalty which is a part of the 'Chapter VI Qualifications and Obligations of the Directors, Supervisors and Senior Managers of A Company' in the CCL2005.[1002] Instead, article 21 appears in the CCL2005 under 'Chapter I General Provisions'.[1003] According to the official legislative interpretation to article 21, the article governs connected transactions as common economic activities that can stabilise the business of the company, divert business risks, and benefit the development of the company, but which may also be misused to the detriment of the interests of the company and thus should be regulated.[1004] There are no official readings on the co-existence of article 21 and article

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[1000] Companies Law of the PRC (2018 Rev) art 21.
[1001] ibid art 216.
[1002] See 5.1.2 for articles in the CCL2005 dealing specifically with the duty of loyalty.
[1003] Companies Law of the PRC (2018 Rev) Chapter I 'General Provisions'.
[1004] Song and Zhao (eds) (n 962) 36-37.

149(4) of the CCL2005. This has triggered great controversy among Chinese scholars over the relation between articles 21 and 149(4), in particular the compatibility of the two articles in regulating interested transactions.[1005] For example, one scholar argues that while article 21 clearly falls within the ambit of the duty of loyalty, it is upgraded into the part of 'General Provisions' in the CCL2005 to emphasise its importance, which, however, does not comply with the logical structure of modern company law and results in the chaos in the structure of the CCL2005.[1006] The co-existence of differing and even conflicting article 21 and article 149(4) in the CCL2005 which are both aimed at regulating interested transactions, clearly poses a great challenge to courts in China when it comes to enforcing the provisions..

To summarise, Chinese company law not only incorporates a defining duty of loyalty and various specific standards and rules under the rubric of the duty of loyalty; it also introduces remedies typically available for fiduciary breaches in common-law systems.

5.2 The Enforcement of Corporate Fiduciary Duties in China's Courts

This section conducts empirical research on the judicial enforcement of transplanted law of corporate fiduciary duties provided in the CCL2005 with a view to outlining how the law of corporate fiduciary duties is understood, interpreted, and applied by Chinese courts.

5.2.1 Sources of Data and Cases

To obtain data from the Chinese court system,[1007] I consulted two widely used electronic databases of Chinese law: the China Judgments Online database,[1008] and the Peking University judicial cases database.[1009] As neither of these two databases is complete, combining the two resulted in a more comprehensive database. In accordance with the 'Measures on Causes of Civil Actions' issued by the Supreme People's Court ('SPC'), relevant cases as regards directors, supervisors, and senior officers' duty of loyalty are included under the directory 'on

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1005 See Hu (n 995).
1006 Tiantao Shi, 'How Should the Company Law Regulate Connected Transactions?' (2021) 4 Law Application 70, 71.
1007 It is to be noted that there is no single, comprehensive source of data on cases decided in Chinese courts.
1008 China Judgments Online <https://wenshu.court.gov.cn/> operated by the Supreme People's Court was established in 2013. It is the most authoritative official database of judicial decisions delivered by the courts in China at all levels. On the other hand, in light of politically-sensitive considerations, this database in fact includes only a small proportion of cases decided within China's judicial system.
1009 This database is not an official one, but one that is operated commercially. It is currently the most complete database of judicial cases in China. Unfortunately, only authorised users can access the database via the internet and look up the cases. Available at <http://pkulaw.com/>.

the company, securities, notes, insurance and other civil disputes' and 'civil disputes as regards infringing the corporate interests' in the databases.[1010] In terms of the selection of samples for empirical research, the research covers judgments by the SPC, high courts, and intermediate courts.[1011] It should be noted that a large proportion of cases decided in the basic-level courts have been appealed or are pending for appeal in higher courts. Furthermore, although higher-court decisions do not serve as precedents and lower-level courts are not obliged to follow them,[1012] in practice lower-level courts largely follow courts superior to them in the same region in China. It is therefore highly unlikely that the application of law by basic-level courts will differ from that in the courts directly superior to them. Given these considerations, the data for the empirical research is confined to judgments of the SPC, the HPCs and the IPCs.

Furthermore, considering the large number of cases nationally, this empirical research uses the data collected from the following courts in four areas of China: the cases decided by the Intermediate People's Courts in Beijing, Shanghai, Guangzhou, and Shenzhen; the cases decided by the High People's Courts in Beijing, Shanghai, and Guangdong Province; and the cases before the SPC. This selection is based on the following criteria: Beijing is China's capital city among the four municipalities of the country;[1013] Shanghai contributes the highest gross domestic product ('GDP') of the municipalities;[1014] Shenzhen is the most developed special economic zone in China;[1015] and Guangzhou is the capital of Guangdong province which is the most developed province in China.[1016] Basically, these four areas represents not only the most developed social economies, but also the highest level of judicial professionalism

1010 Art 276, The SPC 'Measures on Causes of Civil Actions (2020 Rev)' available at <http://www.court.gov.cn/shenpan-xiangqing-282031.html>accessed 12 December 2021.

1011 China's courts operate on four levels: the SPC, the High People's Courts (HPCs), the Intermediate People's Courts (IPCs) and the Basic People's Courts (BPCs).

1012 In light of China's civil law tradition, there is no doctrine of precedent in Chinese law. It means that judgments by high-level courts, even the SPC, neither have an effect as precedent, nor are they expected to be followed by lower-level courts.

1013 China currently has four municipalities Beijing, Shanghai, Tianjin and Chongqing, all of which are under the jurisdiction of the central government of China. The administrative division of the municipalities is equal to province, which is at the highest level of the administrative division of China. See art 30(1) of the Constitution of the People's Republic of China (2018 Rev).

1014 According to the 2020 official report of the National Bureau of Statistics (NBS), Shanghai contributed 561.09 billion US dollars, Beijing contributed 523.42 US dollars, Chongqing contributed 362.5 US dollars, and Tianjin contributed 204.19 billion US dollars. The original statistics calculated in RMB are drawn from the official NBS website <https://data.stats.gov.cn/english/easyquery.htm?cn=E0102> accessed 10 December 2021.

1015 The central government of China set up five Special Economic Zones (SEZs): Shenzhen, Zhuhai, Shantou, Xiamen and Hainan. The SEZs are the areas where some special supporting policies were applied by the Chinese authorities since THE early 1980s to explore the path of market-oriented economic and opening-up reform.

1016 According to the 2020 official report of the NBS, Guangdong province contributed 1,605.84 billion US dollars, ranked first among all the provinces, autonomous regions and municipalities of China. Data available at <https://data.stats.gov.cn/english/easyquery.htm?cn=E0102> accessed 10 December 2021.

and expertise. Accordingly, judgments from the courts in these four areas reflect the highest-standard and most sophisticated enforcement of fiduciary duties in Chinese judicial practice.

Table 1 reflects the temporal distribution of cases. Overall, this empirical research has located a total of 456 corporate fiduciary duty cases during the period from 2006 to 2020 which include 213 cases of misappropriation of corporate property, 24 cases of exploitation of corporate opportunities, 137 cases of self-interested transactions, 7 cases of receiving illegal income. The number of available cases on corporate fiduciary duties from the period 2006-2015 is relatively low possibly because the law was only introduced in 2005. In addition, as there was no statutory requirement of online publication of judicial decisions in China until 2013, fiduciary duty cases decided during the period have not been fully recorded and released by the online database.[1017] Since 2016, the online recorded cases of corporate fiduciary duties then proliferated.

[1017] According to 'Provisions on People's Courts Publishing Judgments on the Internet' which was promulgated by the Supreme People's Court in 2013, all judicial decisions delivered by Chinese courts at all levels must be published in the China Judgments Online database within seven working days from the verdicts coming into force.

TABLE 1: STATISTICS OF ADJUDICATIONS OF SPECIFIC CORPORATE FIDUCIARY DUTIES AT BEIJING, SHANGHAI, GUANGZHOU, SHENZHEN AND THE SUPREME COURT

	Beijing IPC	**Beijing HPC**	**Shanghai IPC**	**Shanghai HPC**	**Guangzhou IPC**	**Shenzhen IPC**	**Guangdong HPC**	**The SPC**	**Total**	**Percentage**
Misappropriation of corporate property	69	1	80	5	21	30	2	5	**213**	46.71%
Interested transactions	30	0	56	5	21	19	3	3	137	30.04%
Exploitation of corporate opportunities	8	1	10	0	4	0	0	1	24	5.26%
Receive illegal income	1	0	1	0	0	5	0	0	7	1.54%
Others	15	1	32	0	19	7	0	1	75	16.45%
TOTAL	**123**	**3**	**179**	**10**	**65**	61	**5**	**10**	**456**	**100%**

TABLE 2: STATISTICS OF ADJUDICATIONS OF CORPORATE FIDUCIARY DUTIES AT BEIJING, SHANGHAI, GUANGZHOU, SHENZHEN AND THE SUPREME COURT THOURGH THE YEARS

	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**TOTAL**
The SPC	0	0	0	0	0	1	0	1	5	0	1	0	0	2	0	**10**
Beijing Courts	1	1	3	12	1	4	1	2	10	13	7	29	14	18	25	**126**
Shanghai Courts	0	2	3	8	5	11	7	6	14	23	23	17	27	24	19	**189**
Guangzhou Courts[1018]	1	1	0	0	3	0	0	4	2	5	6	8	7	13	21	**70**
Shenzhen Courts	0	0	0	0	0	0	1	4	1	5	6	4	8	13	19	**61**
TOTAL	2	4	6	20	9	16	9	17	32	46	43	58	56	70	84	**456**

[1018] This includes the number of relevant cases decided by the High Court of Guangdong Province.

5.2.2 Who Owe Fiduciary Duties

In enforcing fiduciary duties provided in the CCL2005, courts in China adopt both a status-based and a factual-based approach to identify an individual as a corporate fiduciary.

In cases where the defendant's *prima facie* position in the company does not fall within the scope of directors and senior officers as provided in the CCL2005 or in the company's articles of association, courts in China adopt a flexible approach in affirming a defendant as a *de facto* director or senior officer based on the fact that he or she actually manages the affairs of the company. A classic case in this regard was the *Linglanyufeng Cultural Media Company and Others v Mu*[1019] in which a company challenged a chief sales manager who was nowhere officially registered as a senior officer, for breach of the duty of loyalty. The court held that the identification of senior officers should not be limited to the provisions of the CCL2005 or the company's articles of association, instead, a substantive review should be conducted to establish whether the defendant has actually been exercising the powers of a senior officer. In consequence, the court reviewed the internal documents of the company which showed that the defendant was appointed to head up the daily operation of one of the company's training schools. The court consequently held that the defendant was actually exercising the powers of a senior officer and should be recognised as a senior officer of the company.

On the other hand, were a defendant to survive this fact-based scrutiny, the court would find him or her not to be a director or senior officer of the company and he or she should not be challenged in court for breach of the duty of loyalty.

5.2.3 The General Duty of Loyalty

In the enforcement of the duty of loyalty provided in the CCL2005, the SPC has provided the definition of the general duty of loyalty. Also, certain Chinese courts apply the duty of loyalty confirming that a supervisor's duty of loyalty is essentially the same as that of directors and senior officers.

[1019] *Linglanyufeng Cultural Media Company and Others v Mu* Beijing Intermediate Court, 2020, No 8429.

Most significantly, courts in China, and the SPC in particular, interpret the general duty of loyalty in a way that clearly reflects the no-conflict principle and requires fiduciaries' undivided loyalty. In the case of *Shandong Haizhijie Textile Co Ltd v Ahmedgabersobhyismail* in 2020, the Supreme Court interpreted directors, supervisors, and senior officers' duty of loyalty as follows:

> The duty of loyalty means that the directors, supervisors and senior officers of the company shall perform their duties faithfully, and when their own interests conflict with the interests of the company, they shall protect the company's interests, and should not abuse the advantageous position of the senior management to sacrifice the company's interests for their own benefit or for a third party's sake.[1020]

In this case the plaintiff company sued one of its directors for breach of both the duties of loyalty and of diligence. The Supreme Court offered a definition of the duty of loyalty and explained that because the facts of the case involved neither self-profit nor self-benefit for the director, it was in essence a duty of diligence case.[1021] Although the Supreme Court did not have the opportunity to apply the duty of loyalty in this case, its interpretation of the duty of loyalty carries substantial weight in China's judicial system.[1022] In the definition of duty of loyalty provided by the Supreme Court there is clear indication of the no-profit principle as well as the requirement of fiduciaries' undivided loyalty. According to the definition of the duty of loyalty above, corporate fiduciaries should protect the interests of the company whenever their own interests conflict with those of the company. Although it does not mention the no-conflict principle which prohibits conflict between fiduciaries' self-interest and their duties to the company in so many words, it clearly intends to express such a notion.[1023] Moreover, the duty of loyalty so defined also requires fiduciaries' undivided loyalty to the company by proscribing them from abusing their advantageous position for their own benefit or for that of a third party.

With regard to supervisors' duty of loyalty, courts in China adopt either a strict or a flexible approach to the applicability of the prohibitive rules provided in article 148 of the CCL 2005. As discussed, Chinese company law has two sets of prohibitive rules to be applied respectively

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[1020] *Shandong Haizhijie Textile Co Ltd v Ahmedgabersobhyismail* Supreme Court of the PRC, 2020, 640. See also *Ying Chen v Beijing iWatch365 Co Ltd* Beijing No 3 Intermediate Court, 2019 No 15352, 1009.
[1021] ibid.
[1022] It is to be noted that in light of China's civil-law tradition, there is no doctrine of precedent in the Chinese legal system. It means that judgements by the SPC neither have effect as precedent nor they required to be followed by lower-level courts.
[1023] It is in fact not uncommon for some courts and scholars to phrase the no-conflict principle in a such no-conflict of interest and interest manner. See, eg, *Guth* (n 276).

to all corporate fiduciaries, and to directors and senior officers only. When faced with a lawsuit against a supervisor claiming breach of article 148 rules, courts in China show two opposite understandings of articles 148 and 149 as regards supervisors' duty of loyalty. One approach is so strictly based on the literal meaning of articles 148(2) and 149 that, even if a supervisor has performed the acts prohibited in article 149, no enforcement of the duty of loyalty is trigged. For example, in the case of *Bin Liu v Zhanjun Li*[1024] the company filed a lawsuit against one of its supervisors for breach of the duty of loyalty on the ground that he had acted in contravention of article 149 prohibitions. The court held that as the defendant was a supervisor in the company rather than a director or senior officer, even though his behaviour fell within the circumstances stipulated in article148, article148 did not apply.[1025] Reading article 149 strictly and denying its application to supervisors, the court dismissed the case.

