China's Company Law: Practicing Capitalism in a Transnational Economy

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CHINA'S COMPANY LAW: PRACTICING CAPITALISM IN A TRANSITIONAL ECONOMY

Anna M. Han

Abstract: As China embarks on the road to transform itself from a planned economy to one in which market forces play an increasingly important part, the corporation will play a critical role in this transformation. By outlining past and existing economic policies, this article explores how these newly sanctioned corporations will operate in China's changing economy and points out some of the difficulties which the Chinese will encounter. The article also recommends some steps necessary for the Chinese economy to fully enjoy the benefits of efficiently operated corporations.

"Wandering between two worlds, one dead, the other powerless to be born . . . ."

from Matthew Arnold's Grand Chartreuse

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I. INTRODUCTION

As early as 1978, the People's Republic of China ("China") recognized the inevitable death of the communist world and proceeded to design an economic system to suit its unique characteristics and ensure its political survival. After years of isolation, China's desire to rejoin the international market place and modernize prompted one of the boldest economic experiments of our time. After the December 1978 meeting of the Third Plenary Session of the Eleventh Central Committee of the Chinese Communist Party, China embarked upon a course to convert its planned socialist/communist economic system to a "socialist economic structure with Chinese characteristics." The most important features of China's new

2 Baker, supra note 1, at 365.
3 Also referred to as "socialism with Chinese characteristics," this phrase has become the key slogan of Deng Xiao Ping's reform movement. The exact meaning of the phrase is hard to determine, since it has been used to justify almost every change in China that does not comport with traditional
design are its recognition of diverse forms of ownership, its opening of China to foreign trade and investment, and its implementation of various new laws to assist this transformation.

China's modernization began with the introduction of the laws allowing foreign investment in China in the form of joint ventures, and continued with other legislation designed to support this new economic system. A significant development in this continuing series of economic legislation is the promulgation of the COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA, adopted December 29, 1993, effective June 1994 (hereinafter "the Company Law" or "the Law"). The Company Law promotes a fundamental change in the organizational structure of enterprises in China. Unlike previous legislation, such as the joint venture laws, which only covered foreign investment in China, the Company Law potentially allows all domestic entities to operate under a market system. For the first time since 1949, China now officially recognizes and encourages the ownership of property by private individuals in addition to ownership by the State and collectives. If the Company Law is


Id.
implemented effectively, the potential exists for private Chinese enterprises to operate as independent economic units.\(^9\)

Although the law theoretically permits ownership and operation of a market oriented enterprise,\(^10\) numerous problems await such an enterprise in China's current economy. Part II of this Article explores the economic system from which China is emerging and some of the key economic levers which make up the economy, including the role of law in the ongoing transformation. The Chinese government needs to decide how best to utilize law to achieve the economic changes it desires. It could use laws as the West uses laws, to provide the basic structure and rules (leaving economic units to achieve marketization independently), or it could use laws as it did in the past with party directives, micro-managing the enterprises to achieve marketization.\(^11\) The economic laws which have been promulgated in China, including the Company Law, reflect that the government has not been able to decide on the best course.

Part III describes two types of tension which exist in China that may prevent the companies formed under this law from functioning efficiently as market driven economic units. This article suggests that for a Chinese company to operate efficiently under the existing system, some fundamental challenges need to be met. The first challenge is termed "internal" because it refers to management decisions within the companies. The inherent tension is between increasing efficiency (which requires a greater diffusion of decision-making power from the government to the directors of companies) and maintaining centralized political power. To the extent that central planning perpetuated the Communist Party's powers in China by allowing it to allocate resources to sections which benefited the party (e.g.,

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\(^9\) **COMPANY LAW**, *supra* note 5, art. 4.


\(^11\) At least one author has suggested that in China, the state should pursue the role of law maker and not that of the owner to achieve marketization. Donald C. Clarke, *Regulation and its Discontent: Understanding Economic Law in China*, 28 STAN. J. INT'L L. 283 (1992).
the military), the decentralization and marketization of economic power likewise diffuses economic power and transfers it to the private sector. The second type of challenge, termed "external," involves the relationship between decentralized segments of Chinese society and refers to the interaction between the companies chartered under the Company Law and the rest of the Chinese society. This Article explores whether an entity can operate to achieve maximum market efficiency in a society where many of the other actors, such as suppliers and workers, play by different rules and have different goals. The Company Law, to the extent it provides a more efficient operating structure, limits its impact to only the enterprises which are allowed to incorporate. China's central authorities have operated under the belief that by legally recognizing privately owned companies, the country can acquire and operate such entities within its existing system, achieving market efficiency without losing the Communist Party's ideological purity. This author suggests that significant political, economic, and cultural conflicts which exist between these privately held enterprises and the rest of Chinese society must be reconciled.

Part IV of this Article focuses on the provisions of the Law which reflect the desire of the Chinese government to micro-manage enterprises, the effect of which is to reduce the investment of private capital in these companies and further delay privatization. The author recommends how the Law may, nevertheless, be implemented without the detractions.

Part V demonstrates that a single piece of legislation cannot achieve the goals of a market efficient economy without changing other aspects of the economy. In China, the government is so intertwined with the enterprises that changes in the economic structure necessarily entail changes in the political structure. Without critical concurrent reforms in other sectors of Chinese society, the establishment and operation of a private "company" under China's new law will be a daunting, if not impossible, task. Therefore, changes in the economic, social, and political arena are necessary before China's economy can achieve market efficiency. In this part the author also suggests some broad changes are needed on a macro level in Chinese society for companies to reap the benefits of privatization.

12 Some scholars have suggested that any social reform to accommodate a change to a market system requires a more fundamental change in what may be termed "Chinese values." PETER M. LICHTENSTEIN, CHINA AT THE BRINK 80 (1991). This author disagrees that such changes are inevitably necessary. Taiwan, Hong Kong, and Singapore are examples of societies which have maintained traditional Chinese social values, such as a strong emphasis upon family relationships, while thriving under a market economy.
Since these suggestions impact economic, political, and social aspects of the Chinese society, details of their implementation are outside of the scope of this article.

Finally, Part VI concludes that without incentives for management to make decisions based solely on market information, new enterprises formed under the Company Law will not create efficiency in the Chinese economy so long as the economy and its bureaucracy continue to operate in a primarily socialist mode.

II. CHINA’S ECONOMIC SYSTEM

To gain a better understanding of how a company will operate in China’s transitional economy and to better appreciate the obstacles facing the Chinese company, an overview of some of the key economic levers which affect the Chinese economy is essential.

A. A Brief History

When it came to power in 1949, the Chinese Communist Party adopted an economic system and management style patterned after the Soviet model.13 Property was owned either by the State or by collectives.14 Until 1978, China’s economic system did not allow any of the normal market mechanisms found in other countries to function. The economic system was almost fully centralized and decisions that were made through administrative organs were duly executed by the enterprises.15 Every aspect of the economy was planned.16 The government engaged in both macro and micro planning.17 The macro planning included a master list of priority

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13 CHINA’S ECONOMIC REFORM, supra note 3, at 2.
14 Private ownership officially existed for a short period until the early 1950s. It consisted primarily of providers of skilled trades, which had not been subsumed by the collective work groups. During the “Great Leap Forward,” such private ownership was virtually eliminated. Today, a very small segment of the economy, primarily the service industry, is privately owned. For a discussion of these changes see Du Mengkun, Government Budgets, in CHINA’S ECONOMIC REFORM, supra note 3, at 39-40.
16 Although the attempt was made, China never claimed that its planning was perfect. Many gaps existed, and the planning often led to terrible economic consequences such as the widespread famines after the so-called “Great Leap Forward.” LICHTENSTEIN, supra note 12, at 80; A. JAMES GREGOR, supra note 3, at 80 (1995).
17 CHINA’S INDUSTRIAL REFORM, supra note 15, at 148.
industries which would receive material and funds first. Then, the various levels of government administrators micro-managed the enterprises on every aspect of their operation, including purchasing, production, quality control, and labor practices. Those industries on the priority list were supplied with raw materials at state-plan prices which were unrelated to market conditions. The system of controlling everything from the purchasing of raw materials to the sale of goods was implemented in both the state-owned enterprises and in the collectively-owned enterprises. This centralized management approach governed nearly every aspect of all enterprises from 1958 to 1978, covering nearly eighty-five percent of the total economy of China.