In contrast, the other approach is to extend the application of article 149 to supervisors based on the general duty of loyalty in article 148(1). Although a literal reading of article 148 excludes supervisors, because article 147(1) imposes a general duty of loyalty on supervisors the enforcement of the duty of loyalty would still be triggered by article 148(1) in cases where a supervisor violates article 149 prohibitions. A classic case in this regard is *Domestic Services Co Ltd v Bihua Su & Wanrong Wu*[1026] in which the court explained that the reason why the regulatory scope of article 149 does not cover supervisors is that supervisors are generally not directly involved in a company's operation and management and are not party to the company's business information. Given supervisors' position and role in corporate governance, legislators consider it highly unlikely that they will materially misuse information regarding company assets for personal interest.[1027] However, in terms of article 148 of the CCL 2005, supervisors' duties of loyalty are essentially identical to those of directors and senior officers. The court also highlighted that as supervisors are responsible for supervising directors and senior officers in corporate management, they should have higher standards of self-discipline than directors and senior officers.[1028] The court therefore held the defendant liable for breach of the duty of loyalty.

[1024] *Bin Liu v Zhanjun Li* Beijing No 1 Intermediate Court, 2010, No 1099.
[1025] ibid.
[1026] *Domestic Services Co Ltd v Bihua Su & Wanrong Wu* Guangzhou Intermediate Court, 2019, No 9553.
[1027] ibid.
[1028] ibid.

5.2.4 Misappropriation of Corporate Property

During the period 2006–2020 a large proportion of cases before the courts seeking enforcement of the duty of loyalty were indeed based on the claim that a director, supervisor, or senior officer of a company had misappropriated corporate property. Most of the cases involving the embezzlement of corporate funds addressed, for example, the use of corporate funds to invest in private business without approval,[1029] reimbursement of private expenses without justification, or the purchase of an automobile and registering it in the fiduciary's own name.[1030] Similarly, courts in China have recognised the situation where, for instance, a fiduciary of the company privately takes possession of the payments of goods[1031] or cash[1032] or property[1033] (eg, real estate, automobiles, etc.) owned by the company without approval as encroaching on the property of the company. Courts sometimes have difficulty in accurately differentiating between embezzlement of corporate funds and encroaching on the property of the company. In contrast, the situation of a fiduciary's depositing corporate funds into an account under his or her own name or under the name of any other individual is clearly more easily identifiable.

When faced with cases involving a situation not specified in articles 148(2) or 149(1)-(3) which, however, involves the exploitation of corporate property, the courts must apply the general duty of loyalty and find the defendant director, supervisor, or senior officer liable. For example, in the case of *Wuhao Zhao & Shantou Pingtiancheng Materials Company v Shenzhen Mingkeda Co Ltd*[1034] without seeking shareholder approval, a shareholder and director of a company arranged for the transfer of the company's shares in a subsidiary for 1 RMB to another company in which the defendant director was a shareholder. The Shenzhen Intermediate Court found that, given the minimal consideration involved, the contract constituted misappropriation of corporate property. Because the conduct of the director did not fall within the scope of the specific situations in articles 148(2) or 149(1)-(3) of the CCL2005, the court based its decision

[1029] *Yu Zhou and Others v Deng Shi* Shanghai No 1 Intermediate Court, 2016, No 13372.
[1030] *Shenzhen Longyang Numerical Control Technology Co Ltd v Yanda Li* Shenzhen Intermediate Court, 2016, No 20935.
[1031] *Guangdong Dongrihui Food Trade Company v Ganbin Liao and Others* Guangzhou Intermediate Court, 2018, No 6346.
[1032] *Shenzhen Youboshi Electronic Technology Co Ltd* Shenzhen Intermediate Court, 2015, No 553.
[1033] *Beijing Pengnuo Film & Television Industry Consulting Company v Wang and Others* Beijing High Court, 2008, No 837.
[1034] *Wuhao Zhao & Shantou Pingtiancheng Materials Company v Shenzhen Mingkeda Co Ltd* Shenzhen Intermediate Court, 2017, No 1690.

on article 149 and held the director liable for breaching the duty of loyalty and invalidated the contract.[1035]

5.2.5 Exploitation of Corporate Opportunities

In the enforcement of the article 149(5) of the CCL2005 as regards the usurpation of corporate opportunities, courts in different areas of China take the initiative to interpret and apply the corporate opportunity doctrine and the non-compete rule in various ways. In effect, the courts adopt a non-profit approach to corporate opportunities and also proscribe the exploitation of corporate opportunities through a vehicle company which inevitably engages in a business similar to that of the company.

5.2.5.1 Beijing Courts

Based on article 149(5) of the CCL2005, Beijing courts have confirmed the no-profit approach to corporate opportunities in the article 149(5) corporate opportunity doctrine. For example, in the case of *Yanzhi Zhang v Langyimingzhuang (Beijing) Alcohol*,[1036] the company entered into a contract for the sale of wine with a client company without actually executing the contract. The defendant senior officer of the company offered, through another company he controlled, a contract for wine of the same year, type, place, unit price, quantity, and total price of the wine supplied to the client company. The contract was duly executed. Beijing No 3 Intermediate Court held that the defendant, a senior officer charged with wine acquisition, had breached the duty of loyalty resulting in the company losing its business opportunity. The court found that the director should account for the profits made from the contract.[1037] In this case, the court adopted the no-profit principle holding that the sale of wine contract usurped by the defendant through another company constituted a corporate opportunity, and that the defendant who had secured the contract by taking advantage of his position as a senior officer in charge of wine acquisition, was liable for the exploitation of corporate opportunity.

As regards the article 149(5) corporate opportunity doctrine, Beijing courts appear to recognise that the inability of a company to exploit a business opportunity constitutes a defence factor

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1035 *Wuhao Zhao & Shantou Pingtiancheng Materials Company v Shenzhen Mingkeda Co Ltd* Shenzhen Intermediate Court, 2017, No 1690.
1036 *Yanzhi Zhang v Langyimingzhuang (Beijing) Alcohol* Beijing No 1 Intermediate Court, 2016, No 10666.
1037 ibid.

for corporate fiduciaries to appropriate the opportunity. For example, in the 2016 case of *SunRise MGL CO Ltd v Lu Qi & Inner Mongolia Limeng New Energy Co Ltd*,[1038] because the defendant director and senior officer of the company arranged for another company whose controlling shareholder was the defendant's father to enter into a contract with a client of the company, the company sued the director and senior officer for the exploitation of a corporate opportunity. According to the court, to determine whether the defendant director's conduct constituted exploiting a business opportunity that belongs to the company, one should consider whether the company has the corresponding production capability to make use of the opportunity.[1039] The Beijing No 1 Intermediate Court therefore requested the company to prove its production capacity during the period of the term of contract at issue. The company failed to do so and the court dismissed the case. To recognise the inability of the company as a defence factor as part of the corporate opportunity law obviously may further restrict the scope of corporate opportunity under CCL2005.

In cases where it is difficult to justify the application of the no-profit principle, Beijing courts based also on article 149(5) of the CCL2005, apply the non-compete rule to review the scope of the business of the company used as a vehicle in exploiting the business opportunity at issue. In this regard the non-compete rule proscribes the vehicle company from engaging in a business similar to that of the company. For example, in the *Beijing Xinjunlong Technology Co Ltd v Ba*,[1040] immediately after the company had been franchised it closed down. Its director and senior officer's wife then set up a company and secured the franchise. Beijing No. 1 Intermediate Court first confirmed that there are conditions and a possibility for the defendant director and senior officer to take advantage of the fiduciary position and use their control over the corporate business information – eg, client information, operating status, and market situation of the company – for their personal benefit.[1041] However, because it is difficult to prove that the possibility was also the truth, the court then reviewed the business scope of the company in which the defendant's wife was both a legal representative and a shareholder and found that its business scope resembled that of the company. The court thus held that the

[1038] *SunRise MGL CO Ltd v Lu Qi & Inner Mongolia Limeng New Energy Co Ltd* Beijing No 1 Intermediate Court, 2016, No 5874.
[1039] ibid.
[1040] *Beijing Xinjunlong Technology Co Ltd v Ba* Beijing No 1 Intermediate Court, 2019, No 10091.
[1041] ibid.

company controlled by the defendant's wife was in a competitive relationship with the company and that the defendant had breached the non-compete rule.[1042]

As can be seen, in cases involving a specific business opportunity, Beijing courts apply both the no-profit principle and the non-compete rule to hold a corporate fiduciary liable for breach of article 149(5) and the duty of loyalty. Specifically, in cases where the facts and relevant evidence clearly support that the defendant has taken advantage of his or her fiduciary position – including using a company for that purpose – Beijing courts generally apply the no-profit principle holding the defendant liable for breaching the corporate opportunity doctrine. On the other hand, if it is difficult to prove that the defendant has definitely abused his or her fiduciary position or that the opportunity at issue did not come to the defendant by reason of and in the course of his or her fiduciary position, Beijing courts would hold the defendant liable based on the non-compete rule. One classic case in this regard is *Beijing Lianda Power Information Technology Co Ltd v Guo*[1043] in which the court held the defendant director liable for breach of the non-compete rule because he had set up a company dealing in a product with a function sufficiently similar to a product of the company. The court also held the defendant director liable for breach of the corporate opportunity doctrine as he approached and acquired both a prospective client and some employees of the company through a vehicle company.[1044] It appears that the court found it difficult to prove that the defendant had taken advantage of the directorship in the former situation where the vehicle company develops a product similar to that of the company, while the abuse of fiduciary position is more obvious in the latter situation. In the result, the court held the defendant liable for both accounting for profit made and compensating the company for its loss resulting from the defendant's breach of the duty of loyalty.

5.2.5.2 Shanghai Courts

Within the scope of this empirical research, very few cases in Shanghai courts involve a specific business opportunity – most of the cases decided on the basis of article 149(5) of the CCL2005 involve the non-compete rule without raising the issue of exploiting corporate opportunities. Consequently, so few cases cannot reliably reflect the Shanghai courts' approach to the law on

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1042 *Beijing Xinjunlong Technology Co Ltd v Ba* Beijing No 1 Intermediate Court, 2019, No 10091.
1043 *Beijing Lianda Power InformationTechnology Co Ltd v Guo* Beijing No 1 Intermediate Court, 2018, No 8475.
1044 ibid.

corporate opportunities. It appears, however, that here too both the corporate opportunity doctrine and the non-compete rule are applied. In the *Shanghai Dedun Company v Weijun Deng*[1045] case, the two defendant senior officers of a company had set up two other companies whose scopes of business coincided with that of the company. They transferred the fire-fighting product verification certificate of the company to one of the two companies and used the certificate to enter into fire-fighting product sales contracts with third parties. The court held that those sales contracts were corporate opportunities that belonged to the company, and that the defendants had used a corporate asset for the operation of a business similar to that of the company.[1046] It appears that Shanghai courts apply both the corporate opportunity doctrine and the non-compete rule independently to one set of behaviour in the case.

In most of the empirical cases, Shanghai courts apply the non-compete rule in situations where a defendant director or senior officer of the company operates another entity as shareholder, director or senior officer, whose business is similar to that of the company holding the defendant liable for breach of the duty of loyalty. The applicability of the non-compete rule therefore focuses on the interpretation of 'similar businesses' by the courts. In the *Shanghai Changan Automobile Sale Service Company v Qian Yao*[1047] case, when the chief director of the company was challenged in court for breach of the non-compete rule, the court in the first trial held that although the principal businesses of the company and another company operated and controlled by the defendant director both sold Changan cars, considering that the two companies sold different models of cars, their main businesses did not coincide. The decision was subsequently reversed in this regard by the Shanghai No 2 Intermediate Court which explained that, engaging in similar businesses does not necessarily mean that the two companies should supply identical products. The determining factors should rather be similarity as regards the factual types and areas of their business operation.[1048] The court thus held that the two companies operated in the same line of business. However, in light of the fact that the shareholder meeting of the company had approved that the defendant director could set up the new business, the appeal was dismissed. As can be seen from this case, in determining if two companies engage in similar businesses, Shanghai courts look at the main business actually operated and adopt a relatively broad approach to the 'similarity' between businesses.

1045 *Shanghai Dedun Company v Weijun Deng* Shanghai No 1 Intermediate Court, 2020, No 9247.
1046 ibid.
1047 *Shanghai Changan Automobile Sale Service Company v Qian Yao* Shanghai Baoan District Court, 2018, No 10133.
1048 *Shanghai Changan Automobile Sale Service Company v Qian Yao* Shanghai No 2 Intermediate Court, 2019, No 3777.

5.2.5.3 Shenzhen Courts

From the empirical research most of the cases in Shenzhen courts based on the article 149(5) of the CCL2005 do not involve the interpretation or application of either the corporate opportunity doctrine or the non-compete rule, and are frequently dismissed because the facts are obvious or appear to be irrelevant to either of the rules.[1049] In the case of *Dezhang Electronic Technology (Shenzhen) Co Ltd v Wu*,[1050] the court nevertheless interpreted the breach of the non-compete duty as involving three elements: lack of approval by a shareholder meeting; exploitation of the fiduciary's position in the company; and use of a business opportunity acquired for the operation of a business similar to that of the company. Furthermore, according to the court similar business should be determined by the scope of business, the business pattern, areas of operation, types of clients, and other aspects.[1051] Based on the facts of the case, the court held that the defendant senior officer has taken advantage his position to set up another company to operate a business similar to that of the company in the same region. From this it appears that Shenzhen courts interpret article 149(5) of the CCL2005 as a so-called no-compete duty and incorporate the acquisition of corporate opportunities in the duty.

On the other hand, the non-compete duty interpreted by Shenzhen courts still aims to address the problem of exploiting corporate opportunities. In the *Shenzhen Bomeide Robot Co Ltd v Qionghai Wu and Yi Tang* case[1052] the court explained the non-compete duty as follows:

> The non-compete duty essentially intends to prevent conflicts of interests and illegitimate competition. Directors and senior officers are relevant personnel who have access to the company's main business and confidential information at the managerial judgement level. Without the non-compete duty, it is possible that certain directors or senior officers may take advantage of their positional convenience to divert business opportunities that belong to the company to another company, in which the directors or senior officers are shareholders or also directors or senior officers, with the purpose of obtaining unauthorised profits in the harm of the interests of the company.

As can be seen, according to the court, the non-compete duty still aims to address conflicts of interests as well as to prevent the exploitation of corporate opportunities. However, the

[1049] See, eg, *Shenzhen Bomeide Robot Co Ltd v Qionghai Wu and Yi Tang* Shenzhen Intermediate Court, 2018, No 22018; *Shenzhen Mengjiayuan Beauty Treatment Company v He* Shenzhen Intermediate Court, 2019, No 1352; *Jiafeng Wu v Yizhong Wang* Shenzhen Intermediate Court, 2018, No 3494.
[1050] *Dezhang Electronic Technology (Shenzhen) Co Ltd v Wu* Shenzhen Intermediate Court, 2020, No 16081.
[1051] ibid.
[1052] *Shenzhen Bomeide Robot Co Ltd* (n 1049).

combination of the corporate opportunity doctrine and the non-compete rule in a non-compete duty in accordance with the three elements set out above, may narrow the scope of the application of the two rules. For example, it is unclear whether Shenzhen courts intend to limit the prohibited exploitation of corporate opportunities to where a vehicle company is used.