China engaged in what is known as “directive planning” (Ziling Jihua), where production units were given specific production targets to meet. Under directive planning, management of China’s enterprises were nominally controlled by the state, and the actual power resided in the hands of the various administrative organs and the bureaucrats who staffed these organs. Numerous problems resulted from this arrangement. Enterprises lacked the most basic decision making powers. Managers lacked the

18 See generally CHINA'S INDUSTRIAL REFORM, supra note 15, at Chapters 7 and 8.
19 CHINA'S INDUSTRIAL REFORM, supra note 15, at 197.
21 Such planning had the advantage of predictability, to the extent that the targeted goals were met. However, its disadvantages were significant. Enterprises which produced goods lacked decision-making power, management lacked incentive to be innovative and workers failed to share in the profitability (or failure) of the enterprise. See Gene Tidrick, Planning and Supply, in CHINA'S INDUSTRIAL REFORM, supra note 15, at 196-97. For a discussion of centrally planned economies in Eastern Europe and their similarities to China, see Richard Portes, From Central Planning to a Market Economy, in MAKING MARKETS: ECONOMIC TRANSFORMATION IN EASTERN EUROPE AND THE POST SOVIET STATES 20-36 (Shafiqul Islam & Michael Mandelbaum eds., 1993).
22 Du, supra note 14, at 40. In 1978, the state sector's share of industrial output was 77%. By 1994, this figure had fallen to 40%. Mark O'Neill, Senior Official Defends China's State Ownership, REUTER ASIA-PACIFIC BUS. REP., Feb. 7, 1995, available in LEXIS, NEWS Library, BUSDTL file. Among the state enterprises, close to half are losing money, with the government heavily subsidizing these losses. Xiao Yu, Backing for State Firms, S. CHINA MORNING POST, Nov. 7, 1994, at 8.
24 Every Chinese enterprise is run by two heads, the manager or factory director and the party secretary. For most of the past four decades since the Communists took power, any ultimate decision rested with the party secretary. Theoretically, the manager was in charge of production and the party leader was to ensure conformity to party policy. However, if the two objectives clashed, which they often did, the party policy always prevailed. As with any creature with two heads, reaching any particular objective efficiently became difficult if not impossible. LICHTENSTEIN, supra note 12, at 37.
authority to make production and sales decisions, such as determining what to produce, what to purchase, whom to hire, when to borrow money and repay loans, and how to distribute products. All of these decisions were determined by the State's plan as interpreted by several layers of bureaucracy.25

The centralized system took away any incentive for Chinese enterprise to be innovative and profitable. To the enterprises, profits were irrelevant since excess earnings were not retained but simply turned over to the government.26 Losses did not decrease jobs, output, or salaries since the government subsidized these losses.27 The net effect of this system was to encourage, across the economy as a whole, complacency and resignation to the point of stagnation.

B. Role of Law

China's legal system prior to 1978 was devoid of economic legislation.28 It did not have any of the most fundamental legislation such as contract law, tax codes, and corporation codes. Such laws were unnecessary since all economic agreements entered into were between government units. If one party were to breach a contract, any damages ordered would be paid from one government fund to another, a rather meaningless exercise which the Chinese avoided. If a party breached an agreement and the government felt that the breach affected central planning, private enforcement under a judicial proceeding was unnecessary because

25 ZHOU, supra note 3, at 2-5. See also Zheng Guangliang, The Leadership System, in CHINA'S INDUSTRIAL REFORM, supra note 15, at 304. In China, the decision to expand operations due to growing demand was not made within the operating enterprise, but was instead made by an administrative bureaucrat. Usually, this bureaucrat has little or no understanding of the enterprise's product or concern about its market position. The administrator may also have a political agenda which is inconsistent with the welfare of the enterprise. An example of inconsistent goals may be when a factory's resources, machinery, labor, and raw materials are ordered to produce military uniforms which are then "sold" to the government at set low prices to meet a political need when those same resources would be economically more profitable producing consumer clothing in greater demand and selling for higher prices. See supra LICHTENSTEIN, note 12, at 36.

26 Id.

27 Id.

28 As of the 1980's, of the 420 laws, regulations and legal directives which have been promulgated by China since 1979, over 330 regulate economic activities. Gu Ming, Recent Development in Chinese Economic Legislation, 21 U.S. L. Rev. 217 (1987). In the last three years, of the 72 laws adopted by the National People's Congress, 24 were economic laws. China's Economic Legislation at Crucial Stage, XIN HUA NEWS AGENCY, Feb. 29, 1996, available in LEXIS, ASIAPC library, CURNWS file.
the government simply ordered specific performance.\textsuperscript{29} This method sufficed in a planned economy where production units were under direct government control.

With the decision to marketize in 1978, the rules changed. After experiencing governmental control for over thirty years, Chinese enterprises were suddenly called upon to produce market efficiency. The first effort to implement elements of a market system was directed at attracting foreign investment. But given China’s lack of laws, foreigners were unwilling to invest in China, and expressed a reluctance to invest without legal protection and procedures to address breaches. The Chinese government recognizes that its ability to attract such investors depended on the foreign confidence in China’s legal processes. Legal regulations served to engender greater foreign confidence. Therefore, a crucial part of marketization was the adoption of a system of economic regulation. While China recognized the need for economic legislation to replace the command economy with market values, it was also conscious of the loss of power which accompanied the transition. To address this issue, China took its first step toward marketization in a controlled environment by carefully monitoring the type and quantities of foreign investment projects. Each project required approval by the government.\textsuperscript{30}

China’s efforts to change its political and economic systems by legislation which would encourage more reliance on market factors began long before the promulgation of the Company Law. As early as 1979, soon after China’s decision to “open its doors” to the rest of the world, China enacted a set of joint venture laws, which enabled foreign investors to invest in China by joint venturing with Chinese entities.\textsuperscript{31} The joint venture laws were the first introduction of private ownership in China. Although the Chinese partner of a joint venture was almost always a government entity, at least the portion of the joint venture’s assets owned by the foreign party was in private hands.

Pressure from foreign companies desiring more flexible forms of investment in China led to enactment of further legislation allowing for other forms of business, such as cooperative joint ventures and, very

\textsuperscript{29} This preference for specific performance is reflected in the Civil Law, art.111.


The creation of these wholly-owned foreign enterprises meant that at least small parts of China’s economy became privately owned and managed by foreigners. The percentage of such foreign enterprises was so small that it had negligible impact on China’s economy, but it was, nevertheless, an important policy change. China also established various special economic zones along the coastal regions to encourage foreign investment and trade. These zones provided flexible forms of investment to foreign investors and lower tax rates. Most of these zones have been very successful economically. Investment by Hong Kong, Macao, and Taiwan Chinese is especially concentrated in these zones.

Reflected in these past economic laws, and in the Company Law, is the delicate balance of allowing some independent decision making on the enterprise level to achieve maximum operating efficiency while giving up the minimum amount of political control. The laws are typically designed to facilitate activities the government wishes to encourage without relinquishing the rights that would limit state power. Chinese laws tend to contain, paradoxically, provisions which are vague and broadly drafted, accompanied by detailed restrictions. The former gives maximum room for interpretation by bureaucrats, which can vary as government policies change. The latter allows the government to prohibit activities which it deems to be harmful.

Some of this economic legislation has achieved significant success by attracting foreign investment, although foreign investors still often

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34 For example, specific laws encouraging foreign investment would detail the sectors of economy which foreign investment is encouraged but be vague as to the benefits foreign investors would receive when investing in those sectors. Law on Encouragement of Foreign Investment, arts. 2 & 15. Often, laws are broad policy statements which promise unspecified “relevant regulations” to clarify the ambiguities. Until such regulations are issued, interpretation of any ambiguity is left to the bureaucrats who are in charge of enforcement. See supra note 32.

35 In the past 15 years China has received $60 billion in foreign investment. Qiu Qi, China: Trade Minister Optimistic Rejoining GATT, BUS. Wk, Feb. 27, 1994, available in LEXIS, ASIAPC library, BUSWK file.
complain of the difficulties in dealing with Chinese partners who are not motivated by profits and bureaucrats who are obstructionists. The question is whether the same success can be achieved when the scope of the marketization is expanded to individual domestic enterprises.

C. Creating a Socialist Market System

While China has taken steps to transform its economy from one that is planned to one that is driven by market forces, that process is far from complete. Vestiges of the planned economy and its instruments remain and continue to control significant portions of the Chinese economy today.

Much has been written in the western press about this “fundamental change” in China’s policies and many commentators have advanced the idea that this change signals the end of Communism and represents concrete proof of the superiority and basic correctness of western capitalism. However, China’s decision to change its system is markedly different from the changes occurring in the former Soviet Union and various eastern European countries. For example, China’s decision was self-made, not forced upon her by the collapse of the previous system. China was able, at a relatively early date, to perceive the need for this transformation and to take measured steps to implement changes. Other differences in population, size, culture, stage of economic development, natural resources, and political structure render comparisons between China’s transformation and those occurring in Eastern Europe inappropriate.

37 See, e.g., ZHOU, supra note 3, at 14-15, 174.
38 ISLAM & MANDELBAUM, supra note 21, at 15.
39 None of the Eastern European countries or the Soviet Union have a population anywhere near China's. China's economic development has been considered to be further along than most, with the possible exception of Hungary. Politically, China’s leadership is attempting to marketize without dismantling its own power base, in marked contrast to the toppling of the Communist Party in most of the Eastern European countries. Peter Harold, China's Reform Experience to Date, WORLD BANK DISCUSSION PAPERS No. 180, 1992, at 1-4. For those interested in the experience and analysis of Eastern European countries and the former Soviet Union, see generally CAPITALIST GOALS, SOCIALIST PAST: THE RISE OF THE PRIVATE SECTOR IN COMMAND ECONOMIES (Perry L. Patterson ed., 1993); ECONOMIC ADJUSTMENT & REFORM IN EASTERN EUROPE & THE SOVIET UNION (Joseph C. Brada et al. eds., 1987); ECONOMIC TRANSFORMATION IN CENTRAL EUROPE: A PROGRESS REPORT (Richard Portes ed., 1994); THE ECONOMIC TRANSFORMATION OF EASTERN EUROPE (Bernard S. Katz & Libby Rittenberg eds., 1992); PRIVATIZATION & ECONOMIC REFORM IN CENTRAL EUROPE (Dennis A. Rondinelli ed., 1994); ROMAN FRYDMAN & ANDRZEJ RAPACZYNSKI, THE PRIVATIZATION PROCESS IN CENTRAL EUROPE (1993); ROMAN FRYDMAN & ANDRZEJ RAPACZYNSKI, PRIVATIZATION IN EASTERN EUROPE: IS THE STATE WITHERING AWAY? (1994); MARKET SOCIALISM OR THE RESTORATION OF CAPITALISM? (Anders Aslund ed., 1992); REFORMING THE
Another major distinction between China's transformation and that occurring in Eastern Europe and Russia is that China's change, at least nominally, is only in the economic sphere. Politically, China continues to adhere to Marxist/Maoist doctrines.\(^4\)

China is one of a few countries in the world which still professes adherence to communism.\(^4\) Of these countries, China is the only one with any significant economic power. Recognizing that continued adherence to the rigid, centrally planned economic system of traditional Communism would not induce the desired type of progress and growth, China has embarked on a path to create a “socialist system with Chinese characteristics” or “socialist market economy,” which essentially consists of injecting certain market aspects into a planned economy.\(^4\) To China, it matters little that “socialism” and “market system” are contradictory terms. The Chinese leadership would like to keep the facade of socialism, as it is the basis which the Chinese Communist came to power, while adopting as much of capitalism in substance as it can in the economic sector. To avoid the appearance of abandoning socialism, China initially called the new system a “commodity production economy” and later changed the label to a “socialist market economy.”\(^4\)

Some scholars may be interested in debating whether China is “maintaining a socialist economy with unique Chinese characteristics” as its leaders declare, or whether it has become capitalist and is simply continuing outdated political rhetoric for the convenience of those in power. Others may well adopt Deng Xiao Ping's pragmatic (and much touted) slogan: “It doesn't matter what color the cat so long as it catches mice.”\(^4\) This attitude

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\(^{40}\) LICHTENSTEIN, supra note 12, at 11.

\(^{41}\) Other communist countries include Cuba, North Korea, and Vietnam.


\(^{43}\) The label “commodity production economy” or “commodity economy” was used early in the reform process in 1983 and 1984 to avoid antagonizing the more conservative factions of the communist party. See JOSEPH FEWSMITH, DILEMMAS OF REFORM IN CHINA: POLITICAL CONFLICT AND ECONOMIC DEBATE 133 (1994). In 1992, after the Fourteenth Party Congress, when the reform movement was more secure, the use of the term “socialist market economy” was adopted. Id. at 146. See LICHTENSTEIN, supra note 12, at 41. Apparently, the purpose of introducing market mechanisms into a socialist system is to make the planning more efficient and flexible, not change the system to a capitalist economy.

\(^{44}\) ZHOU, supra note 3, at xi.
allows the Chinese government to maintain a pretense that it has not abandoned the principles upon which the Communist Party was founded while implementing reform measures which look more and more like capitalism.

D. The Key Economic Levers

The following is a more detailed discussion of the major economic levers which propel the Chinese economy. Particular emphasis is placed upon the factors which closely relate to the operation of a company in China’s transitional economy. The specific factors also relate clearly to certain fundamental preconditions of a market economy: the ability to decide what to produce, how much to produce, the number and specifics of employees, prices of goods and services provided and allocation of profits.

1. Production

In planned economies, factories produce goods to meet government specifications and not market demands. Since purchase decisions are also made by the State, no real incentive exists for the enterprises to produce innovative goods with better quality. In contrast, enterprises in market economies manufacture to meet market demands. As China’s economic growth is highly dependent upon export, Chinese enterprises are now beginning to plan their production and design their products according to the demands of the international market. Without price de-control, access to investment and raw material, and the ability to hire and fire workers as needed, the ability of individual factories to respond to market signals remains limited.45

Furthermore, making efficient production decisions depends on access to market information which in turn allows decisions to be made according to the information received. While it clearly is true that market economies do not always have perfect access to information, in China, the type of information available to a production unit is particularly skewed and inadequate. The government is the primary, if not the sole source, of such information and often, the statistics reflect political agenda and not actual information.

45 ZHOU, supra note 3, at 58-59.
The problem is further complicated when portions of the economy remain under central planning and portions attempt to operate under market rules. Information and statistics cannot reflect true market conditions, only partial or mixed messages.

There is also the question whether market information, to the extent it is available, will lead to appropriate production responses by the enterprise. A possible example of a perverse response in a transitional economy is that a factory would raise prices to counterbalance the decreased demand for its products. This decision could well be the result of a need for full employment or the vestiges of an older system which dictated production units. Chinese enterprises are so accustomed to their monopolistic practices that their response to competition may not be the same as an enterprise familiar with operating under market rules.

2. Prices

In China, the government is the arbiter of prices of goods rather than the supply and demand of market forces. Often, these prices are arbitrary and bear no relationship to the cost of manufacturing or market prices. The danger of massive price reform—relinquishing governmental control and allowing price to be determined by market demand and

46 See infra note 61 and accompanying text.

47 Under a planned economy, information is gathered by the government and the decisions are made accordingly. Although this information was not perfect, at least it was as close to complete as the government could make it. With part of the enterprises in state hands and part private, the collection and dissemination of information will be much more difficult. One of the greatest challenges facing a transition economy is the task of facilitating information flow and exchange to allow for informed decisions. China is no exception. Raimund Dietz, Ten Propositions Towards a Theory of Transformation, in FROM COMMAND TO EXCHANGE COMMUNICATION, IN THE TRANSITION FROM COMMAND TO MARKET ECONOMIES IN EAST-CENTRAL EUROPE 77 (Sandor Richter ed., 1992).

48 See infra note 55.

49 For example, one author has noted how readily Chinese distributors accept pricing policies and leads set by others in the distribution chain. This acquiescence is attributed to vestiges of old state pricing policies. Jane Greaver, The Right Price. CHINESE BUS. REV., Sept.-Oct. 1995, at 31.


51 As a result of arbitrary pricing, China often found itself subsidizing exports when the price of manufacturing exceeded the international market prices. Id. Subsidies of exports have been gradually eliminated in the early 1990s. Speech by Heng qi Ding, Commercial Counsel, People's Republic of China Consulate General, San Francisco on June 24, 1996 during World Affairs Council Conference, U.S.-China Trade: MFN, WTO - 1997. Oakland, California.
supply—is the possibility of runaway inflation once price control is lifted.52 Due to long term price control and shortage of goods, the sudden lifting of controls may cause certain prices, especially of goods in short supply, to increase unchecked. These increases may far outpace the real income earnings of the people.53 To prevent this problem, the Chinese government has kept the prices of basic commodities such as rice and oil stable while allowing more fluctuations with non-essential goods such as television and fans.54

3. Labor Policies

A central factor in planning production and setting prices is the cost of labor. In China, where there is an abundance of labor, efficient allocation and pricing of labor have previously been unimportant. Instead, the goal of labor allocation was to achieve full employment. This goal is hardly surprising, for the Chinese communists came into power during an era of great labor unrest. In that era, the need to keep workers occupied, however inefficiently, far exceeded the need for efficient allocation.55

52 Josef C. Brada et al., Economic Stabilization, Structural Adjustment, and Economic Reform; in ECONOMIC ADJUSTMENT AND REFORM IN EASTERN EUROPE AND THE SOVIET UNION 6-7 (Josef C. Brada et al. eds., 1988). See Hsu, supra note 23, at 143.

53 China has already seen inflation in the prices of consumer products. For years, China's national resources were invested almost exclusively to increase her industrial and military output. This emphasis was at the expense of producing consumer goods. If enterprises are allowed to decide what to produce, the natural inclination would be to produce consumer goods which are in greater demand. See Greaver, supra note 49, at 47.


55 Chinese workers do not choose the fields which they wish to enter. Rather, upon graduation from high school or other educational institutions, workers are assigned to various enterprises. William Byrd & Gene Tidrick, Factor Allocation and Enterprise Incentives, in CHINA'S INDUSTRIAL REFORM, supra note 15, at 67-69. Therefore, it is often possible to find a worker in a toy factory whose interest lies in garment design, or a worker in a botanical garden whose major in college was English. With this type of labor allocation, China's labor system is, at best, inefficient.

In the 1960's and early 1970's, the problem of too many urban laborers was solved by simply sending high school and college graduates to the countryside to learn from the peasant class. Brugger, supra note 42, at 87; see also Zhao Lukuang & Lu Guotai, Employment and Wages in Cities and Towns, in CHINA'S ECONOMIC REFORM, supra note 3, at 188. Workers could be recalled if they were needed. If they were not needed, they would simply be left on semi-permanent agricultural duty. Brugger, supra note 42, at 86-88. While this system of allocation did not take into account the talents or desires of the worker, it is accepted by most as a better alternative to unemployment. For an interesting discussion of the history of the assignment system, see Zou Ji, The Assignment of Jobs to College Graduates, in CASE STUDIES OF CHINESE ECONOMIC REFORM 51-79 (Timothy King & Zhang Jiping eds., 1992).
As a direct result of the need to solidify control and gain worker support, the government guaranteed the state sector life long employment. The term "iron rice bowl" is used to describe the notion that one could not be fired regardless of one's performance on the job. While this practice has been somewhat curtailed in China, the concept of lifelong, or at least long-term, guaranteed employment prevails. Because vestiges of the "iron rice bowl" remain, enterprises find it is still difficult to fire an inefficient worker in China today. The government is equally afraid to change the status quo.