5.2.6 Interested Transaction Regulation

The enforcement of the law on interested transactions reveals a common adoption of the fairness standard review of interested transactions. Courts in Beijing and Guangzhou conduct a fairness review of interested transactions based on both procedural and substantial fairness standards. Courts in Shanghai and Guangzhou conduct a fairness review of interested transactions based on the fair-price standard. Although the SPC has issued a judicial interpretation in the regard, it does not clarify the position with regard to the farness standard required.

5.2.6.1 The SPC

With regard to the law on interested transactions, the SPC has interpreted the application of article 21 of the CCL2005 under an official judicial interpretation providing guidance for all courts in China.[1053] In 2019, the SPC issued ‘Provisions (V) of the Supreme People’s Court on Several Issues concerning the Application of the Company Law of the People’s Republic of China’. Article 1 provides:

> Where the interests of a company is damaged by any connected transaction, and the company as the plaintiff requests any of the controlling shareholder, the actual controller, directors, supervisors and senior executives to compensate for the loss caused in accordance with the provision of Article 21 of the Company Law, and the defendant makes a defense merely on the excuse that the procedures prescribed by laws, administrative regulations or the company's bylaws such as information disclosure and approval by the shareholders’ meeting or general assembly of shareholders have been fulfilled in this transaction, the people's court shall not support it.[1054]

The SPC first confirms that article 21 applies to connected transactions between a company and any entity with which its directors, supervisors, or senior officers have a connected

[1053] The SPC has the legislative power to issue judicial interpretations in accordance with the art 104 of the Law on Legislation (2015 Rev).
[1054] Art 1, Provisions (V) of the Supreme People’s Court on Several Issues concerning the Application of the Company Law of the People’s Republic of China.

relationship. Second, this judicial interpretation indicates that the no-harm requirement in article 21 refers to a substantial fairness standard. Mere disclosure and shareholder approval of connected transactions does not adequately meet this requirement. Courts must, therefore, review the actual fairness of connected transactions regardless of any internal approval by the company. However, this judicial interpretation is unclear as to whether the fairness standard in article 21 requires substantial fairness only, or both procedural and substantial fairness. Moreover, it provides no guidance on how to review the substantial fairness of connected transactions – eg, does a substantial fairness standard equate to a fair-price requirement?

5.2.6.2 Beijing Courts

Courts in Beijing traditionally adopt both substantial and procedural fairness standards dealing with both direct and indirect interested transactions. The courts rely on article 21 of the CCL 2005 and adopt the fairness standard to review indirect interested transactions requiring both substantial and procedural fairness. Although they still deem indirect interested transactions as a breach of the duty of loyalty,[1055] Beijing courts apply article 21 in preference to articles 148 and 149(4). In the case of *Beijing Brain Think-Tank Education Technology Co Ltd v Shixun Lin & China-Europe International Education Co Ltd*[1056] the chairman of the board of a company had an indirect interest in a transaction between the company and another company of which he was also the chairman of board. The court relied on article 21 and recognised the transaction as a connected transaction. It held that to determine whether a related-party transaction harms corporate interests is based on several considerations: whether information disclosure of the transaction is sufficient; whether the procedures as regards the transaction comply with both the Chinese company law and the company's articles of association; whether the price of the transaction is fair; and whether or not the transaction is contrary to common practice.[1057] Based on the fact that the challenged transaction had not been duly approved by the board of the company,[1058] the court held that the transaction was prejudicial to the interests

[1055] *Ying Chen v. Beijing iWatch365 Co Ltd* Beijing No 3 Intermediate Court, 2019, No 15352.
[1056] *Beijing Brain Think-Tank Education Technology Co Ltd v Shixun Lin & China-Europe International Education Co Ltd* Beijing No 4 Intermediate Court, 2018, No 382.
[1057] ibid.
[1058] It is to be noted that since the company is a foreign invested enterprise, it has no meeting of shareholders, while the board of directors serves the function of shareholder meeting.

of the company and the defendant chairman was found liable to compensate for loss suffered by the company.

Moreover, courts in Beijing also rely on article 21 of the CCL 2005 and apply a substantial and procedural fairness standard to both direct and indirect interested transactions. In the case of *Bingjiang Han v Cunzhao Sun*[1059] the defendant director twice breached the duty of loyalty: first, without shareholder approval he transferred equity he held in another company to the company in which he served as a director; second, as an executive director and again without shareholder approval, he entered into a contract with a sole proprietorship under his control. The first is a direct breach of the duties, while the second is an indirect breach of the director's duty of loyalty. The court interpreted the fairness standard in article 21 as requiring both a procedural and a substantial fairness standard. The procedural fairness standard means that connected transactions must be duly disclosed and approved by shareholders in accordance with law and the company's articles of association.[1060] The substantial fairness standard asks whether the company's income is equal to the consideration paid by the company, and if the company is willing to trade with a third party on the same terms.[1061] Furthermore, the court found that the defendant director or senior officer bears the burden of proof, and if they fail to prove the fairness of an interested transaction, the transaction would fail the fairness standard review.

5.2.6.3 Shanghai Courts

In terms of the relationship between articles 149(4) and 21, Shanghai courts apply article 149(4) where the fiduciary deals with the company directly, or indirectly through connected individuals.[1062] They apply article 21 to the situation where the company deals with an entity of which the fiduciary is a shareholder. In the case of *Shanghai Yuanyang Metal Products Company v Shanghai Jiqi Metal Products Company & Zhang*,[1063] the company in which the defendant served as a senior officer had for many years purchased steel from two companies

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[1059] *Bingjiang Han v Cunzhao Sun* Beijing Intermediate Court, 2020, No 7060.
[1060] ibid.
[1061] ibid.
[1062] In earlier cases Shanghai courts also applied art149(8) as a basis for finding interested transactions by virtue of connected persons as breaches of the duty of loyalty.
[1063] *Shanghai Yuanyang Metal Products Company v Shanghai Jiqi Metal Products Company & Zhang* Shanghai High Court, 2020, No 249. See also *Puxu Vacuum Equipment International Trade (Shanghai) Company v Hui Chen* Shanghai Intermediate Court, 2020, No 4296.

controlled by the defendant's wife and his wife's sister respectively. The court held that the failure of the defendant fully to inform the company of the interested nature of those transactions rendered his conduct self-dealing prohibited by article 149(4) of the CCL2005.[1064] Finding the defendant senior officer's conduct a breach of the duty of loyalty, the court then conducted a fairness review of the interested transactions in order to grant remedies. However, because the plaintiff company failed to prove its damages resulting from the interested transactions the court dismissed the case.

It can thus be seen that in the application of article149(4) finding the fiduciary's self-dealing with the company, Shanghai courts adopt a substantive fairness review of the contracts rather than ordering the rescission of the contract. In fact, neither the CCL2005 nor courts in Shanghai adopt the strict self-dealing rule which renders self-dealing contract voidable at the option of the company. As discussed, the CCL2005 is unclear as to the voidability of self-dealing contracts which is a part of the self-dealing rule in UK's common law. In enforcing the self-dealing rule in article 149(4), Chinese courts commonly view self-dealing contracts as valid rather than voidable. For example, in the case of *Chengjia Liang v Aiguo Bao*[1065] where the shareholder sought invalidation of the interested transaction, the court refused to invalidate the transaction in order to ensure the stability of the company's business. This case reflects the common practice in China's courts. As a result, finding any breach of article 149(4), Chinese courts grant remedies of either accounting for profit based on article149 or monetary compensation based on article 150, but not rescission of the self-dealing contract. Therefore, the prohibition on self-dealing in article149(4) has been transformed into the remedial fairness standard in court enforcement. The company will succeed only where the fiduciary fails the remedial fairness review – ie, there is a profit to account for or damages to be compensated. Failing this, if the contract is fair the case will be dismissed.

In indirect interested transactions between the company and an entity in which the defendant director or senior officer holds shares, courts in Shanghai apply article 21 and adopt a fairness-review approach to interested transactions. In the case of *Yazhe Software v Ni Jianqi*[1066] the company entered into a contract with another company controlled by one of the former's senior officers. A shareholder of the company brought a derivative action based on article 149(4)

[1064] ibid.
[1065] *Chengjia Liang v Aiguo Bao* Shanghai Intermediate Court, 2015, No 1796.
[1066] *Yazhe Software v Ni Jianqi* Shanghai No 2 Intermediate Court, 2016, No 21.

claiming that the defendant had participated in self-dealing. The court explained that article 149(4) applies when a director or senior officer deals directly with the company and consequently gains some personal profit.[1067] According to the court, article 149(4) should not be interpreted broadly to include where the company deals with another company controlled by the defendant and the resulting profit does not accrue to the director or senior officer personally.[1068] The court therefore dismissed the case. Subsequently the same plaintiff shareholder brought a derivative suit in the court again claiming, this time based on article, that the defendant had taken advantage of his related relationship to harm the interests of the company.[1069] In the latter case the court confirmed that article 21 requires a fairness standard and reviewed the fairness of the contract based on a fair-price standard.[1070] Because the interested contract proved to be fair, the court ultimately dismissed the case.

5.3 The Enforcement of Corporate Fiduciary Duties by the CSRC

Notably, the empirical research has revealed that courts in China only hear those fiduciary duty cases related to privately held companies rather than public firms listed on a stock exchange.[1071] This section first explains the courts' dismissive attitude to private enforcement by shareholders of listed companies in China. The second then discusses the legislation as well as the enforcement of the duty of loyalty by the CSRC.

5.3.1 Courts' Attitudes to Shareholder Protection in Listed Companies

As the national regulatory body of public securities markets, the CSRC[1072] initiates China's public enforcement of corporate and securities law, whilst private enforcement is supposed to be carried out by market participants such as the shareholders of listed companies via litigation in Chinese courts.[1073] In terms of relevant legal consequences, public enforcement commonly

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1067 ibid.
1068 ibid.
1069 Yazhe Software v Ni Jianqi Shanghai No 2 Intermediate Court, 2016, No 7836.
1070 ibid.
1071 According to the empirical research, all fiduciary duty cases heard by courts in China are related to limited liability companies (LLCs) and foreign-invested enterprises (FIEs). See also Guangdong Xu *et al*, 'Directors' Duties in China' (2013) 14 European Business Organization Law Review 57.
1072 According to art 179 of the Securities Law, the CSRC performs the functions: formulating relevant rules and regulations; supervising and administrating relevant securities activities; and investigating into and punishing any violation of any law or administrative regulation on the supervision and administration of the securities market.
1073 See Robin Hui Huang, 'Enforcement of Chinese Insider Trading Law: An Empirical and Comparative Perspective' (2020) 68(3) American Journal of Comparative Law 517, 526.

triggers penalties imposed by the CSRC – ie, administrative liability, while private enforcement should lead to civil liabilities and remedies granted by courts.[1074] However, in practice, private litigation initiated by shareholders of listed companies is in principle not permitted in China. This is based on certain politically-sensitive considerations. For one, under the current political environment in China, a shareholder's class action is regarded as a serious challenge to social stability in that gathering a great number of aggrieved shareholders in an organised body clearly triggers anxiety and concern for government authorities.[1075] For another, considering the large number of SOEs among Chinese listed companies,[1076] the large-scale class lawsuits can subject state-owned listed companies to massive private securities litigation judgements.[1077] The strict restrictions on the number of private securities claims can effectively reduce such a politically dangerous exposure. Yet another reason is that if the people's courts are permitted to accept private litigation initiated by shareholders of listed companies, it is very likely to sharpen the conflict between individual investors and the state.[1078] Overall, based on the political economy of Chinese securities markets, permitting securities private litigation means that the government itself can be sued by shareholders – something which is unacceptable in Chinese political reality.[1079]

From an historical perspective, China's practice of private securities litigation started in 1998 and peaked between 2000-2002 where there was a sudden explosion of securities scandals in the public capital markets.[1080] The investors who had suffered serious losses filed private lawsuits against the listed companies. Against this background, during 2001-2003 the SPC issued three very significant circulars governing securities litigation which finally constituted a substantial barrier to private securities litigation in Chinese practice.[1081] In September 2001, the SPC issued the first circular titled 'Notice of the Supreme People's Court on Refusing to Accept Civil Compensation Cases Involving Securities for the Time Being'[1082] which clarified that the Chinese courts on all levels throughout the country would not accept civil

1074 ibid 526.
1075 Walter Hutchens, 'Private Securities Litigation in China: Material Disclosure about China's Legal System' (2003) 24 University of Pennsylvania Journal of International Economic Law 599, 645.
1076 The Chinese stock markets are still dominated by SOEs: the percentage of the listed firms which are controlled by the state or local governments was as high as 57.19 % in 2016. See Xinhong Wang and Zhuanjun Zhang, 'An Analysis one the Characteristics of the Listed Companies in China' (2019) 6 Commercial Accounting 29.
1077 Hutchens (n 1075) 644.
1078 ibid 645.
1079 ibid 638-639.
1080 Robin Hui Huang, 'Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment' (2013) 61 The American Journal of Comparative Law 757, 760.
1081 See Huang (n 1074); Xu *et al* (n 1075).
1082 No 406 [2001] of the Supreme People's Court (the First SPC Notice).

compensation claims from securities markets. The reason offered by the SPC was that legislative and judicial limitations at the time meant that the courts were not ready to hear such cases.[1083]

Once the First SPC Notice appeared, it was subjected to heated criticism. The SPC then issued its second circular, 'the Second SPC Notice', in January 2002.[1084] In terms of this notice civil claims arising from false disclosure and misrepresentation in the securities markets could be heard by the courts, but subject to the condition that an administrative penalty had been imposed for an alleged fraud.[1085] One year later in January 2003, the eagerly-awaited Third SPC circular on the securities private litigation arising from misrepresentation was issued. The circular contained 37 detailed provisions and established a relatively comprehensive legal foundation for civil litigation regarding the disputes in China's securities markets.[1086] Although the Second SPC Notice and the SPC Provisions removed the absolute ban on private securities litigation, private litigation in the courts has not yet played an important role in resolving disputes for companies listed on the Chinese stock markets.