In China's labor market, a new form of state sanctioned nepotism has emerged. It is not uncommon for a person who is retiring to be replaced by his or her child, regardless of the child's background or training. In fact, this practice of handing a job to one's offspring has been used by many industries to induce early retirement of older workers. The replacement worker, however, may neither be experienced nor have any interest in the job. While inefficient, the system of replacement by a child insures that retiring workers receive their share of a pension for a set amount of time, and the children are guaranteed a job.

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56 Since all enterprises were owned by the state, almost every job was guaranteed life long employment. As of 1995, it is estimated that state-owned enterprises still employ about 70% of China's urban workers. Problems Remain for China in Economic Reform Process, Int'l Bus. & Fin. Daily (BNA), (Feb. 21, 1995), available in LEXIS, FEDSEC library, BNAIBF file.

57 The rice bowl represented the job. To break your rice bowl is to lose your job. If the bowl was made of iron, it was unbreakable.

58 This issue of replacing inefficient workers first became a problem when Sino-foreign joint ventures had great difficulty firing inefficient workers. This problem persists today. Lees and LIAW, supra note 50. With increases in foreign investors complaining the Chinese government reluctantly allowed the firing of workers from the joint venture. However, the state owned enterprises were slow to adopt this practice and redundant workers still exist at these enterprises. Byrd and Tidrick, in CHINA'S INDUSTRIAL REFORM, supra note 15, at 68, 74; GU ZHIBIN, CHINA BEYOND DENG: REFORM IN THE PRC 57-58 (1991).

59 CHINA'S INDUSTRIAL REFORM, supra note 15, at 70.

60 For example, at one major steel producer, with 200,000 employees, 17,000 children replaced retiring parents between 1980-83. CHINA'S INDUSTRIAL REFORM, supra note 15, at 70-71.

61 Despite its label as a socialist country, China has yet to develop a formal social security system. Chinese workers rely heavily on the pension they receive from their employer upon retirement. Experimentation with unemployment insurance and other social insurance programs has begun in some of the special economic zone where enterprises are seeking to attract skilled workers from outside the SEZs. To do so, these enterprises, having been allowed more self direction than others in China, have experimented with innovative programs including medical insurance, old age pensions, and workman's compensation. See generally, China-Social Insurance in the South, 1992 NATIONAL TRADE DATA BANK MARKET REPORTS, Dec. 17, 1992, available in LEXIS, WORLD library, BUSANL file. Because these pensions are paid by the specific unit or enterprise and not by a national or provincial common fund, the lack of social security further reduces job mobility for workers. Furthermore, for those who have never been employed, the expectation is that families will take care of members who cannot work.
Traditionally, wages in Communist China were set by the government and responded to neither productivity nor efficiency. The Marxist ideal of “from each according to his ability, to each according to his need” undermined any incentive to work, because the State theoretically provided for each citizen’s needs regardless of an individual’s employment status. In the last few years, officials have been touting a new slogan: “compensation according to work done.” Various enterprises have introduced bonus systems, which theoretically award bonuses according to the workers’ performance. In reality, many of the bonuses are still awarded on a massive company-wide basis, without singling out individual workers based on merit. Years of indoctrination with egalitarian theory make it hard for workers and managers to adopt to radically different ideas such as paychecks which are not all identical and to accept merit based compensation.

Labor issues played an important role in the events which led to the 1949 revolution in China. Chinese officials are certainly sensitive to this issue and will go to great lengths to avoid actions which would result in widespread unemployment. China also refuses to officially recognize unemployment as a problem and has made no provision for unemployment compensation. This refusal to confront the existence of unemployment has also created an anomaly in China’s labor statistics: an entire class of youth who are “waiting for assignment” do not appear in China’s official statistics.

63 Directly, the state employs 108 million people, almost three-fourths of the urban labor force. This figure does not include industries heavily subsidized or dependent on the government to maintain its operations. Sheryl WuDunn, For Sale: Creaky Gears of Chinese Communism, N.Y. Times, May 2, 1993, § 4, at 7, available in LEXIS, WORLD library, ARCNWS file.
65 CHINA’S INDUSTRIAL REFORM, supra note 15, at 73.
66 Widespread unemployment and food shortages were the two main causes of poverty and hunger in China prior to the revolution. On the promise of food and employment for all and equitable distribution of wealth, the Communist Party came to power in 1949. See S. BERNARD THOMAS, LABOR AND THE CHINESE REVOLUTION 236-47 (1983).
67 Problems Remain for China in Economic Reform Process, supra note 56. The continuous subsidy of inefficient and poorly managed enterprises has been attributed to the government’s fears of the resulting unemployment if such enterprises were allowed to go bankrupt. The Company Law also reflects the government’s sensitivity to labor concerns by inclusion of representatives of employees on the Board of Directors. COMPANY LAW, supra note 5, art. 45.
unemployment numbers. The State would like to see some of these young people enter the newly emerging private sector, but many of these prospective workers are afraid to risk their chance to grasp the "iron rice bowl" by forsaking public-sector employment.

4. Sources of Capital: Loans and Investors

In the past, the government was the sole source of funding and allocation of capital by the government did not necessarily correspond to the efficiency of the enterprise, and inefficient enterprises which operated continually at a loss could still obtain capital from the government. Unlike capitalist societies where only enterprises with good or excellent performance would be able to obtain additional capital, the Chinese government continually subsidized enterprises without regard to efficiency or profitability, often only to further governmental policy objectives. Much of the government subsidies were designed to keep enterprises in operation in order to avoid unemployment of the workers, a political rather than economic decision. As a result, well-connected but inefficient enterprises often were able to obtain large capital infusions to continue operating.

Even as China moves towards a system where capital is acquired from sources other than direct government grants, such as bank loans, problems still exist with the system. Often banks are pressured by officials


69 Retirement Insurance Gives People More Job Choices, XINHUA NEWS AGENCY, Apr. 6, 1994, available in LEXIS, ASIAPC library, XINHUA file. However, as social insurance programs are implemented, these anxieties should be alleviated. Yojana Sharma, China-Labor: State Social Security to Replace Iron Rice Bowls, INTER PRESS SERVICE, June 24, 1994, available in LEXIS, Market library, FACNWS file.

70 Expansions were funded by government allocations in the form of budgetary grants. Singh, supra note 20, at 3. If such grants were unavailable because there was a shortage of funds nationally, then the project would be stalled, sometimes indefinitely. Tremendous inefficiencies resulted. When the government coffers were flush, numerous grants were made to start a number of projects simultaneously. Singh, supra note 20, at 3. When a shortage of funds developed at the government level, all of the projects, without regard to their merits, would be halted. Singh, supra note 20, at 3.

71 Problems Remain for China in Economic Reform Process, supra note 56.


73 See Singh, supra note 20.
seeking loans for specific pet projects of the local officials. Banks operating locally must respond to pressure from local officials who have a special interest in seeing a particular project funded. The notion that "official notes could become bank notes" (*Tiaozi Bian Piaozi*) has become an accepted phrase.\(^7^4\) With this type of inefficient allocation of capital where banks lend based on the amount of pressure received rather than the feasibility of the project, well-connected but inefficient enterprises will often receive funding instead of the efficient ones.

Some portions of China's economy, especially those funded by foreign investment, operated under some pressure to be efficient. For example, joint ventures often borrowed funds from foreign banks based on economic projections in the joint ventures' feasibility reports.\(^7^5\) These loans were usually guaranteed by the investors or the Bank of China.\(^7^6\) The success and failure of these joint ventures taught lessons of fiscal responsibility to Chinese enterprises unaccustomed to such notions.

Another traditional source of capital in market economies is accumulated profits. However, in Chinese enterprises, the notion of accumulating profits for future expansion is not always attractive to the managers and owners of the enterprise. Although theoretically an enterprise may now keep some of its profits, the managers and owners often fear the ever present possibility that the government will take its "share," either by direct collection or by changing the tax laws. Also, because managers do not necessarily benefit from capital expansion, the incentive is to spend profits on the type of expenditure which would immediately benefit the workers (e.g., a cafeteria, more cars for management, bonuses to management and workers, etc.) and not on expanding production.

Even if an enterprise wanted to expand and could set aside funds for that purpose, the inability to acquire property or competitors without government approval hinders efficient expansion. In China, since each enterprise is under the supervision of a ministry, the target company or adjacent facility which one enterprise may wish to acquire are often under the administration of different ministries, each of whose approval would be

\(^7^4\) See *Hsu*, *supra* note 23, at 100.

\(^7^5\) All joint ventures in China are required to prepare a feasibility report as part of the approval process. *Procedures for the Registration, Examination and Approval of Joint Ventures Using Chinese & Foreign Investment, CHINA LAW No. 92*, available in LEXIS, ASIAPC library, CHINAL file.