However, there is a recent break-through case signalling a shift in the attitude of Chinese courts in protecting shareholders in China's listed companies. In the recent case of *Kangmei Pharmaceutical Co Ltd*,[1087] delivered in November 2021, a company listed on the SHSE published an audit report in December 2018 signed and approved by all the directors, including independent directors, which contained false statements. In April 2021, 52 037 investors filed a lawsuit against the company and directors at fault for compensation for the losses arising from their misconduct.[1088] The Guangzhou Intermediate People's Court held that the company should compensate the investors for their loss of 2.459 billion RMB resulting from its financial fraud.[1089] The actual controller of the company and other six persons directly responsible were ordered to bear joint and several liability, and the 13 directors and supervisors of the company to bear 20%, 10% and 5% of the liabilities respectively according to their degree of fault.[1090]

1083 ibid.
1084 Notice of the Supreme People's Court on the Relevant Issues concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market (2002) No 43 [2002] of the Supreme People's Court.
1085 ibid s 2.
1086 Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market (2003) No 2 [2003] of the Supreme People's Court (the SPC Provisions).
1087 *Huajun Gu and Others v Kangmei Pharmaceutical Co Ltd* Guangzhou Intermediate Court, 2020, No 2171. The judgment has not yet been published.
1088 ibid.
1089 ibid.
1090 ibid.

This case is essentially the first class action in the securities market in China since the implementation of the Securities Law, and also the civil compensation case of false statement with the largest number of participants and the highest compensation amount in the history of A-share market in China.[1091] However, as the case is still subject to appeal in the higher-level court, the judgment has not yet come into effect.

5.3.2 Legislation and Enforcement of Fiduciary Duties by the CSRC

Given the courts' attitude to private enforcement of corporate and securities law in listed companies, the enforcement of fiduciary duties of the senior management of listed companies is confined to public enforcement by the CSRC. On the one hand, in addition to and in accordance with the CCL2005, the CSRC have issued administrative regulations setting out directors, supervisors, and senior officers' duty of loyalty. For example, the CSRC 'Guidelines on the Articles of Association of Listed Companies' provide a law of the duty of loyalty identical to that in the CCL2005 to govern directors and senior officers in listed companies. Its article 97 provides the duty of loyalty, the proscriptive fiduciary rules, and relevant remedies identical to those in articles 148, 149 and 150.[1092] In addition, listed companies may include in their AOAs requirements additional to the mandatory duties and rules. Similarly, article 8 of the 'Measures for the Administration of the Takeover of Listed Companies' promulgated by the CSRC also provide that directors, supervisors, and senior officers of the acquired company owe the duty of loyalty to the company.[1093]

On the other hand, the CSRC in fact provides no corresponding enforcement of the duty of loyalty. Essentially, the CSRC imposes administrative penalties on directors and senior officers of listed companies based on securities law rather than on company law.[1094] In relevant administrative punishment decisions, the CSRC generally simply states that a director of a listed company should perform his or her duties with loyalty.[1095] However, the CSRC does not apply the duty of loyalty directly as basis for those administrative punishment decisions. Instead, the CSRC bases those punishment decisions primarily on the securities law holding

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[1091] Mingyong Ding, 'Kangmei Pharmaceutical Lost the Lawsuit! The First Class Action in China' < https://m.yicai.com/news/101228505.html > accessed 12 December 2021. China A-shares are the stock shares of mainland China-based companies that trade on the two Chinese stock exchanges, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE).

[1092] CSRC Guidelines on the Articles of Association of Listed Companies (2019) art 97.

[1093] Measures for the Administration of the Takeover of Listed Companies (2020 Rev) art 8.

[1094] Xu *et al* (n 1072) 80.

[1095] ibid.

directors and senior officers accountable for insider dealing, false statement, market manipulation, short-term trading, illegal takeover, and so on. Chinese securities law, however, is silent on the duty of loyalty of directors and senior officers.[1096] The law of fiduciary duties, therefore, cannot be readily applied in the CSRC's enforcement against directors and senior officers in listed companies. Nevertheless, given the fact that courts in China are ready to make a shift in their attitude to the private enforcement by shareholders of listed companies, courts, rather than the CSRC, should take on the task of enforcing fiduciary duties in listed companies.

Concluding Remarks

This chapter explores how the law of corporate fiduciary duties, as a product of legal transplantation, is legislated, interpreted, and applied by law reformers and enforcement agencies in China. In particular, special attention is paid to how the legislative, judicial, and administrative institutions in China rise to the challenges brought by the fact that the concept and law of fiduciary duties are closely related to the common-law system and tradition.

The chapter first examines how fiduciary duties are legislated in CCL2005 as a product of legal transplantation and local adaptation. The legislation in CCL2005 clearly shows the borrowing of fiduciary duties from both the UK and US corporate laws. CCL2005 adopts a US-style status-based approach providing directors, supervisors, and senior officers as corporate fiduciaries. CCL2005 has introduced a general duty of loyalty together with proscriptive rules governing common conflicting situations – the common law-style fiduciary duties. CCL2005 has borrowed from UK company law the self-dealing rule whose operation can be contracted out by companies' articles of associations. CCL2005 also appears to have borrowed from UK company law the no-profit approach to corporate opportunities prohibiting the exploitation of corporate opportunities through taking advantages of the fiduciary position.

This chapter then, based on empirical research, explores how fiduciary duties are enforced in China. The empirical research reveals that Chinese courts take initiative to interpret and apply legislated fiduciary duties in CCL2005 in a similar manner as common-law courts do. In this regard, courts in China clearly have adapted institutionally to their civil-law tradition and habits of interpreting and applying law in a restricted manner. Most significantly, in the law

[1096] The Law on Securities of the People's Republic of China (2019 Rev).

enforcement Chinese courts have innovatively addressed those problems caused by the uncertainty of CCL2005 provisions.

Chapter 6: Assessment of The Legal Transplant Case Study

To evaluate China's transplantation of fiduciary duties into its company law, Chapter 1 lays out an analytical framework of the conditions for the process to be effective as well as criteria for reviewing its efficacy. Based on this theoretical framework, this chapter provides a detailed analysis in a view to answering of the central questions of this research.

6.1 Assessment of the Effectiveness of the Legal Transplant Case Study

This part discusses to what extent the transplantation of fiduciary duties in Chinese company law has been effective.

6.1.1 Assessment in the Convergence Dimension

As discussed in Chapter 1, in the convergence dimension, the criterion for success is that the transplanted rule in China should be in line with the conceptual core of the original rule in the source common-law system.[1097] This requires that the fiduciary duties in Chinese company law[1098] must be in line with the conceptual core of those in common-law corporate law.

In common-law systems, despite controversy over the nature and contents of fiduciary duty concept, it is widely agreed that the duty of loyalty is the distinguishing and defining obligation of a fiduciary which requires his or her undivided loyalty.[1099] Chinese company law incorporates a general duty of loyalty which is in line with the conceptual core of the duty of loyalty in UK and US corporate law. Both the UK and US corporate law provide that corporate fiduciaries owe a duty of loyalty to their company.[1100] This is reflected in Chinese company law in the CCL2005 which imposes an overarching, open-ended, and situation-specific duty of loyalty together with relevant remedies available for its breach – eg, the accounting for profit.[1101] The SPC interprets the duty of loyalty in the CCL2005 as requiring directors,

[1097] See 1.2.3.1.
[1098] For the purpose of assessing the effectiveness of China's transplantation of corporate fiduciary duties, 'Chinese company law' refers to both the law in the CCL2005 as well as relevant interpretations of the CCL2005 provisions by China's courts in law enforcement based on the empirical research conducted in Chapter 5.
[1099] See 2.2 and 2.3.
[1100] See 3.3 and 4.3.2.
[1101] See 5.1.2.

supervisors, and senior officers to show undivided loyalty to the company.[1102] Further, the duty of loyalty in common-law systems is, in the main, reflected in and operates through the no-conflict and no-profit principles.[1103] Chinese company law, too, has incorporated the no-conflict principle and the no-profit principle. CCL2005 implies the inclusion of the no-profit principle as a manifestation of the duty of loyalty.[1104] The SPC defines the duty of loyalty in the CCL2005 in a manner which clear points to the no-conflict principle.[1105]

Moreover, Chinese company law incorporates standards and rules as regards common conflict situations which are by and large in line with the conceptual core of those standards and rules in the UK and US corporate law. In common-law systems, corporate laws provide specific standards and rules with regard to common situations where the duty of loyalty may be breached, such as interested transactions, exploitation of corporate opportunities, property, and information.[1106] Chinese company law includes rules specifically governing these common conflict situations which are equivalent to their common-law counterparts. First, with regard to the misappropriation of corporate property, Chinese company law in effect provides a rule prohibiting any misappropriation of corporate property which accords with the rule in the UK and US corporate law. Although the CCL2005 prohibits various forms of misappropriation of corporate property by fiduciaries, in the absence of a general rule of prohibition, Chinese courts interpret the general duty of loyalty to include any other situation outside of the CCL2005 provision.[1107] As a result, Chinese law and enforcement in effect require an express and overall prohibition on the misappropriation of corporate property.

Second, with regard to the regulation of interested transactions, UK and US corporate law both permit fiduciaries' dealings with the company subject to *ex ante* disclosure or approval by corporate bodies or/and *ex post* judicial review.[1108] The CCL2005 provides – albeit in somewhat ambiguous terms – both a rule of prohibiting self-dealing and a rule of fairness for connected transactions.[1109] Although courts in different areas of China adopt somewhat divergent approaches to interested transactions as they interpret and apply the CCL2005 provisions differently, they in effect all permit interested transactions subject to a judicial

1102 See 5.2.3.
1103 See 2.3.1, 3.2.1, 3.2.2, and 4.3.2.
1104 See 5.1.2.
1105 See 5.2.3.
1106 See 3.3.
1107 See 5.1.3 and 5.2.4.
1108 See 3.3.4 and 4.3.2.1.
1109 See 5.1.5.

fairness review.[1110] Third, as an example of common-law systems both UK and US corporate law prohibit the exploitation of corporate opportunities, although they approach the identification of a corporate opportunity differently.[1111] The CCL2005 provides both a corporate opportunity doctrine and a non-compete rule which conceptually aims to address the same legal problems.[1112] While courts in different areas of China still have different approaches to the combined application of the corporate opportunity doctrine and the non-compete rule, they essentially apply a no-profit approach in identifying a corporate opportunity together with a non-compete rule preventing the acquisition, even if it does not involve taking advantage of a management position, of opportunities that fall within the scope of the company's line of business.[1113]

Chinese company law therefore provides fiduciary duties largely in line with the conceptual core of fiduciary duties in common-law corporate law, such as that in UK and US company law.

6.1.2 Assessment in the Operative Dimension

In the operative dimension, as discussed in Chapter 1, the criteria for effective transplantation involve the frequency and the nature of use of the transplanted rule in the recipient system.[1114] The basic requirement is that the transplanted rule should be in use in the recipient country, though the frequent use required is measured as a matter of degree rather than quantitively. In essence, unless the transplanted rule is not used at all or only very rarely in legal enforcement and practice, the standard will have been met.[1115] Further, as regards how the rule is used the standard of effectiveness requires the transplanted rule to be used either in a manner identical or reasonably similar to its use in the source system, or it is used in a manner that fits well into the recipient system itself.[1116] Accordingly, the effectiveness of China's transplantation should be assessed in this operative dimension by whether the law of corporate fiduciary duties is in frequent use in Chinese practice as well as whether the law is used in China in a manner

1110 See 5.2.6.
1111 See 3.3.4 and 4.3.2.2.
1112 See 5.1.4.
1113 See 5.2.5.
1114 See 1.2.3.2.
1115 See 1.2.3.
1116 ibid.

identical or reasonably similar to its use in common-law systems, or is used in a manner that fits well into the Chinese legal system.

In law enforcement and practice, courts in China clearly apply the law of corporate fiduciary duties on a relatively frequent basis in deciding cases involving alleged breaches of fiduciary duties by directors, supervisors, and senior officers. From the empirical research it emerges that courts are faced with cases on all common conflicting situations.[1117] Notably, cases involving the misappropriation of corporate property have dominated the number of fiduciary duty cases which represent more than half of the cases.[1118] This means that the current breach of fiduciary duties by directors, supervisors, and senior officers in China's companies primarily take the form of misappropriating the property of the company. This is inevitably the case because the exploitation of corporate property for personal benefit tends to be more practically possible than in other conflicting situations. Besides, during the period shortly after the initial transplantation of fiduciary duties in the CCL2005, directors, supervisors, and senior officers in China's companies have not become sufficiently aware of the prohibition of this form of clear fiduciary breach. On the other hand, cases involving a fiduciary dealing with the company or exploiting a corporate opportunity are sufficiently common to reveal that courts in China apply the law of corporate fiduciary duties on a relatively frequent basis.[1119] In particular, there has been a surge in fiduciary duty cases in Chinese courts between 2016-2020.[1120]

As regards how the law is used in China for law enforcement, courts indeed apply the law of corporate fiduciary duties in a manner reasonably similar to its use in common-law systems. Common-law courts apply the fiduciary doctrine in a situation-specific and open-ended manner in the corporate law context either identifying someone as a fiduciary using a fact-based approach, or affirming a fiduciary's conduct outside the scope of common conflicting situations as a breach of fiduciary duty.[1121] Some courts in China adopt both a fact-based approach in identifying an individual as a corporate fiduciary where the defendant's *prima facie* position in the company does not fall within the scope provided in the CCL2005.[1122] Furthermore, some courts in China indeed apply the duty of loyalty confirming that a supervisor's duty of loyalty

1117 See 5.2.1.
1118 ibid.
1119 ibid.
1120 ibid.
1121 See 3.2.1, 3.3.1, and 4.3.2.
1122 See 5.2.2.

is essentially the same as that of directors and senior officers.[1123] Moreover, some courts in China also apply the duty of loyalty on a general basis capturing fiduciary breaches when specific provisions in the CCL2005 appear not to apply.[1124] Specifically, courts in China conduct fairness reviews of interested transactions in a similar manner to common-law courts. For example, Shanghai courts conduct a fairness review of interested transactions to determine the profits made by the defendant director or senior officer in order to grant remedies.[1125] This resembles the remedial fairness review of interested transactions adopted by New Jersey courts during the early twentieth century.[1126] Similarly, Beijing courts conduct a fairness review of interested transactions based on both procedural and substantial fairness in a way similar to that used in Delaware courts in reviewing interested transactions in terms of both fair dealing and fair price.[1127]

It can consequently be seen that the law of corporate fiduciary duties is in relatively frequent use in Chinese practice and in a manner reasonably similar to its use in common-law systems.

6.1.3 Assessment in the Instrumental Dimension

In the instrumental dimension, as discussed in Chapter 1, the efficacy of China's adoption of a transplanted common-law concept is evaluated by assessing whether the transplanted rule is achieving its legal purposes in the Chinese system.[1128] Accordingly, in this dimension the efficacy of China's transplantation should be assessed on whether the law of corporate fiduciary duties is achieving its legal function in China.

In common-law systems the concept of fiduciary duty serves some unique functions for the benefit of society as a whole.[1129] For example, it maintains the integrity and utility of some socially and economically important relationships, including but not limited to, the relationship between a director and the company. Particularly, in the corporate context, the law of fiduciary duties serves to address agency problem and reduce agency costs ensuring the due performance of fiduciaries' duties as regards the management of corporate affairs.[1130] Overall, the

[1123] See 5.2.3.
[1124] See 5.2.4.
[1125] See 5.2.6.
[1126] See 4.1.1.
[1127] See 4.3.2.1 and 5.2.6.
[1128] See 1.2.3.
[1129] See 2.1.1.
[1130] See 2.1.2 and 2.1.3.

transplanted law of corporate fiduciary duties is functioning in China in a manner similar to that in common-law countries. In practice, courts in China apply the general duty of loyalty as well as fiduciary standards and rules on a regular basis to hold directors, supervisors, and senior officers in non-listed companies liable for accounting for profits, monetary compensation, or even invalidation of contracts when they involve those common conflicting situations or any behaviour in violation of their undivided loyalty to the company.[1131] This is exactly how the law of corporate fiduciary duties is functioning in common-law systems.

Moreover, the law and enforcement of corporate fiduciary duties in China is capable of providing deterrence to fiduciaries' potentially disloyal behaviour. First, with a rule of prohibition together with the remedy of accounting for profits, the law and enforcement in China clearly deters directors, supervisors, and senior officers from misappropriating corporate property.[1132] Second, Chinese law and enforcement adopt an *ex post* fairness-standard review of interested transactions, using either both substantial and procedural fairness standards or a substantial fairness standard only.[1133] This resembles the Delaware pattern of interested transaction regulation,[1134] while, unlike Delaware law, China's regulation of interested transactions gives no safe harbour effect to either board approval or shareholder approval. With a fairness standard together with relevant remedies, Chinese law and enforcement not only deters potentially unfair interested transactions, but also protects fair transactions which benefit both the company and directors, supervisors, and senior officers.

Third, Chinese law and enforcement adopt a no-profit principle together with a non-compete rule capturing potential exploitation of corporate opportunities.[1135] This resembles the UK model of the corporate opportunity doctrine[1136] in the no-profit context, and the Delaware model[1137] in that the non-compete rule essentially requires an opportunity that belongs to the company to fall within the company's line of business. The scope of corporate opportunities in Chinese law is not as broad as in UK company law but is also not as limited in scope as under Delaware corporate law. In this way the Chinese law of corporate opportunity deters directors, supervisors, and senior officers from exploiting any business opportunity of the company while

1131 See 5.3.
1132 See 5.1.3 and 5.2.4.
1133 See 5.1.5 and 5.2.6.
1134 See 4.3.2.1.
1135 See 5.1.4 and 5.2.5.
1136 See 3.3.3
1137 See 4.3.2.2.

ensuring them fairness in allowing them to take advantage of opportunities that do not fall to the company. It can thus be seen that the law of corporate fiduciary duties functions in the Chinese legal system in a manner capable of achieving its designated legal functions in the original common-law systems.

On the other hand, there is virtually no private enforcement of the fiduciary duties of directors, supervisors, and senior officers in China's listed companies.[1138] Relevant agency problems in China's listed companies are subject to the securities law regime and the enforcement of securities laws by the CSRC.[1139] However, despite the social, economic, and political importance of listed companies in China, there are relatively few of these companies compared to the number of non-listed companies. According to the statistics published by the State Administration for Market Regulation (SAMR) and the SSE and the SZSE respectively, at the end of 2020 there were 43 314 000 registered companies in China[1140] of which 4 197 were listed on the SSE and SZSE.[1141] The listed companies represent less than 0.01% of the total number of registered companies in China. Moreover, there is a clear shift in the courts' attitude towards the private enforcement by shareholders of listed companies. Considering that relevant obstacles to private enforcement resulted from political considerations only, once the attitude of the courts changes, a rapid improvement can be expected. Nevertheless, it remains true that the law of corporate fiduciary duties is not achieving its designated legal functions as regards listed companies in China.

In sum, in the convergence dimension Chinese company law provides fiduciary duties largely in line with the conceptual core of fiduciary duties in common-law corporate law, such as that of the UK and US. In the operative dimension, the law of corporate fiduciary duties is in relatively frequent use in Chinese practice and is used in a manner reasonably similar to its use in common-law systems. In the instrumental dimension, the law of corporate fiduciary duties is achieving its designated legal function only as regards non-listed companies.

1138 See 5.3.1.
1139 See 5.3.2.
1140 The Number of Market Entities in China (2020), available at <https://www.samr.gov.cn/zhghs/tjsj/202106/t20210611_330716.html> accessed 11 December 2021.
1141 Annual Report of Securities Transactions at the SSE 2020, available at <http://www.sse.com.cn/market/stockdata/overview/yearly/> accessed 11 December 2021; Annual Report of Securities Transactions at the SZSE 2020 available at http://docs.static.szse.cn/www/market/periodical/year/W020210426383781777776.pdf accessed 11 December 2021.

On the other hand, considering that the empirical research was based on a designated scope of data, the above assessment is based on the enforcement of fiduciary duties with highest-level quality, not even average-level quality. This empirical research which intends to reflect the enforcement of corporate fiduciary duties in China's courts uses the data collected from courts in four areas of China which represent not only the most developed social economies, but also the highest level of judicial professionalism and expertise. In consequence, judgements by courts in these four areas are indicative of the highest standard of enforcement of corporate fiduciary duties in Chinese judicial practice. In contrast, law enforcement of corporate fiduciary duties in less developed areas in China can hardly match the practice in these four areas and thus may prove to be of lower quality. This means that if the empirical research based on data collected from courts nationwide, the effectiveness of China's transplantation of corporate fiduciary duties may be considerably less compelling. However, it is clearly impractical to conduct nationwide empirical research in this PhD project as the cases considered already total 456.[1142] This notwithstanding, it is fair to conclude that China's transplantation of corporate fiduciary duties is largely effective. As pointed out in Chapter 1, using the metaphor of botanical transplantation, the success of a transplant in effect means that the plant has taken root in foreign soil; but it need not necessarily thrive.[1143]

6.2 Explaining the Effectiveness of the Legal Transplant Case Study

In an effort to explain the relatively high level of effectiveness of China's transplantation of fiduciary duties from common-law corporate law as discussed in the previous section, this section analyses the transplantation case study based on relevant conditions for effective legal transplantation as identified in Chapter 1.

6.2.1 Transferability of Common-Law Corporate Fiduciary Duties to China

As discussed in Chapter 1, an important condition for effective legal transplantation is the transferability of a legal rule: the higher the transferability, the more effective the transplantation tends to be.[1144] What determines the transferability of a legal rule, also addressed in Chapter 1, is how closely the rule is linked to its peculiar context in the source

1142 See 5.2.1.
1143 See 1.2.3.
1144 See 1.2.2.1.

system.[1145] In the case of corporate fiduciary duties, their transferability to the Chinese legal system depends on how closely they are linked to some peculiar context in common-law systems which is absent in China. Clearly, corporate fiduciary duties are closely linked to and highly reliant on the equity and case-law traditions in their original common-law systems[1146] which do not feature in China's civil-law tradition.

The equity jurisdiction in common-law systems serves as the philosophical and institutional foundation for the law of fiduciary duties. The fiduciary doctrine is one of the equitable doctrines originating in equity jurisdiction and is therefore situation-specific, flexible, and open-ended in accordance with its equity origins.[1147] Equity jurisdiction provides the fiduciary doctrine with flexible remedies including the accounting for profits, proprietary constructive trust, rescission of resultant transactions, equitable compensation, and injunction.[1148] However, in the Chinese legal system equity jurisdiction or even anything similar is totally foreign. Similarly, the case law tradition of the common-law systems has carved out a set of standards and rules in corporate law based on equitable fiduciary principles. The contents and contour of current corporate fiduciary duties in both the UK and the US are products of more than 200 years' developments in case law.[1149] In this long history, courts in common-law systems have laid out a law of fiduciary duties which is inherently difficult to circumscribe. The understanding and application of current law of corporate fiduciary duties are, therefore, heavily reliant on the entire body of case law in common-law systems. However, the Chinese legal system, as a rule, follows the continental European model as well as the civil-law tradition.

It thus can be seen that the transferability of fiduciary duties from common-law corporate law to Chinese company law is relatively low. Consequently, scholars often argue that the transplantation of fiduciary duties from common-law to civil-law systems such as China is extremely difficult.[1150] Indeed, examining the transferability of fiduciary duties can reveal relevant challenges posed to China's law reformers and enforcers by the proposed transplantation. First, the situation-specific, flexible, and open-ended features of fiduciary duties make codification extremely difficult, which in turn challenges Chinese law reformers' ability to transplant the law of fiduciary duties through legislation. As a civil-law system, the

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1145 ibid.
1146 See 2.4, 3.1 and 4.1.
1147 See 2.4.1.
1148 See 2.4.3.
1149 See 3.2 and 4.1.
1150 See, eg, Pistor and Xu (n 264); Xu *et al* (n 1072); Howson (n 152).

primary source of law in China is legislation. China's initial transplantation of fiduciary duties also takes the form of legislative incorporation in the CCL2005. The long debate as well as many years of hesitation by the Law Commissions in the UK when the law of directors' general duties including fiduciary duties was codified in the CA2006, clearly show the difficulty facing legislators in China.[1151] Similarly, because the law of corporate fiduciary duties is embedded in a large body of case law developed over two hundred year in common-law jurisdictions, it is obviously challenging, if not impossible, for legislators in China to incorporate this in a couple of legislative articles.

Second, in contrast to courts in common-law systems which are not only capable of applying principle-based law but also familiar with equity tradition and techniques, Chinese courts and judges which have neither an equity nor a case law tradition, may be neither capable of nor comfortable with working with situation-specific and open-ended standards.[1152] The law of fiduciary duties thus challenges the ability of the courts to overcome their predisposition to apply specific legislative provisions in preference to more general principles or standards.[1153] Moreover, in the absence of the large body of local case law, Chinese courts may have no basis for interpreting and applying relevant legislative provisions as regards the law of fiduciary duties. It is noteworthy that even courts in the UK are required to rely on precedent in the interpretation and application of directors' fiduciary duties codified in the CA2006. Third, the elusiveness as well as peculiarity of the fiduciary concept to people in civil-law jurisdictions make it very challenging for local citizens or even legal professionals in China properly to know and understand the law of fiduciary duties. Even in its original common-law systems, the concept of fiduciary duty is elusive and the nature and contents of the duty highly debated.[1154] The difficulty of equipping civil-law legislators, judges, lawyers, and other legal professionals with an adequate level of knowledge of the law of fiduciary duties goes without saying.

It thus can be seen that the context differentiation between common-law and civil-law systems makes the transferability of the law of corporate fiduciary duties relatively low, which poses serious challenges for both legislators and enforcers in China in their attempts to undertake an effective legal transplant.

[1151] See 3.1.3.
[1152] Lee (n 140).
[1153] Kanda and Milhaupt (n 95).
[1154] Pistor and Xu (n 264).

6.2.2 Transplant Adaptation by Law Reformers in China

Transplant adaptation, as the first stage in local adaptation, occurs when law reformers in the recipient country first transplant a legal rule from its source legal system by way of legislation. In response to the challenges identified in examining the transferability of a legal rule, law reformers' adaptability can first be manifested by their informed choice of the appropriate model for transferring the legal rule from multiple options in foreign legal systems.[1155] Another manifestation of law reformers' adaptability involves their sensible modification of the chosen model to meet local context and needs.[1156] Accordingly, at the initial transplantation of corporate fiduciary duties from common-law corporate law, China's law reformers' adaptability should be manifested by their informed choice of the appropriate model of law as well as sensible modification of the chosen model to meet local context and needs.

Intriguingly, the law reformers clearly legislated fiduciary duties in the CCL2005 on the basis of comparative research. When the draft of the CCL2005 was submitted for discussion and adoption, the NPC drafting committee made the following statements:

> We have done comparative studies and special investigations of foreign company laws and borrowed useful experiences from foreign company law legislations. We have also run an international seminar in Shanghai, inviting company law experts from the US, Germany, Japan, Korea, Hong Kong Special Administrative District and other countries to discuss special issues collectively.[1157]

Although this is a general statement as regards the legislation of the entire CCL2005, to borrow the law of fiduciary duties from common-law systems should inevitably be included in relevant comparative studies and backed up by expert discussion. Moreover, the legislation of fiduciary duties in articles 148 and 149 clearly shows that it is not borrowed directly and exclusively from either UK or US law, or any other single jurisdiction. Based on the comparative research, law reformers in China have conducted a useful initial transplantation of corporate fiduciary duties from common-law systems.

Most significantly, in the CCL2005 Chinese law reformers introduced a general duty of loyalty together with fiduciary standards and rules which govern common conflict situations in the

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1155 See 1.2.2.2.
1156 ibid.
1157 See Explanatory notes of the NPC drafting committee.

corporate setting already identified in common-law systems. Despite the open-ended and situation-specific features of the duty of loyalty, the fiduciary doctrine operated in the long historical development of common-law corporate laws to identify situations of interested transactions, exploitation of corporate opportunity, property, and information as common breaches of the duty of loyalty.[1158] In modern times, even in common-law systems, judgments that go beyond these common conflicting situations are rare. Moreover, the operation of the fiduciary doctrine also introduced context-specific standards and rules for those common situations in corporate law which have subsequently developed to be current versions of the law in the corporate law of, for example, the UK and US.[1159] Law reformers in China have in this way introduced to the CCL2005 fiduciary standards and rules as regards almost all of these common conflict situations.[1160] This not only provides specificity and guidance for court enforcement as to how to decide cases when faced with relevant conflict situations, but also confines the direct application of the general duty of loyalty by China's courts to a minimum. Furthermore, the CCL2005 has also transplanted the general duty of loyalty together with corresponding remedies, which in effect has introduced the common-law fiduciary doctrine in China's corporate law.[1161] This also makes it possible for courts in China to apply the duty of loyalty both on a general basis and in a situation-specific and open-ended manner.