\(^7^6\) However, recently, China has declared a new policy of restricting government guarantees of any further loans. Quak Hiang Whai, *China Loan Guarantee Ruling Holds Up Some Agreement*, *BUS. TIMES*, May 17, 1995, at 23.
required for merger or acquisition. Therefore, the normal economies of scale that might be achieved by combining certain enterprises do not occur naturally in China. Unfortunately, the Company Law does nothing to eliminate this bureaucratic roadblock as it explicitly states that the administrative organs in charge of the enterprises owned by the State would remain in charge of the company after incorporation. The Law also specifies that mergers of companies limited by shares are subject to approval of the state authorized departments after the shareholders have adopted a merger resolution.

III. INTERNAL AND EXTERNAL CHALLENGES

Despite all of the recent changes to the economy, until the promulgation of the Company Law, China remained primarily a socialist country wherein almost all property was owned by the State. Now, after adopting the Company Law, China officially recognizes and encourages private ownership by Chinese citizens. Notably, however, the Law makes no provision to privatize the existing state owned enterprises, it merely allows for incorporation in appropriate cases. How well these "privately run and operated" and newly incorporated, state owned corporations will face the challenges of functioning in China's present society is the question at hand.

In addition to how the Company Law will interact externally with the rest of China's evolving economy, several intrinsic problems in the Company Law deserve critical attention. With the marketization of enterprises in China, the question of control remains. If the government can no longer directly order the decisions of many enterprises, who will monitor the activities of the companies? If a company is not totally owned by private citizens, with their self interest as the motivating factor, who will monitor the activities of the managers and workers? In a capitalist model, theoretically, the market system monitors the companies—the stock market reflects the inefficiencies of the enterprise by depressing the price and investors sell their stock. In severe situations, creditors force the enterprises

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77 See Singh, supra note 20, at 20.
78 COMPANY LAW, supra note 5, art. 66.
79 COMPANY LAW, supra note 5, arts. 182-83.
into bankruptcy or the competition takes over the operation. These external monitoring devices are currently unavailable or inadequate in China.  

The next section analyzes the Company Law in detail, including analysis of how some of the provisions of the Law may be ill suited to the goal of marketization. In many instances the Law provides only a cosmetic change to the organization of the Chinese enterprises. The old Chinese adage of “changing the soup but not the medicine” (huan ton bu huan yau) is apt in this instance.

A. Internal Challenges

1. Corporate Control: Relationship Between China’s “Board of Stockholders” and the “Board of Directors”

The Chinese equivalent for a publicly traded United States corporation is a company limited by shares. The equivalent of a U.S. closely held corporation in China is a “limited liability company” ("LLC"). Wherever the term “company” is used in this article, the reader should interpret it as a limited liability company. Unless specifically noted, the discussion which follows is applicable to both types of companies.

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80 Currently, the Chinese stock market has relatively few shares listed, and with the restrictive provisions of the Company Law, few new ones are likely to be listed in the near future. China currently lacks any meaningful securities regulation to ensure that the market actually reflects the value of the stock and to prevent manipulation of the market by individuals or government entities. Although China issued Provisional Regulations on the administration of the Issuing and Trading of Stocks on April 23, 1993 ("Provisional Regulations") and Interim Procedures for Prohibiting Securities Fraud ("Interim Procedures"), aimed at trading on inside information and fraud such as use of material information to affect the market, these measures do not provide clear definitions or remedies to stockholders who are harmed by these activities. Provisional Regulations, BBC Summary of World Broadcast, May 20, 1993, available in LEXIS, News library, BBSCW File; Interim Procedures, BBC Summary of World Broadcast, Sept. 2, 1993, available in LEXIS, News library, BBSCW File. China's much debated securities law may actually be passed in the next two years. China's Economic Legislation at Crucial Stage, Xinhua News, Feb. 29, 1996, available in LEXIS, ASIAPC library, XINHUA File.

81 Some translate the term "Gu Fen Yo Xian Guan Shi" to "Joint Stock Company." COMPANY LAW, supra note 5, art. 2.

82 Although the limited liability company also exists as a form of business in forty-eight states of the United States, the differences described below will seek to contrast the Chinese limited liability company from the "C" corporation and the newer "LLC" in the United States. Arnold D. Litt, Susan M. Marra & Robert A. Mathers, Tax Hot Spots in Conversions to Limited Liability Companies, N.J.L.J., Aug. 21, 1995, available in LEXIS, News library, NILAWJ File; Maria Shao, Legislators Pass "Limited Liability" Bills, THE BOSTON GLOBE, Nov. 17, 1995, available in LEXIS, News library, BGLOBE File.
Although the structure of a Chinese LLC looks like its counterparts in the United States, Japan, and Germany, some dramatic differences exist.\textsuperscript{83} For example, the Company Law specifies that the shareholder group is intended to be the company’s most powerful authority.\textsuperscript{84} While theoretically the shareholders in any private enterprise are the owners, and therefore in control of the enterprise, in larger corporations in the United States such control has long passed from the owners to the managers. Unlike the United States, where shareholders merely meet to vote on resolutions already passed by the board of directors, the shareholders in a Chinese company are authorized to pass their own resolutions and to approve the company’s budget as well as profit distributions.\textsuperscript{85}

Because the Company Law vests the power to determine a company’s business policies and investment plans in the hands of the “shareholders,” as opposed to a board of directors, the power to control a large part of the State’s assets remains effectively in the hands of the State’s administrative organs. In fact, for a company which is wholly state owned, the Law does not even pretend that the power has shifted to the “shareholders.” Companies wholly owned by the State need not establish a board of shareholders, but may instead empower a board of directors, appointed by the state, to exercise all powers of the company.\textsuperscript{86}

Theoretically, of course, all state-owned property is owned by the “whole people.” However, since the whole people, as shareholders, could not possibly exercise their rights in directing the company’s business policies and investment plans, business decisions are made by the same bureaucrats who controlled the enterprise before the enactment of the Company Law. Given the shareholders’ power to “decide the company’s expansion and reduction plan as well as to issue corporate bonds and to make decisions on mergers and liquidation,”\textsuperscript{87} as representation of the “shareholders” an administrative organ can completely control the direction of a company partly owned by the state and even order the dissolution of a company by voting as the representative of the shareholders. Even if such a decision is contrary to the interest of the company and against the


\textsuperscript{84} \textit{COMPANY LAW, supra} note 5, art. 37.

\textsuperscript{85} \textit{COMPANY LAW, supra} note 5, art. 38

\textsuperscript{86} \textit{COMPANY LAW, supra} note 5, art. 66, 68.

\textsuperscript{87} \textit{COMPANY LAW, supra} note 5, art. 19, 20.
recommendation of the board of directors, the Law does not prevent such actions.

In the United States, all of the above described powers would typically rest with the board of directors. While the United States shareholders may have a say in voting to accept or reject major decisions affecting the disposition of the company, they normally lack the power to initiate such a resolution. In stark contrast, according to the Company Law, a limited liability company in China does not even require a board of directors. Article 45 of the Company Law states only that a limited liability company may establish a board of directors. Thus, key decision making powers have been taken from the board of directors, who might be comprised of professional managers, and placed with the shareholders who are represented by life-tenured civil servants. In the case of wholly state owned enterprises, the board of directors is appointed by the state, thereby maintaining much the old line of control and the old style of management.

In the United States, allocation of decisional responsibility to the board of directors stems from the notion that the directors are more familiar with the company's operation than the average shareholder. Thus, the board's expertise places them in a better position to initiate actions and make decisions. In China, by putting these powers into the hands of the less knowledgeable shareholders instead of the board of directors, the Company Law fails to utilize the potential board's expertise. By limiting the power of the board or simply appointing the board from existing bureaucrats, a conversion from a state owned enterprise to a state owned LLC does very


89 The directors have all corporate powers and the ability to manage the business and affairs of the corporation. Model Business Corp. Act § 35 (1978); Revised Model Business Corp. Act §§ 8.01, 8.11, 8.30 (1984).

90 COMPANY LAW, supra note 5, arts. 43, 51, but see Robert A. Art and Minkang Gu, China Incorporated: The First Corporation Law of the People's Republic of China, 20 YALE J. OF INT'L L. 273, 295 (Summer 1995) (stating "Every corporation must have a board of directors . . . .").

91 Another element that reflects the socialist/communist nature of the Chinese company is the requirement in Article 45 of the Company Law that an employee representative be elected to the board. Again, this is a requirement not found in the United States. COMPANY LAW, supra note 5, art. 45.

92 COMPANY LAW, supra note 5, art. 68.

little to change the power and management structure of the enterprise. This is perhaps the intended result since the party exerts greater authority over bureaucrats than over professional managers.

This peculiarity of the Chinese company structure is further reflected in the deliberately vague language in the law, which places limitations on the board of directors’ powers. The board is charged with the implementation (Zhi Xing) of shareholders’ resolutions, the determination (Jue Ding) of the company’s business and investment plans, and the formulation (Zhi Ding) of the company’s profit distribution and loss recovery plan. The Law does not state that the board of directors has the power to decide profit distribution and loss recovery; rather, the board is to formulate such a plan for the shareholders to decide upon, and then to implement the shareholders decision. Again, this approach contrasts sharply with the organization of a corporation in the United States, where such basic business decisions rest solely with the board of directors, and the disgruntled stockholders' remedy is to elect a new board. Since the State will be the majority shareholder of these converted enterprises, delegation of key powers to the shareholder level effectively allows the State to retain control. When the State is the sole shareholder of a converted enterprise, the State appoints the board members and thereby achieves even more direct control.

2. **Supervisory Committee**

Another organizational feature of the Chinese company is the “supervisory committee” which consists of shareholders’ representatives

94 COMPANY LAW, supra note 5, art. 112(2).
95 COMPANY LAW, supra note 5, art. 112(3).
96 COMPANY LAW, supra note 5, art. 112(5).
97 In the United States, the board of directors is elected by the shareholders pursuant to the corporation’s articles of incorporation. MODEL BUSINESS CORP. ACT § 36 (1978); REVISED MODEL BUSINESS CORP. ACT §§ 8.03, 8.05 (1984). Additionally, the shareholders may also remove the directors with or without cause. MODEL BUSINESS CORP. ACT § 39 (1978); REVISED MODEL BUSINESS CORP. ACT § 8.08 (1984).
98 State owned companies that have “gone public” by listing on the Chinese Exchange have generally limited the percentage to 25% of all shares available and none have sold more than 50%, effectively keeping control in the hands of the government, as the majority shareholder. Matthew D. Latimer, Gilding the Iron Rice Bowl: The Illusion of Shareholder Rights in China, 69 WASH. L. REV. 1097, 1106, (1994).
99 COMPANY LAW, supra note 5, art. 68.
elected by the shareholders in accordance with the company’s articles of association, at least one employee representative elected by the employees, and outside supervisors not affiliated with the company. The Company Law is unclear on when such a committee is required. The Law states only that a limited liability company of a "relatively large" scale requires such a committee. How the Chinese authorities will define a company with a "relatively large" operation remains unclear. When such a committee is required, it has considerable power over management of the company. As its name indicates, the committee possesses the power to supervise and investigate many aspects of the company’s affairs, including its financial affairs. The committee also has the right to supervise specific acts of the directors and managers, and presumably to take action when necessary to prevent illegal activity by the directors and managers. Furthermore, the supervisors have the power to convene the shareholders and may attend meetings of the board of directors as non-voting delegates. Most interestingly, the supervisory committee can be delegated "other powers" as stipulated in the company’s articles of association.

China’s hesitancy to relinquish administrative control over its enterprises explains the creation of such a powerful supervising body. Even though both state and privately owned companies are now supposed to operate autonomously, the existence of supervisory committees highlights an ongoing reluctance by the Chinese authorities to relinquish direct control. By creating such committees and giving them broad powers, the

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100 COMPANY LAW, supra note 5, art. 52. This is similar to civil law countries such as Germany, where a Supervising board is elected by the shareholders, and is limited to larger corporations. See COMMON MARKET REPORTS: GERMAN STOCK CORPORATION ACT, 11-12 (Friedrich K. Juenger & Lajos Schmidt trans., 1967); Donna Shook-Wiercimok et al., Germany, in SHAREHOLDERS' LIABILITY: THE COMPARATIVE LAW YEARBOOK OF INTERNATIONAL BUSINESS 177-91 (Dennis Campbell & Jennifer Powers eds., 1993).

101 COMPANY LAW, supra note 5, art. 52.

102 COMPANY LAW, supra note 5, art. 54.

103 Article 54 of the Law is somewhat confusingly worded to state that a supervisory committee or supervisors shall have the right to "supervise acts conducted by directors and managers during the performance of their duties which are in violation of the law, statutory regulations or the Company’s articles of association." The author believes that the intent of the Law is not for the supervisors to be sure that directors and managers are actually performing tasks in violation of the law, rather, they have the ability to take action should a director or manager act in violation of a law or statute. COMPANY LAW, supra note 5, art. 54.

104 COMPANY LAW, supra note 5, art. 54.

105 COMPANY LAW, supra note 5, art. 54. This last provision can vest extraordinary powers in this committee.
government can continue to influence the operation of the larger companies through placement of administrative bureaucrats in the supervisory committees even when it loses its controlling interest in the companies. Since the Law does not require that the supervisors have any expertise or understanding of the company’s business, the type of problems encountered when bureaucrats were directing the production and operational aspects of the Chinese enterprises could well appear with the new limited liability companies.

In addition to not requiring that the supervisors be experts in their fields, another glaring omission of the Company Law is the lack of meaningful restrictions on the supervisors’ activities. Article 59 requires that directors, supervisors, and managers not profit personally from the positions by acceptances of bribes or other illicit gains, but the prohibition of directors and managers from engaging in activities which constitute embezzlement or conflicts of interest, in articles 60 and 61, does not extend to supervisors. Therefore, while a director or manager owes a fiduciary duty to the company, a supervisor has the power to supervise the activities and interfere in the operation of the company without similarly owing the company any duty of loyalty. If China intended the supervisors to monitor the activities of the management, it has neglected to watch the monitors. This omission of the supervisor from articles 60 and 61 should be remedied at the earliest opportunity by an amendment to the Law.

To monitor corporate activities, China could adopt mechanisms currently used in other markets. For example, stock markets and securities commissions can regulate such behavior as insider trading and stock manipulations by management. Outside creditors can also monitor the decisions of the management for profit maximization. Boards of directors can monitor management and respond to inefficiency by firing and hiring. The existence of a supervising board with broad powers will frustrate the desired market efficiency if the supervisors are not familiar with the company’s business and have no incentive to see the company profit.

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106 The Law is completely devoid of provisions which protect the interest of minority investors from the manipulation of the majority shareholder.
107 COMPANY LAW, supra note 5, art. 59.
108 COMPANY LAW, supra note 5, arts. 60, 61.
109 COMPANY LAW, supra note 5, art. 61.
3. Management Decisions

a. The Decision Making Process

For a business to operate under true market principles, concern over profit and efficiency should override considerations of public policy and state welfare. Some might argue that public welfare should be an integral part of corporate decision making, but in China, the enterprises have not enjoyed the opportunity of this debate as politics overshadowed all of the decisions made. This author would suggest that for China to enjoy the benefits of efficient management decisions, public policy should be at most a partial consideration in determining the best decisions for a corporation. Ideally, management decisions of the company should be made independent of politics.

Unfortunately, for the past four decades, the Chinese political and social systems have discouraged independent management decisions. During the Cultural Revolution, people learned that if they spoke out or made a suggestion, their words could be misinterpreted or twisted and used as weapons to attack them during subsequent political campaigns. If a manager made an innovative decision to improve production, he or she might well be accused of borrowing from the capitalist system and, despite production increases, be punished for such innovation. In addition to active repression of innovation, China's iron rice bowl system of lifetime-tenured employment also discourages creative thinking on the part of managers or workers.

As a result of the fears of political reprisal and poor matching of skills to jobs, China's enterprises suffer from a severe shortage of management talent. During the late 1970s and early 1980s, China recognized the need for professional management skills and began training managers in business schools. A few students were sent abroad to be educated in the United States or European business schools. Many of these students did not return to China and the knowledge they acquired abroad

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112 Id., at 166; See Gregor, supra note 3, at 79.
was lost to the Chinese enterprise. The government’s handling of student protests in June of 1989 did nothing to encourage Chinese students abroad to return.

Unable to utilize the students’ knowledge, China has taken other measures to fill its management gap. In the beginning, the government felt that many skills would be acquired through the Sino-foreign joint ventures. However, the limited number of such ventures kept the total number of initiates small. More recently, China is taking affirmative steps to ensure more managers are trained abroad and that they return to manage enterprises in China. China also hopes that the Company Law, along with a new openness to investment from Western nations and Asia (including Hong Kong, Singapore and Taiwan where fewer differences in language and management style exist) will help the country to quickly build its base of professional managers.

Under the Western corporate model as it is followed in the United States, the board sets the general direction for the company, but managers are essentially free to make day-to-day decisions without interference. In practice, the management team makes recommendations to the board which are typically rubber-stamped, so management wields almost absolute power. Stockholders are so far removed from day-to-day affairs as to be nearly irrelevant. In countries such as Japan and Germany, management also exercises tremendous control over the day to day affairs of the corporation,

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113 It is estimated only one out of three students sent abroad ever return. In an effort to attract these students back, China has begun to offer tax incentives and job offerings. Josephine Ma, Overseas Educated Enticed to Return Home, SOUTH CHINA MORNING POST, Sept. 28, 1994, available in LEXIS, Nexis Library, SCHINA File.

114 LICHTENSTEIN, supra note 12 at 18.

115 For example, the City of Shanghai has an ongoing management program with the City of San Francisco. Every two years, managers from various enterprises are selected to undergo a one and half year training course in China on all aspects of the business including marketing, financing and accounting. At the end of the classes, the managers come to the United States to be placed with U.S. companies to observe and learn about U.S. management practices. This management training has returned to Shanghai hundreds of mid-level managers who have since been promoted to positions of importance over the years. For most, the critical lesson was not the acquisition of technical expertise, but being able to practice management in a capitalist environment where efficient decision making is prized. Interview with Philip Boyle, former Chair of Business Program, San Francisco-Shanghai Sister Cities Committee.