On the other hand, law reformers in China have hardly made an informed choice as to the appropriate model for the regulation of interested transactions. The CCL2005 appears to have borrowed the self-dealing rule from UK company law which served as a default rule of interested transaction regulation prior to 2006.[1162] In this regard, law reformers appear to be informed of neither the UK law of interested transactions nor relevant context in the UK. Fundamentally, the self-dealing rule drawn from the direct application of the no-conflict principle does not reflect the corporate-law context in commercial reality. The rule, therefore, quickly evolved in both the UK and the US to relax its element of strict prohibition subsequent to its introduction in corporate law.[1163] In UK company law, although the self-dealing rule long served as the default rule period, the strict prohibition on self-dealing transactions required by the rule has also long been relaxed though the regime of AOA authorisation in most UK

[1158] See 3.1 and 4.1.
[1159] ibid.
[1160] See 5.1.2.
[1161] ibid.
[1162] See 5.1.5.
[1163] See 3.1.2 and 4.1.1.

companies.[1164] The functioning of the AOA authorisation was based on the UK's legal tradition and practice as part of the local context: the contractual conception of companies and the common practice for companies to use their AOAs as a tool for shareholder agreement.[1165] The rule of prohibition together with the regime of AOA authorisation in effect permit interested transactions subject to some ex ante disclosure or/and board approval required in corporate AOAs.[1166] However, as China does not have such an AOA tradition, the poor functioning of the AOA authorisation regime has in effect resulted in a strict rule of prohibition in article 149(4) of the CCL2005.[1167] However, the strict rule of prohibition can hardly be viewed as a suitable rule for the regulation of interested transactions in the corporate law context.[1168]

Moreover, law reformers in China did not deal adequately with the relationship between the transplanted common-law fiduciary duties and other rules in the CCL2005 which were intended to address similar legal problems. When borrowing the common-law-style fiduciary duties in the CCL2005, Chinese law reformers inevitably retained some rules originating in civil-law corporate legislation. For example, in addition to the borrowed common-law-style corporate opportunity doctrine, the CCL2005 includes a non-compete rule which is a civil-law concept aimed at addressing similar legal problems.[1169] This actually may be part of the local adaptation made by law reformers at the stage of initial transplantation as the CCL2005 is characteristic of a mixed model of company law which incorporates elements of both civil-law and common-law corporate law.[1170] However, the incorporation of civil-law elements in the regime of common-law fiduciary duties results in considerable uncertainty and confusion in the structure of fiduciary duties, and also complicates subsequent enforcement adaptation by law enforcers in China. Judgments delivered by Chinese courts cannot be said to match the standard of common-law judgments which typically take the form of case-by-case argumentation with detailed justification.

[1164] See 3.1.2.
[1165] See Kershaw (n 382).
[1166] See 3.1.2.
[1167] See 5.1.5.
[1168] See Zohar Goshen, 'The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality' (2003) 91 California Law Review 393.
[1169] See 5.1.4
[1170] See, eg, Kaixiang Liu and Jing Liu, 'The Historical Cause of Chinese Shareholder Primacy - Taking the Reform of State-Owned Enterprises as A Clue' (2021) 6 Law Forum 51.

6.2.3 Enforcement Adaptation by Law Enforcers in China

Following the adoption of a legal rule in the recipient legal system, the next stage of local adaptation takes place through the enforcement of the rule. The effectiveness of enforcement adaptation in legal transplantation can also be attributed to the adaptability of local actors. As discussed in Chapter 1, local enforcers' ability to adapt could be indicated by their ability to improve the quality of the adopted rule as well as their ability to effect the necessary institutional adaptation of local law enforcement.

As part of the enforcement adaptation during the transplantation of common-law corporate fiduciary duties, courts in China clearly show their ability to advance the quality of law in their enforcement of fiduciary duties. First, when identifying an individual as a fiduciary, although the CCL2005 adopts a status-based approach, the Chinese courts adopt a fact-based approach which captures whomever in fact manages the affairs of the company as a fiduciary.[1171] Second, although the CCL2005 only prohibits various specific forms of misappropriation of corporate property by fiduciaries, courts in China apply the general duty of loyalty in effect establishing a general rule of prohibition.[1172] Third, as regards interested transaction regulation, the CCL2005 not only adopts a strict rule of prohibition in article 149(4), but also provides a rule of fairness in article 21 which potentially also deals with indirect interested transactions. Courts in China take the initiative in interpreting and applying articles 149(4) and 21 in a compatible manner in effect establishing a rule for reviewing the fairness of interested transactions.

Furthermore, as more fundamental adaptation, courts in China have effected institutional changes in their enforcement of fiduciary duties. As part of the civil-law tradition, Chinese courts and judges have no law-making power – their primary role in the Chinse legal system is to enforce laws and regulations in practice.[1173] When hearing a case, a Chinese judge will generally identify the applicable provisions in state laws, and then examine relevant administrative or departmental regulations, or even local regulations, for provisions that serve to interpret those state-law provisions. The judge then applies deductive legal reasoning as

[1171] See 5.2.2.
[1172] See 5.2.4.
[1173] Law on Judges of the People's Republic of China (2019 Rev) art 3.

typically followed by jurists in civil-law systems,[1174] to apply the legal rule derived from both the state-law provisions and relevant interpretations to the facts of the case at issue. However, in enforcing the law of corporate fiduciary duties, courts in China have undertaken institutional adaptation to how they traditionally approach cases. First, they take the initiative in going beyond the wording of the CCL2005 provisions when interpreting and applying the law of fiduciary duties. The SPC has taken the initiative in defining the duty of loyalty, the notion of undivided loyalty, and the no-conflict principle, despite the CCL2005 providing no definition of the duty.[1175] Furthermore, although the CCL2005 provides differing fiduciary rules applicable to supervisors and directors, and senior officers, respectively, the Chinese courts apply the duty of loyalty to confirm that supervisors' duty of loyalty is essentially the same as that of directors and senior officers.[1176]

Secondly, courts in China are flexible and situation-specific in their interpretation and enforcement of the law of fiduciary duties in the CCL2005. For example, the courts adopt a fact-based approach to corporate fiduciaries as discussed above. Further, courts in China apply the general duty of loyalty flexibly whenever the specific rules in article 149 appear not to be sufficiently applicable to the facts of the case before them.[1177] The law of interested transaction regulation and the corporate opportunity doctrine in the CCL2005 feature the co-existence of two sets of rules,[1178] which allows for courts to interpret and apply them innovatively. This notwithstanding, the professional approach adopted by Chinese courts has resulted in a chain of cases which function as a deterrent. Thirdly, courts in China are not only willing to interpret and apply the CCL2005 provisions flexibly, they also deliver relatively well-reasoned legal judgments in support of their flexible interpretation and application.[1179]

It thus can be seen that during the process of transplantation Chinese courts have made significant adaptations in their enforcement of the transplanted law of fiduciary duties in the CCL2005.

[1174] George Mousourakis, *Comparative Law and Legal Traditions: Historical and Contemporary Perspectives* (Springer 2019) 28.
[1175] See 5.2.3.
[1176] ibid.
[1177] See 5.2.
[1178] See 5.1.4 and 5.1.5.
[1179] See 5.2.

6.2.4 Legal Demand for the Law of Corporate Fiduciary Duties in China

As discussed in Chapter 1, closely related to the internalisation of a borrowed legal rule in the recipient legal system is the social demand for such a rule which also constitutes a critical condition for effective legal transplantation. The lack of local demand can be attributed to either the absence of actual need in society, or to the existence of local substitutes for the rule. In China's transplantation there is a clear need for the law of corporate fiduciary duties in Chinese society and there is no clear indication of the existence of local substitutes for the law.

In general, as a useful tool for addressing the agency problem and reducing agency costs, the law of fiduciary duties constitutes a critical part of modern corporate law and corporate governance worldwide. This means that as a general matter the law of fiduciary duties should be needed in any modern company law which provides for the separation of ownership and control.[1180] In particular, it is widely agreed that in China's corporate governance the agency problem between the corporate management and shareholders is pressing. Significantly, in Chinse SOEs the separation of state ownership from management in the course of SOE reform SOEs are faced with the problems of 'absent owner' and 'insider control'.[1181] This has resulted in an increasingly severe vertical agency problem in China. One main theme in SOE reform is the expansion of enterprise autonomy, a policy under which the government loosens the grip of state-ownership over management, which consequently has delegated independent decision-making power to the management of SOEs.[1182] On the other hand, in seeking the autonomous management of SOEs, the government has developed an effective system to supervise the senior executives of SOEs.

Specifically, the ability of the state as an owner to hold the management of SOEs accountable has been greatly weakened by the lack representatives accountable to the state. The state has only a conceptual existence and must of necessity act through government agencies – eg, the state-owned Assets Supervision and Administration Commission of the State Council ('SASAC') at central and local level, which is ultimately organised by officials.[1183] In such an

[1180] Howson (n 152).
[1181] Yuwa Wei, *Comparative Corporate Governance: A Chinese Perspective* (Kluwer Law International 2003) 95
[1182] John Farrar, 'Developing Corporate Governance in Greater China' (2002) 25(2) University of New South Wales Law Journal 466. Also see John Farrar, 'Developing Appreciate Corporate Governance in China' (2001) 22 Company Lawyer 92.
[1183] David C Donald, *A Financial Centre for Two Empires: Hong Kong's Corporate, Securities and Tax Laws in Its Transition from Britain to China* (CUP 2014) 49.

extended agency chain the monitoring responsibilities are largely bypassed. Although the SASAC at central and local level as well as the parent SOEs are supposed to represent the state in monitoring the senior executives of SOEs, it is the government officials who actually carry out the responsibilities of supervision. However, as agents who are supposed to represent the state, these officials are not in the best position to monitor senior managers of SOEs effectively. Few of the officials have either sufficient incentive or the necessary skills or information to fulfil their responsibilities.[1184] The officials appointed to supervise do not enjoy shareholders' residual rights or other interests directly linked to the performance of the SOEs.[1185] Further, due to the close relationship between the parent SOE and the listed subsidiary, it is common for directors or senior officers in the listed SOE also to hold positions in the parent SOE.[1186] Consequently, in the absence of proper checks and balances on the part of the de jure owners, the senior executives can have significant *de facto* control over the operation of the SOEs. The increasingly severe vertical agency problem in China generally and in SOEs in particular, clearly demands the law of fiduciary duties in China's company law.

Moreover, China has no clear local substitutes capable of replacing the law of corporate fiduciary duties or limiting its importance. In legal transplantation cases, local substitutes for a legal rule as solutions to legal issues are common in society. Fundamentally, the existence of local substitutes capable of rendering a specific legal rule entirely redundant, the borrowed legal rule may not actually be used or enforced in the recipient country.[1187] For example, in Japanese company law the existence of a local substitute for the law of fiduciary duties in Japanese society led to the non-use of the duty of loyalty on a general basis for almost 40 years post-transplantation.[1188] In China, there are no clear local substitutes capable of addressing agency problems sufficiently to make the law of corporate fiduciary duties completely unnecessary.

Further, there are other non-regulatory strategies which also serve to address agency problems in the corporate context and which may make the law of fiduciary duties less important. For

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1184 Wei (n 1185) 24.

1185 Donald Clarke, 'Corporate governance in China: An Overview' (2003) 14 China Economic Review 496, 500. The government officials neither bear any economic risk of a corporate collapse nor benefit from the profits made by the SOEs.

1186 Jin Qian Qiu, 'Corporate Governance in China: From the Protection of Minority Shareholders Perspective', (2006) 2 Corporate Governance Law Review 311, 316.

1187 See 1.2.2.4.

1188 See Kanda and Milhaupt (n 95).

example, despite the economically effective feature of the Delaware model of corporate fiduciary duties,[1189] some local context in Delaware clearly supports its effective functioning by providing forces of deterrence to corporate opportunism. First, the success of Delaware model clearly relies on the judicial professionalism of Delaware courts not only in enforcing fiduciary duties, but also as deterrence.[1190] Second, the active market for corporate control and the effective capital market in Delaware both provide forces of deterrence as regards fiduciary breaches by directors and senior officers in Delaware corporations.[1191] Third, the local business environment and social culture also support the Delaware model of corporate fiduciary duties which provides relatively less deterrence.[1192] For example, the entrepreneurs serving as management of the Fortune 500 and large listed companies, most of which are registered in Delaware, would prefer reputation over disloyal profits. By way of contrast, in China these mechanisms capable of providing deterrence to corporate opportunism, such as the market for corporate control, the efficient capital markets, the managerial labour market for corporate managers, creditor monitoring, and cultural norms of behaviour are not yet well-developed.[1193]

6.2.5 Knowledge of Corporate Fiduciary Duties by People in China

Effective legal transplantation demands knowledge of the borrowed legal rule among the people in the recipient country. This requisite knowledge may involve not only the rule itself, but also its underlying context in the source system.[1194] Furthermore, the extent of the knowledge required when transferring a legal rule differs for legal professionals and the ordinary 'locals' in the recipient country.[1195]

1189 See Goshen (n 1169).
1190 Bernard Black, 'Is Corporate Law Trivial? A Political and Economic Analysis' (1990) 84 Northwestern University Law Review 542, 589-590; Curtis Alva, 'Delaware and the Market for Corporate Charters: History and Agency' (1990) 15 Delaware Journal of Corporate Law 885, 918.
1191 See eg, Henry G Manne, 'Mergers and the Market for Corporate Control' (1965) 73 Journal of Political Economy 110; Bernard Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 UCLA Law Review 811.
1192 Lynn Stout, 'On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can A Transplant Take?' (2005) available at <https://escholarship.org/uc/item/553455cf> accessed 12 December 2021.
1193 See Donald Clarke, 'Law Without Order in Chinese Corporate Governance Institutions' (2010) 30 Northwestern Journal of International Law & Business 131.
1194 See 1.2.2.5.
1195 ibid.

Overall, legislators, judges, and lawyers indeed show an adequate level of knowledge of not only the law of corporate fiduciary duties, but also its context in the original common-law system. When law reformers initially legislated the law of fiduciary duties in the CCL2005, they clearly showed a proper degree of knowledge of the law and context as regards common-law fiduciary duties. First, law reformers correctly understand the duty of loyalty as a general duty of situation-specific and flexible application to situations where the self-interest of fiduciaries may possibly arise.[1196] Second, they are conversant with the relevant equitable remedies peculiar to breach of the duty of loyalty, most notably the accounting for profit.[1197] Third, law reformers are familiar with those situations where the duty of loyalty is commonly breached identified in common-law corporate law.[1198] Fourth, law reformers and legislators understand precisely the proscriptive nature of the duty of loyalty as shown by their provision of rules to address common conflicting situation clearly and proscriptively.[1199] Fifth, law reformers and legislators appear to be aware of the no-profit principle in relation to not only the general duty of loyalty, but also the corporate opportune doctrine.

Similarly, courts in China also are also well versed in the law and context of common-law fiduciary duties when required to interpret and apply relevant CCL2005 provisions in law enforcement. First, the SPC correctly understands the duty of loyalty as requiring corporate fiduciaries' undivided loyalty and prohibiting conflicts of interests.[1200] Second, judges understand precisely the duty of loyalty as a general duty to be applied flexibly and situation-specifically to situations where fiduciary standards and rules do not apply.[1201] Third, judges are also aware of open-ended nature of the fiduciary doctrine which enables them to identify those in *de facto* control of corporate management as a fiduciary.[1202] It may be impractical to assess the extent of awareness or knowledge about the law of fiduciary duties in the CCL2005 or even in its original common-law corporate laws by ordinary people in China. Still, the empirical research shows that both companies and corporate actors with a foreign background clearly have a good sense of directors' fiduciary duties, for example, FIEs. Moreover, there should not be much concern regarding lawyers' knowledge of corporate fiduciary duties. An increasing number of the lawyers employed in China's firms have received their legal

[1196] See 5.1.2.
[1197] ibid.
[1198] ibid.
[1199] ibid.
[1200] See 5.2.3.
[1201] See 5.2.3 and 5.2.4.
[1202] See 5.2.2.

education from UK and US law schools. Also, as lawyers are themselves fiduciaries to partners and clients, they should have an adequate idea of the no-conflict requirement.