116 In the United States, the most famous proponents of this theory are Berle and Means. See BERLE & MEANS, supra note 93.
with monitoring of major management decisions done by the board, banks and other institutional investors. 117

Under the Chinese Company Law, although the board of directors oversees many aspects of a company's daily operations, the board is ultimately answerable to the shareholders' board. If the company is privately owned, then the system can work efficiently. Where the company is wholly owned by the State, the administrative organ in charge of the company directly controls the board of directors by appointment. 118 As added insurance, the supervisory committee can use its power to force decisions to conform to official government policies. No matter how skillful the new managers are, their decisions would be subject to constant bureaucratic interference. The Company Law fails to change the line of traditional authority and to encourage an efficient decision making process.

Furthermore, managers will always worry that if the political winds change and China begins another political campaign such as the one it waged in the 1980's on "spiritual pollution," innovative managers would be the target of attacks for bringing Western style management to the Chinese socialist enterprises. Such political campaigns tend to steamroller over people, and the fact that the management skills may well have been acquired at the government's direction and indeed sponsorship would be of little avail. Accordingly, Chinese managers bear the risks of their bad decisions, especially political ones, but do not necessarily benefit directly from good decisions.

For China to attract and utilize the best management talents, one critical element is the need to assure managers that while they must bear the negative consequences of their economic decisions, they will not be subjected to second guessing of their management decisions based the government's political agenda. While managerial talents may be willing to risk their jobs due to bad management decisions, the idea that making politically incorrect decisions may be punished will cause most managers to be so risk adverse as to be afraid of making decisions.

117 For a discussion of Japanese corporate governance, see ZENICHI SHISHIDO, INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE IN JAPAN (1994).
118 COMPANY LAW, supra note 5, art. 66.
119 LICHTENSTEIN, supra note 12, at 100. The campaign denounced all Western influences on Chinese culture imported since 1978, with the targets ranging from taste in popular music to increase in prostitution.
b. Management Incentives

Another vacuum which currently exists in Chinese enterprises, and which the Company Law does not address is a system of incentives for those making management decisions. Capitalist society rewards owner-managers with a return in capital for wise and efficient decisions. Board managed or manager-managed enterprises in the same capitalist model often use a mixed package of stock incentives and salary increases and bonuses based on the performance of the company. In China, assuming that performance of a company can be measured, the incentive to make decisions which promote the well-being of the company, in contrast to the individual decision maker, is absent. Where a Chinese company is actually owned by individual investors, and management decisions are made free from bureaucratic interference, then the incentives do exist.

However, under the Company Law a great majority of the shares in the companies will be in the hands of the State, and the state representative has at least two interests which may conflict: the interest of the company and that of the state. For example, take the most fundamental of business goals: maximizing profits. For an individual owner, if taxes can be avoided legally, there is every incentive to do so. In contrast, for a representative of the State, minimizing taxes for the company results in less income for the State, his or her employer. The representative's decision may depend on such factors whether his or her salary is allocated from funds directly tied to the profits of the company or from a general fund representing the amount of tax revenues the government collects, which might lead to a decision which is inefficient for the company.

A less-than altruistic government employee may have even more conflicting interests in addition to those of the company and the government, such as self-interest and interests of those who can afford a bribe. In these instances, decisions may well be made based on the amount of bribery received or other benefit promised, totally inconsistent with either the interest of the company or the government.


121 Corruption in China is a rampant and pervasive phenomenon. Business is often done by either outright bribery or use of "connections" (Guan xi) to pressure the officials in charge of the approval process into approving an unsound transaction. Despite recent crackdown on corruption and prosecution of high officials on corruption charges, corruption remains a major problem with doing business in China.
Chinese managers, especially those who are strictly employees, have even less incentive than managers elsewhere to act in the interest of the company. Bad managers in the Western corporate world are replaced and their reputations as poor managers will most likely spread in the business community, foreclosing future employment opportunities. In China, the vestiges of the "iron rice bowl" syndrome linger, and bad managers are often retained, but given less decision making power. This practice leads to inefficiency for the company: paying for an employee who is not contributing to the overall profitability of the company. If the new corporations in China are to achieve maximum economic efficiency, managers who are professionally trained, and whose interest is closely tied to the welfare of corporations, should be installed at all levels of the corporation. More specifically, manager compensation and continuing employment should be tied directly to the profitability of the company. The State, as the shareholder, should remain as passive as possible and only intervene when major decisions are being considered. Similarly, the state should judge these decisions as a private shareholder would, rather than confusing other public policy considerations with the goal of profit maximization.

B. External Challenges

1. Administrative Controls

Article 67 of the Law, stating that the assets of a state wholly owned company will be under the supervision of the government authorized investment body or departments, is troubling. Presumably, the Law intends that whichever state agency originally owned the company before its transformation into a "limited liability company" will have the ability to supervise and administer the enterprise's activities. This provision clearly

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122 This is not to suggest that the state should abandon its public function. Rather, the author suggests that the instrument to achieve these policy considerations not be thorough interference with the internal functions of the enterprise as owners. Instead, the government should implement its public policies through separate legislation. For example, if full employment is a public concern, the government should not, as an owner of the enterprise, force hiring or retention of unproductive workers, instead, it can legislate programs for re-educating of redundant workers or provide unemployment insurance.

123 COMPANY LAW, supra note 5, art. 67.
defeats the original purpose for enacting the Company Law—to allow companies to make responsible economic decisions relying upon market rather than political factors. China’s administrative organs clearly lack the information necessary to properly decide the variety, quantity and price of products, and how much to allocate to the Chinese and international markets. The separation of these enterprises from the state administrative organs was intended to allow the enterprises to operate autonomously. Article 67 potentially defeats those purposes. An alternative view would be that article 67 perfectly accomplishes the government’s goal of keeping control.

In practice, the degree of supervision (or interference) could vary vastly from enterprise to enterprise. But as long as such interference is possible, the enterprise will not be able to function independently whether it remains a “state-owned enterprise” or becomes a separately incorporated LLC. The one exception is that when a “large state-owned company has demonstrated good business circumstances and sound business management, it may be empowered to exercise rights of ownership of assets by the State Council.” However, it is unclear when a company will be considered to have demonstrated sufficiently sound business management and judgment so that it will be allowed to freely exercise the rights of ownership. Even if such a company obtains its rights, there is nothing in the Law to prevent the State Council or the administrative organizations which are in charge of the company from suddenly retracting these rights or exercising them on behalf of the enterprise. Also, since this privilege to exercise the rights of ownership is only limited to large scale companies, most of the medium-sized, state-owned companies will remain under the direct control of the administrative organs.

Article 67 further reflects China’s intent to continue administrative supervision of the country’s various enterprises. If the interference by these administrative organs reaches to the level of production, pricing and labor policies, then the independence of these enterprises is completely illusory.

2. Conflicting Orders - Too Many “Mothers-in-Law”

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124 See note 47, supra, and accompanying text.
125 COMPANY LAW, supra note 5, art. 72.
Despite provisions in the Chinese Constitution to the contrary, the confusing and often overlapping lines of authority remains a problematic issue facing China's enterprises. Every Chinese enterprise must respond to the orders of several administrative organs at any given time. For example, a factory which produces petroleum products would be under the direct supervision of the Ministry of Petroleum. Additionally, the local Labor Bureau would be in charge of the allocation of workers to a factory, while decisions regarding exports from the factory are made by the state Import-Export Corporation in charge of the products of the enterprise. This type of interference is not regulatory, as in other nations, but direct intervention by the bureaucrats who staff each of these administrative organs. These bureaucrats rarely have the expertise or incentive to properly supervise the various enterprises for which they are responsible since their expertise is administrative, not technical or managerial. Coordination among these administrative agencies is also notoriously poor.

In addition, Chinese enterprises often suffer under multiple administrative orders. The enterprise may receive one set of orders from the central government and yet another set from the provincial or local authorities. These different sets of orders may not be the same, and, in fact, they often conflict. With all of these "Mothers-in-Law" telling them what to do, enterprises often spend much of their time avoiding or circumventing orders rather than complying with them.

As a consequence, enterprises have developed a philosophy that government orders should be circumvented and not followed. Any cohesion in planning and coordinating the various administrative agencies is lost by the efforts of the enterprises to avoid these top-down orders. One example of such avoidance of central orders is for enterprises to break one large project into small parts so the cost of each part falls below the amount

126 Article 16 of the Chinese Constitution states that a state-owned enterprise shall have power to make its own decisions. P.R.C. CONST., art. 16.
127 All import and export of Chinese products are under the auspices of Chinese state authorized import-export corporations and their local branches. For example, all petroleum by-products would fall under the China National Petroleum By-Products Import-Export Cooperation and all handicraft would be under the control of China National Handicraft Import-Export Corporation.
128 See generally CHINA'S INDUSTRIAL REFORM, supra note 15 at 144. See also, Chen, Planning Supply and Marketing, in CHINA'S INDUSTRIAL REFORM, supra note 15, at 162-67, 180.
129 In China, the phrase "popo duo" or "too many mothers-in-law" is used to describe the numerous administrative and bureaucratic controls faced by Chinese enterprises. See HSU, supra note 23, at 88; Chen, Planning Supply and Marketing, in CHINA'S INDUSTRIAL REFORM, supra note 15, at 44, 162.
130 See generally ZHOU supra note 3, at 44.
which a project will require central government approval.\textsuperscript{131} Many limitations on the decision-making powers of particular enterprises are codified in the statutes which govern them. For example, numerous articles in the “Law on Industrial Enterprises Owned by the People”\textsuperscript{132} set forth limitations on the management powers of the enterprises.