On the other hand, it is inevitable that legislators and judges will, to some extent, be unfamiliar with some elements of the corporate fiduciary law in the common-law systems. Law reformers and legislators appear not to understand that in common-law corporate law, a single rule of interested transactions regulation applies equally to both direct self-dealing and indirect interested transactions.[1203] They also appear to have little understanding of the similarity and difference between the common-law corporate opportunity doctrine and the civil-law non-compete rule.[1204] For judges in China, even though they have succeeded in approaching the co-existence of two sets of rules as regards the exploitation of corporate opportunities actively and innovatively, they appear to be unfamiliar with the corporate opportunity doctrine as applied in UK or US corporate law.[1205] Judgments emanating from the Chinese courts show no evidence of the judges recognising either the no-profit principle as part of the UK corporate opportunity doctrine, or that the non-compete rule requires the line-of-business test as part of the Delaware corporate opportunity doctrine. Similarly, judges conduct their fairness review of interested transactions without insight into the approach followed by US judges.

Concluding Remarks

Based on the analytical framework laid out in Chapter 1, this chapter evaluates and explains the effectiveness of China's transplantation of fiduciary duties in its company law with a view to answering the central research question of this project.

The effectiveness of China's transplantation of fiduciary duties is evaluated in three dimensions: the convergence dimension, the operative dimension, and the instrumental dimension. In the convergence dimension, Chinese company law provides fiduciary duties largely in line with the conceptual core of fiduciary duties in common-law corporate law. In the operative dimension, the law of corporate fiduciary duties is in relatively frequent use in Chinese practice and in a manner reasonably similar to its use in common-law systems. In the instrumental dimension, the law of corporate fiduciary duties is achieving its designated legal functions as

[1203] See 5.1.5.
[1204] See 5.1.4.
[1205] See 5.2.5.

regards non-listed companies in China, while there is no private enforcement of fiduciary duties in listed companies. Therefore, China's transplantation of corporate fiduciary duties has been, to a large extent, effective.

The effectiveness of China's transplantation of fiduciary duties from common-law corporate law is explained based on relevant conditions for effective legal transplantation: the transferability of the legal rule from the original system to the recipient system, the transplant adaptation by law reformers, the enforcement adaptation by law enforcers, the legal demand for the rule, knowledge of the transferring legal rule by actors in the recipient country. The low transferability of the law resulting from the huge context differentiation cross legal systems is a most disadvantageous factor to China's effective transplantation of common-law fiduciary duties in its company law. On the other hand, other factors facilitate the effectiveness of the legal transplantation. Fundamentally, there exists social demand for the law of corporate fiduciary duties in China. Local institutions in China have managed to make positive adaptations in response to the challenges arising from the context differentiation.

Chapter 7: Conclusion

Based on the analytical framework drawn from legal transplant theories as laid out in Chapter 1, the in-depth analysis of the common-law fiduciary duty concept in Chapter 2 and fiduciary duties in UK and US corporate law in Chapters 3 and 4 respectively, and the empirical examination of how Chinese legislators and enforcers rise to challenges brought about by the cross-system legal transplantation in Chapter 5, Chapter 6 provides a detailed analysis with a view to answering the central research question of this project: to what extent the legal transplantation of common-law fiduciary duties into Chinese company law is effective and what explains the effectiveness or ineffectiveness of the transplantation?

This chapter first provides a summarised conclusion to the central research questions evaluating and explaining the effectiveness of the legal transplant cases study. Secondly, based on some core research findings of this project, this chapter concludes with some more generalised observations regarding legal transplant theories. Specifically, it responds to the questions of how likely it is for a common-law concept to be effectively transplanted to China, and whether a legal transplant from a civil-law source is more likely to be effective than one from a common-law source. The chapter also concludes the thesis with an analysis of relevant limitations of this research, possible reforms for China to achieve a better legal transplant, and the possible further research.

7.1 The Effectiveness of China's Transplantation of the Common-Law-Style Corporate Fiduciary Duties

Based on the analytical framework laid out in Chapter 1, the effectiveness of China's transplantation of fiduciary duties in its company law is evaluated in Chapter 6 in three dimensions: the convergence dimension, the operative dimension, and the instrumental dimension.

In the convergence dimension, the criterion for effective legal transplantation requires that the transplanted rule in China should be in line with the conceptual core of the original rule in the source common-law system. In line with UK and US corporate law, Chinese company law first incorporates an overarching, open-ended, and situation-specific duty of loyalty together with relevant remedies available for its breach. Second, the duty of loyalty in Chinese company law is, to some extent, reflected in and operates through the no-conflict and no-profit principles. Third, Chinese company law incorporates standards and rules as regards common conflict situations, such as interested transactions, exploitation of corporate opportunities, property, and information, which are by and large in line with the conceptual core of those standards and rules in the UK and US corporate law. Consequently, Chinese company law provides fiduciary duties largely in line with the conceptual core of fiduciary duties in common-law corporate law.

In the operative dimension, the effectiveness of China's transplantation should be assessed by whether the transplanted law is in frequent use in Chinese practice as well as whether the law is used in China in a manner identical or reasonably similar to its use in common-law systems or in a manner that fits well into the Chinese legal system. In law enforcement and practice, courts in China clearly apply the law of corporate fiduciary duties on a relatively frequent basis in deciding cases involving alleged breaches of fiduciary duties by directors, supervisors, and senior officers. Moreover, from the empirical research it emerges that courts are faced with cases on all common conflicting situations. As regards how the law is used in China for law enforcement, courts indeed apply the law of corporate fiduciary duties in a manner reasonably similar to its use in common-law systems. Some courts in China adopt a fact-based approach in identifying an individual as a corporate fiduciary where the defendant's *prima facie* position in the company does not fall within the scope provided in the CCL2005. Similarly, some courts in China confirm that a supervisor's duty of loyalty is essentially the same as that of directors and senior officers. Furthermore, some courts in China also apply the duty of loyalty on a general basis capturing fiduciary breaches when specific provisions in the CCL2005 appear not to apply. It thus can be seen that the law of corporate fiduciary duties is in relatively frequent use in Chinese practice and in a manner reasonably similar to its use in common-law systems.

In the instrumental dimension, the efficacy of China's adoption of a transplanted common-law concept is evaluated by assessing whether the transplanted rule is achieving its legal functions in the Chinese system. Overall, the transplanted law of corporate fiduciary duties is functioning in China in a manner similar to that in common- law countries. In practice, courts in China apply the general duty of loyalty as well as fiduciary standards and rules on a regular basis to hold directors, supervisors, and senior officers in non-listed companies liable for accounting for profits, monetary compensation, or even invalidation of contracts when they involve those common conflicting situations or any behaviour in violation of their undivided loyalty to the company. Moreover, the law and enforcement of corporate fiduciary duties in China is capable of providing deterrence to fiduciaries' potentially disloyal behaviour. For example, Chinese law and enforcement adopt an *ex post* fairness-standard review of interested transactions, using either both substantial and procedural fairness standards or a substantial fairness standard only. It not only deters potentially unfair interested transactions, but also protects fair transactions which benefit the company. Similarly, Chinese law of corporate opportunity deters directors, supervisors, and senior officers from exploiting any business opportunity of the company, while ensuring them fairness in allowing them to take advantage of opportunities that do not fall to the company.

On the one hand, there is virtually no private enforcement of the fiduciary duties of directors, supervisors, and senior officers in China's listed companies. Relevant agency problems in China's listed companies are subject to the securities law regime and the enforcement of securities laws by the CSRC. However, despite the social, economic, and political importance of listed companies in China, there are relatively few of these companies compared to the number of non-listed companies. More importantly, there is a clear shift in the courts' attitude towards the private enforcement by shareholders of listed companies. In light of the obstacles raised by political considerations, once the attitude of the courts changes a rapid improvement can be expected. Moreover, the problem is essentially not uniquely relevant to legal transplantation process, and it is a common problem for domestic law as well. Nevertheless, it remains true that the law of corporate fiduciary duties is not achieving its designated legal functions as regards listed companies in China.

It is therefore concluded that, to a large extent, China's transplantation of corporate fiduciary duties from common-law systems is effective.

7.2 Explaining the Effectiveness of China's Transplantation of the Common-Law-Style Corporate Fiduciary Duties

The relatively high level of effectiveness of China's transplantation of fiduciary duties from common-law corporate law is explained in Chapter 6 in terms of relevant conditions for effective legal transplantation as identified in Chapter 1: the transferability of the legal rule from the original system to the recipient system, the transplant adaptation by law reformers, the enforcement adaptation by law enforcers, the legal demand for the rule in the recipient society, knowledge of the transferring legal rule by actors in the recipient country.

First, in light of the huge context differentiation between common-law and civil-law systems, the transferability of corporate fiduciary duties from common-law systems to China tends to be low. As discussed in Chapter 1, the transferability of a legal rule depends on how closely the rule is linked to its peculiar context in the source system. The law of corporate fiduciary duties is closely linked to and highly reliant on the equity and case law traditions in the original common-law systems which do not feature in China's civil-law tradition. The low transferability of the law leads to great challenges posed to China's law reformers and enforcers by the proposed transplantation. Specifically, the situation-specific, flexible, and open-ended features of fiduciary duties make codification extremely difficult, which in turn challenges Chinese law reformers' ability to transplant the law of fiduciary duties through legislation. Similarly, the law of fiduciary duties challenges the ability of the courts in China to overcome their predisposition to apply specific legislative provisions in preference to more general principles or standards. Furthermore, the elusiveness as well as peculiarity of the fiduciary concept to people in civil-law jurisdictions make it a great challenge for local citizen or even legal professionals in China properly to understand the law. Consequently, the low transferability of the common-law fiduciary duties together with the resultant great challenges constitute the main disadvantage for China's transplantation to be effective.

Second, law reformers in China have conducted a useful initial transplantation of fiduciary duties from common-law systems in the CCL2005, even though the legislation of specific rules can hardly be satisfactory. Most significantly, law reformers in China have introduced to the CCL2005 fiduciary standards and rules which govern common conflict situations in the corporate setting already identified in common-law systems. This confines the direct application of the general duty of loyalty by China's courts to a minimum. The CCL2005 has also transplanted the general duty of loyalty together with corresponding remedies, which in effect has introduced the common-law fiduciary doctrine and makes it possible for courts in China to apply the duty of loyalty both on a general basis. On the other hand, to look at some fiduciary doctrines and rules more closely, they are not free from problems. For example, law reformers have hardly made an informed choice as to the appropriate model for the regulation of interested transactions. The CCL2005 appears to have borrowed the strict rule of prohibition from UK company law. In this regard, law reformers appear to be informed of neither the UK law of interested transactions nor relevant context in the UK. Moreover, law reformers in China did not deal adequately with the relationship between the transplanted common-law fiduciary duties and other rules retained in the CCL2005 originating in civil-law corporate legislation which were intend to address similar legal problems.

Third, courts in China have managed to make significant and effective adaptations in the enforcement of corporate fiduciary duties. In enforcing corporate fiduciary duties in the CCL2005, courts in China clearly show their ability to advance the quality of law. As discussed, the legislation of specific rules as regards interested transaction regulation and corporate opportunity doctrine in the CCL2005 can hardly be satisfactory. Given the fact, Chinese courts have managed to interpret relevant provisions in the CCL2005 in a proactive and innovative manner making some seemingly conflict rules compatible. Furthermore, as more fundamental adaptation, courts in China have effected institutional changes in their enforcement of corporate fiduciary duties. The best example illustrating this point is that although the CCL2005 provides differing fiduciary rules applicable to supervisors and directors, and senior officers, respectively, the Chinese courts apply the duty of loyalty to confirm that supervisors' duty of loyalty is essentially the same as that of directors and senior officers. Finally, courts in China are flexible and situation-specific in their interpretation and enforcement of the law of fiduciary duties in the CCL2005.

Fourth, there clearly exists legal demand for the law of corporate fiduciary duties in China, and there is no clear indication of local substitutes for the law. As discussed in Chapter 1, the social demand for a borrowed legal rule closely affects its effective internalisation in the recipient legal system, while the lack of actual need for the rule can be fatal to a legal transplant. In general, as a useful tool for addressing the agency problem and reducing agency costs, the law of fiduciary duties constitutes a critical part of modern corporate law and corporate governance worldwide. As a general matter, it thus should be included in any modern company law which provides for the separation of ownership and control, such as the CCL2005. In particular, it is widely agreed that in China's corporate governance the agency problem between the corporate management and shareholders is pressing. Particularly, in Chinese SOEs are faced with the problems of 'absent owner' and 'insider control' which have resulted in an increasingly severe vertical agency problem in China. Moreover, there is no clearly observed local substitutes in Chinese society which are capable of addressing agency problems sufficiently to replace the law of corporate fiduciary duties. Although some non-regulatory strategies also serve to provide deterrence to corporate opportunism, such as the active market for corporate control and the effective capital market, these mechanisms are not yet well-developed in China.

Fifth, legislators, judges and other legal professionals in China show a sufficiently high level of knowledge of the common-law corporate fiduciary duties. Generally speaking, legislators, judges, and lawyers indeed show an adequate level of knowledge of not only the law of corporate fiduciary duties, but also its context in the original common-law system. When law reformers initially legislated the law of fiduciary duties in the CCL2005, they clearly showed a proper degree of knowledge of the law and context as regards common-law fiduciary duties. Similarly, courts in China also are well versed in the law and context of common-law fiduciary duties when required to interpret and apply relevant CCL2005 provisions in law enforcement. Moreover, an increasing number of the lawyers employed in China's firms have received their legal education in UK and US law schools, thus there should not be much concern regarding lawyers' knowledge of corporate fiduciary duties. On the other hand, it is inevitable that legislators and judges will, to some extent, be unfamiliar with some elements of the corporate fiduciary law in the common-law systems. For example, Chinese judges appear to be unfamiliar with the corporate opportunity doctrine as applied in UK or US corporate law.

It thus can be seen that a most disadvantageous factor to China's effective transplantation of common-law fiduciary duties in its company law is the low transferability of the law resulting from the huge context differentiation across legal systems. On the other hand, there are some important factors facilitate the effectiveness of the legal transplantation. Fundamentally, there exists social demand for the law of corporate fiduciary duties in China, and relevant corporate actors have incentives to enforce the law in courts in China. Local institutions in China have managed to make positive adaptations in respond to the challenges brough about by the context differentiation. To summarise, with local legal demand as a pre-condition, the relatively high level of effectiveness of China's transplantation of common-law corporate fiduciary duties is primarily ascribed to the highly effective local adaptation by Chinese law reformers and enforcers.

7.3 Some Implications of the Case Study for Legal Transplant Theories

The case study of China's transplantation of common-law fiduciary duties in its company law has certain important implications for some generalised questions on legal transplant theories. It not only contributes to the legal transplant scholarship, but also has practical significance. The developing world and international development agencies can embark on legal transplantation equipped with a firm grasp of what is required of an effective legal transplant.

7.3.1 How Likely is it for a Common-law Concept to be Effectively Transplanted to China?

The legal transplant case study sheds some light on how likely it is for other common-law concept to be effectively transplanted into China. It may provide some guidance for China's legal transplant practice – whether China should better avoid transplanting a common-law concept as it is a doomed failure.

On the one hand, the transferability of a typical common-law concept from the original common-law countries to China is expected to be relatively low, and it brings about great challenges to local adaptation by law reformers and enforcers in China. The legal transplant case study shows that if a common-law concept relates closely to the legal tradition in common-law systems, its transferability to civil law systems, such as Chinese legal system, tends to be inherently low. The low transferability of the common-law concept consequently inevitably results in challenges for the legislative, judicial and administrative institutions in China. Specifically, it challenges Chinese legislators' ability to codify the concept embedded in a large body of case law; it challenges Chinese enforcers' ability to apply the concept in a similar manner as common-law courts; and it also challenges local people's familiarity with the concept.

On the other hand, the relatively low transferability of a common-law concept is not fundamentally determinative and does not necessarily mean that China' legal transplantation will inevitably be ineffective. The effectiveness of legal transplantation essentially depends on whether and to what extent local institutions in China manage to adapt in response to those challenges brough about by context differentiation between common-law and civil-law systems. The legal transplantation case study tells us that law reformers in China are capable of codifying, in a satisfactory or unsatisfactory manner, a common-law rule embedded in case law; and that Chinese courts can manage to make institutional adaptations applying a common-law concept in a flexible and situation-specific way; and that other legal professionals in China have the ability to equip themselves with knowledge of a common-law concept by means of domestic or foreign legal education or training, and so on. Although the extent to which local institutions in China manage to adapt may differ depending on the circumstances, overall the case study reveals that China's institutions are capable of undertaking a certain measure of adaptation.

However, it doesn't necessarily mean that it is highly likely for any common-law concept to be effectively transplanted to China. The legal demand for a certain common-law concept is an issue that requires case-by-case analysis. It is unrealistic to formulate a generalised observation regarding the local demand for a specific legal rule in China. Furthermore, it is worth noting that, although the legal transplant case study is characteristic of the context differentiation between common-law and civil-law systems, the transferability of another common-law rule may depend on context factors other than legal system and tradition.

Therefore, the common-law source of a legal rule does not constitute a substantial obstacle for relevant legal transplantation to be effective, though the likelihood of a particular common-law concept being effectively transplanted to China still warrants a case-by-case analysis.

7.3.2 Would China's Legal Transplantation from Civil-law Systems be More Likely to be Effective?

Despite that the common-law source of a legal rule doesn't constitute a substantial obstacle for legal transplantation to be effective, there is still the question whether legal transplantation from a civil-law source is more likely to be effective than that from a common-law source. Drawing on the legal transplant case study and taking China's transplantation of the German two-tier boardroom structure as an example, the efficacy of legal transplantation from civil-law systems can be analysed based on the theoretical framework laid out in Chapter 1.

First, the transferability of a legal rule from civil-law systems to China is not necessarily higher than that of a common-law rule. As discussed in Chapter 1 and mentioned above, the transferability of a legal rule depends on how closely the rule is linked to its peculiar context in the source system. In this regard, relevant context involves not only the legal system and tradition, but also social, economic, cultural, and political context factors. Although the legal contexts between one civil-law system and another are similar in major respects, there still exist other context factors that can be very different. If the transferring legal rule happens to relate closely to such context in the original civil-law country, its transferability to Chinese legal system could still be relatively low. For example, the transferability of the German boardroom structure to China depends on whether the law is closely related to and highly reliant on some peculiar social, economic, cultural, or political context in the German legal system which is absent in China. Particularly, if the law relates to some political context in Germany, the absence of similar political context in China is expected to hinder effective legal transplantation.

Second, local adaptation by law reformers and enforcers in China when transplanting a civil-law concept is not necessarily more effective. Indeed, the legal transplant case study tells us that local institutions' capability of adapting during the initial transplant or the subsequent enforcement, tends not to be a major concern. However, local adaptations could also be effected to avoid some substantial context obstacles rather than to address challenges resulting from context differentiation. This kind of unsatisfactory adaptations arising from insurmountable context obstacles could be fatal for the effectiveness of legal transplantation. For example, Chinese's law reformers may introduce the German boardroom structure into the CCL2005 without giving the supervisory board the equivalent level of supervisory power as German law does. In such cases, there may be major social and political obstacles for Chinese law to allow the board high-level supervisory power. This type of transplant adaptation can clearly be detrimental to the effectiveness of legal transplantation. In contrast, the unsatisfactory legislative technique itself is unlikely to be fatal to a legal transplant.

Third, since the local demand for a certain legal rule is essentially a case-by-case matter, the social demand for a civil-law rule in China is not necessarily higher or lower that for a common-law rule. However, the existence of actual legal demand for the rule together with the absence of local substitutes are essential for effective legal transplantation. In the case of transplanting the German boardroom structure to China, the local demand for the law in China warrants a careful analysis in terms of the actual legal demand and potential local substitutes. It is worth noting that although China transplanted the German boardroom structure in the CCL2005 this does not necessarily indicate the existence of local demand for the law. The lack of local demand often explains the ineffectiveness of a given legal transplant.

As can be seen, legal transplantation from a civil-law source is not necessarily likely to prove more effective than that from a common-law source. Each particular legal transplant case demands a detailed analysis. In the case of transplanting the German boardroom structure to China, the efficacy of the transplantation depends more on to what extent the rule is closely connected to some peculiar context in Germany and the actual local demand in China for this rule.

7.3.3 The Theoretical Framework as a Useful Tool for Analysing the Efficacy of Legal Transplant Cases

It is clear that the efficacy of a given legal transplant entails case-by-case analysis. The analytical framework laid out in Chapter 1 can serve as a useful tool for analysing the potential effectiveness of legal transplant cases. Although it is designed for the case study of China's transplantation of common-law fiduciary duties, the framework can also be used more generally. One case in point is that the transplantation of fiduciary duties from the UK to some US states ('the UK-to-US transplantation') by and large confirms the framework.

First, the UK-to-US transplantation confirms that context differentiation, major or minor, is inevitable in any legal transplantation. It also confirms that the transferability of a legal rule necessarily constitutes a condition for effective legal transplantation. When the UK-to-US transplantation initially took place during the nineteenth century, the local context in the UK and US could be expected to have been similar in many aspects. However, this does not mean that there was no context differentiation at all or the transferability of the law was not a factor influencing the transplantation. For example, New York courts borrowed the fair-dealing rule from English trust law to regulate interested transactions, but the strict self-dealing rule adopted in English company law did not transfer to New York. The underlying rationale is that US corporate law allowed directors to deal with the company in their personal capacity, while UK company law did not. It can be seen, even in cases where the context differentiation between the original and the recipient system is minor, context factors can still affect the transferability of a legal rule.

Second, the UK-to-US transplantation confirms that local adaptation is an important element in legal transplants. As discussed in Chapter 4, the early history of corporate fiduciary law in the US features not only legal transplantation from English corporate law and trust law, but also frequent cross-state legal borrowing. In both types of legal transplantation transplant adaptations without adaptation was rarely observed. In this regard, the early divergence of UK and US corporate fiduciary law results primarily from adaptation made in both types of legal transplantation. Third, the UK-to-US transplantation confirms that social demand for a certain legal rule can facilitate the occurrence and effectiveness of legal transplantation. For example, in nineteenth century some more economically advanced states in the US – New York and New Jersey, for example – took the lead in transplanting the law on interested transactions from the UK. In contrast, the transplantation of fiduciary principles from English equity establishing the early version of US corporate opportunity doctrine was more actively undertaken by those US states with ample mining resources.

Fourth, the UK-to-US transplantation confirms that absolutely accurate understanding and complete knowledge of a transferring rule by legal professionals in the recipient legal system is neither realistic nor necessary for legal transplantation to be effective. The UK-to-US transplantation showed that some US courts indeed failed to understand the UK law of fiduciary duties accurately or fully. For example, in the early development of the US corporate opportunity doctrine, US courts appeared to depart from the strict application of fiduciary principles without even being aware of doing so. And in such cases, US courts were still able to apply the law in an adaptive manner with proper reasoning or justification.

It thus can be seen that the UK-to-US transplantation confirms the legal transplant theoretical framework laid out in the thesis, and that the framework can be used for evaluating the efficacy of both existing and prospective legal transplantation not only from a foreign legal system to China, but also from one legal system to another.

7.4 Limitations of This Research

The limitations of this PhD research involve two aspects: the collection of data in the empirical research which reveals the legal enforcement of corporate fiduciary duties by Chinese courts; and the insufficient analysis of the broad social, economic, cultural, and political context in the legal transplant case study.

The empirical research in Chapter 5 is limited not only by the availability of court judgements, but also by the scope of court cases chosen from the plethora of available case law. The empirical research is based on court judgements reported in China's two most authoritative databases. However, these two databases do not reflect the totality of cases adjudicated by all levels of courts in China during the period from 2006 to 2020. In consequence, the empirical observations in this research are not exhaustive but are drawn from cases available on two leading databases only. Furthermore, in consideration of the still large number of cases heard by all levels of courts in China from 2006 to 2020 available on the two databases, the scope of the empirical research is further confined to cases adjudicated by the SPC, the HPC, and the IPC in four cities of Beijing, Shanghai, Guangzhou and Shenzhen. Considering the fact that courts in these most economically developed cities represent the highest level of China's judicial professionalism and expertise, the results of the empirical research also reflect the highest-standard of enforcement of corporate fiduciary duties in China's judicial practice. This means that empirical research based on data collected from courts national-wide are likely to reflect somewhat diluted results.

A further limitation of this research concerns the insufficiently engaged analysis of the broad social, economic, cultural, and political contexts that are not closely connected with legal transplant, legal system, or tradition. Because the legal transplant case study is characteristic of the contextual differentiation between common-law and civil-law systems, this research focuses in the main on factors within the legal context. There may still be other context factors influencing, in a more or less subtle sense, the legal transplant case study. For example, it could well be that the Confucian culture may impact on the personal relationship between investors and management and so dilute the local demand for fiduciary duties as a solution to agency problem in Chinese companies. Similarly, although this research shows that the judicial enforcement of directorate fiduciary duties is effective in China, the limited scope and length prescribed for any thesis precludes a detailed consideration of these aspects.

7.5 Suggestions for Reform

Although China's transplantation of common-law fiduciary duties proves to have been largely effective, local adaptation by law reformers and enforcers in China still requires reform and improvement in some respects. Two major problems restricting the effective enforcement of corporate fiduciary duties involve the problem of inconsistent application of law by Chinese courts, and the non-enforcing status of directorate fiduciary duties in China's listed companies.

A prominent problem closely related to the enforcement of corporate fiduciary duties in China is the non-enforcing status of the fiduciary duties of directors, supervisors, and senior officers in China's listed companies as discussed in Chapter 5. It is also mentioned in Chapter 5 that there appears to have been a potentially breakthrough judgement in November 2021. However, as this case is still before the courts, the eventual outcome may not live up to its promise as a signal decision regarding the non-justiciability of private enforcement by shareholders of listed companies in China. If this indeed happens it will leave little space for reform. In essence, the reason why the private litigation initiated by shareholders of listed companies is in principle not permitted in China rests on politically-sensitive considerations. For example, a shareholders' class action is regarded as a serious challenge to social stability. While it is not uncommon for political factors to present context obstacles in China's legal transplantation, they are also the most difficult to obstacle to challenge and overcome.

Another problem relevant to China's judicial enforcement of corporate fiduciary duties is the inconsistent application of laws and non-standardised exercise of discretion in the judicial practice of China's courts. Even though the problem is not directly related to the legal transplantation of corporate fiduciary duties, it has a negative impact not only on the effective enforcement of corporate fiduciary duties by the courts, but also the functioning of the duties within the Chinese legal system. The SPC has made great efforts to resolve the problem of judicial inconsistency. One case in point is the recently issued 'Implementation Measures of the Supreme People's Court for the Unified Application of Law' ('the SPC Implementation Measures') which came into effect on 1 December 2021. It intends to function as an institutional foundation for unifying the application of laws at the highest level of China's court system and so to ensure judicial fairness and improve judicial credibility. This notwithstanding, there is a road ahead in the quest for judicial consistency in China. In this regard the experience and practice in other civil-law countries, such as Germany, could be properly examined and emulated. Moreover, the SPC may properly use its judicial interpretation as well as the guiding case system to ensure conformity within the judicial system.

7.6 Issues for Further Research

This thesis has endeavoured to make an essential contribution to research on the enforcement of corporate fiduciary duties by Chinese courts. However, relevant research can go further in the following dimensions. First, the empirical research in Chapter 5 only covers cases adjudicated by the SPC, the HPC, and the IPC in four cities of Beijing, Shanghai, Guangzhou and Shenzhen in China. The legal enforcement of corporate fiduciary duties by courts in other provinces and cities in China thus requires further empirical research. This will establish whether courts in less economically developed regions in China have undertaken a similarly effective enforcement of the CCL2005 fiduciary duties. Furthermore, as the number of fiduciary duty cases heard by Chinese courts is increasing annually, the legal enforcement of corporate fiduciary duties in the following five to ten years also requires follow-up empirical research.

Second, as discussed in Chapter 5, there is virtually no private enforcement of the fiduciary duties of directors, supervisors, and senior officers in China's listed companies. However, the recent ground-breaking case highlighted in the previous section needs to be followed up. This judgment, if it survives the appeal process, may be regarded as a milestone in company-law enforcement in the China, and more cases involving private enforcement of fiduciary duties regarding Chinese listed companies can be expected. If courts in China gradually play a more active role in enforcing directors' fiduciary duties in listed companies, how would the regulatory power of the CSRC interact with the judicial jurisdiction of courts, and how can a balance be struck between courts and the CSRC in terms of solving the agency problem in China's listed companies? Further empirical research can shed light on the above questions.

Furthermore, it is well known that SOEs play an important role in the Chinese economy. However, this research does not distinguish specifically between the various forms of companies, and pays no special attention to directors' fiduciary duties in SOEs. The future research with regard to the enforcement of directors' fiduciary duties of SOEs may involve the following issues: whether the ownership structure of SOEs will make the agency problem in SOEs different from that in non-state companies? Whether and to what extent the lack of private owners in SOEs will be a barrier to enforcing directors' fiduciary duties? And, whether and to what extent the sensitive political status of SOEs will dilute the application of fiduciary duties in SOEs and result in some form of alternative resolution or local substitute for fiduciary duties in practice?

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