The Company Law does not make any attempt to streamline these various administrative organs. In fact, some questions have already arisen as to how many approvals a Sino-foreign joint venture which is also limited liability company must obtain and who has the authority to grant them.\textsuperscript{133}

3. \textit{Political Control}

In almost all aspects of Chinese society, political control is of paramount importance because control ensures stability and perpetuation of those people in power. Without control, there is fear that the booming economy and the introduction of Western ideas may well “corrupt” the Chinese people.\textsuperscript{134} By carefully controlling change, the Chinese Communist Party hopes to maintain its power. The question is, will the Party continue to support these changes in the long run if its grip begins to loosen? In the past, when a program or a particular legislation enjoyed sustained support from the Party, changes were brought about rapidly.\textsuperscript{135} Similarly, when there is a shift in government policy and the support is withdrawn, the demise of the program can be equally rapid.\textsuperscript{136}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{131} Singh, \textit{supra} note 20, at 22.
\item \textsuperscript{133} This question was posed by a U.S. business person at a conference sponsored by the 1990 Institute entitled “China Foreign Trade and Investment Laws” held in San Francisco on March 24 and 25, 1995, and was directed at a high-level Chinese official from the Ministry of Foreign Economic Trade and Cooperation (MOFTEC). The official was unable to answer. Ostensibly, a Sino-foreign joint venture contract is under the supervision of MOFTEC. The Company Law, on the other hand, specifies the State Administration for Industry and Commerce and other “relevant state authority” for approval. \textit{COMPANY LAW}, art. 19.
\item \textsuperscript{134} See LICHTENSTEIN, \textit{supra} note 12, at 72.
\item \textsuperscript{135} When China wanted to encourage the development of small private businesses in the early 1980’s, it allowed the establishment of \textit{getihu} or individually owned business. Bank loans and licenses were freely available to individuals who wanted to set up their own businesses, usually in the service sector such as tailoring, shoe repair, etc. \textit{SUSAN YOUNG, PRIVATE BUSINESS AND ECONOMIC REFORM IN CHINA} 15-16, (1995).
\item \textsuperscript{136} For example, when the private sector grew and began to compete with the government enterprises, officials who disliked the proliferation of the private businesses would demand the removal of the businesses from their vicinity by launching “environment beautification campaigns.” \textit{Id.} at 76.
\end{itemize}
\end{footnotesize}
society has traditionally followed orders from the top, and the people are used to massive and sometimes 180 degree changes from one program to another.\textsuperscript{137}

If China, due to changes in leadership or policy, decides to revert to a more communist system and abolish private ownership, the owners of the private companies will undoubtedly lose much. Such change has already happened once before in recent Chinese history. After the Communist takeover of mainland China in 1949, officials purported to allow private ownership.\textsuperscript{138} Many capitalists stayed in China, believing in the government’s support of private ownership.\textsuperscript{139} However, as the Chinese Communist party strengthened its hold on China in the early 1950s, such private holdings were systematically seized and converted to public ownership.\textsuperscript{140} Bearing this in mind, the new class of entrepreneurs and capitalists in China should be cautious. Until the government marches irrevocably down the path to privatization, the dangers of losing one’s investment is always present when investing in these newly formed companies.\textsuperscript{141}

4. **Interpretation of the Law**

For any law to be effective in China, it must be enforced by the bureaucrats who interpret and apply the law. Because of China's cautious approach to legislation, laws are often drafted to reflect its broad policy, and specific interpretation is left to the bureaucrats. This practice allows shifts and adjustment of policy without the need to amend the law. If the bureaucrats support the Company Law, they can make the formation and operation of companies relatively smooth and efficient. On the other hand, if the bureaucracy decides that such a law is undesirable, for whatever reason, it can, through various bureaucratic means, make the registration of

\textsuperscript{137} Despite the irrationality of such swings, the pattern repeats over and over. For a discussion of the phenomenon, see ZHOU, supra note 3, at 15.


\textsuperscript{139} Id.

\textsuperscript{140} Id.

\textsuperscript{141} China’s experience with privatization in the agricultural and service sector can teach valuable lessons to the larger industries. See infra note 181. See also, e.g., Liu Jisheng, The Reform of State-Owned Enterprises, in CASE STUDIES OF CHINESE ECONOMIC REFORM (Timothy King and Zhang Jiping, eds., 1992).
a company and its operation extremely difficult. Applications can be misplaced, requests for more details can be made repeatedly, and rejection can be groundless. Therefore, successful operation of these newly created companies will operate effectively will depend largely on the officials responsible for interpreting and applying the Company Law. Even if the central government does not totally reverse policy and reassert control of these newly corporatized enterprises, interference by bureaucracy could easily stifle, and ultimately kill, maturing companies just learning about the market system.

5. Approval Process

The approval process to decide whether or not a company may be established may well be subject to pressures similar to those placed on the Chinese banks. For example, if a ministry is interested in one of its enterprises obtaining LLC status, it may pressure the agency in charge of approving the application for registration. Therefore, in anticipation of such a possibility, the Company Law requires that failure to comply with registration requirements due to pressures from a “higher level” will result in liability to the departments responsible for registration. Such departments are subject to administrative punishments and, in serious cases, criminal liabilities.

Article 223 is a rare official recognition by the Chinese government that such pressure tactics are prevalent in China. Authorities have often been known to exert influence to get projects they favor approved, or to get special treatment for pet enterprises. It is precisely these tactics which have caused Chinese banks to finance numerous projects which would not

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142 While China passed a set of regulations on the registration of the companies outlining details for more advance approvals (article 14), documentation for actual registration (article 17) subsequent changes (articles 23-35), and its eventual dissolution (articles 36-38), the decision to approve does not rest exclusively with the State Administration for Industry and Commerce and its local chapters. Instead, the regulation refers to various unspecified “relevant laws and regulations” which may require that “certain items” be submitted to a “relevant” state authority for examination and approval prior to the commencement of the registration process. COMPANY LAW, supra note 5, art. 19. It is this type of ambiguous language which provides opportunities for random exercises of administrative discretion. See Administrative Rules of the People’s Republic of China Governing the Registration of Companies, supra note 10.

143 COMPANY LAW, supra note 5, art. 233.

144 COMPANY LAW, supra note 5, art. 233.
otherwise merit the funds.\textsuperscript{145} The Company Law's recognition of the problem and the provided solution are important steps in ensuring that the authorities responsible for the regulation of companies exercise independent decision making powers.

The Company Law perhaps could further ensure the unbiased examination of companies by imposing liability on actual individuals in high government positions. This would more effectively prevent high officials from exerting pressure on departments responsible for registering a company. For example, if relatives of a high official attempt to form a company but find themselves unable to comply with all of the statutory requirements, the official may exert pressure on the registering department. In such an event, the Chinese courts should apply article 223 by analogy and find such individuals directly liable for the damages which result from improper registration of a company. Personal liability would be a far more effective deterrent than sanctions against the official department. Approvals which are obtained by exercising unsound administrative discretion will lend to the existence of unsound corporations. Specifying a standard for an enterprise to incorporate and minimizing bureaucratic discretion will go a long way towards elimination of this problem.

If the above issues are not resolved, private enterprises and any efficiency they may bring to the Chinese economy will be short-lived. The failure of these enterprises may also trigger the very social and political unrest which the Chinese leadership fears. Should China fail to make a timely transition into a market economy, two possible consequences may result. If reform does not achieve the economic benefits quickly, the Chinese people may push for a more rapid pace of economic reform. The government may respond by reverting back to a system of a rigidly planned economy if it fears that rapid reforms will erode its power. This would bring about the potential of civil unrest and possibly a revolution. Even if the Chinese populace accepts this reversal, it could lead to the withdrawal of foreign investments (which have only entered China in the past fifteen years), the retrenchment of any political reform, and the inability of China to emerge as a fully participating member of the world economy.\textsuperscript{146} Alternatively, instead of open rebellion, the Chinese people could chart their

\textsuperscript{145} Singh, supra note 20, at xiv-xv.

\textsuperscript{146} China has applied to join GATT and its successor, the World Trade Organization and any such reversal of economic policies may well jeopardize its application.
own economic course by subverting and disregarding official policies.\footnote{There are already signs of provinces and municipal government, especially in the South, which are disregarding central government directives and promoting much more liberal economic policies. \textit{Deng Urged to Implement Reforms}. UPI, Aug. 22, 1995, available in, LEXIS, ASIAPIC Library, UPI file; \textit{Beijing and the Regions; Guangdong Governor Denies Hindering Central Decrees}. \textit{BBC SUMMARY OF WORLD BROADCASTS}, Mar. 17, 1995, available in, LEXIS, ASIAPIC library, BBCSWB file.} This could lead to official central government dictating one policy and the regional and municipal governments implementing another, leading to chaos and uncertainty. Neither of these options is desirable from the perspective the those currently in power. To maintain power and stability, the Chinese government desires to see changes restricted to the economic sphere without jeopardizing its own political power and without unduly changing the Chinese society. The following section suggests changes which need to be made for China to fully enjoy the benefits of the Company Law.

IV. INVESTMENT INCENTIVES AND PRIVATIZATION

Although the Company Law provides a framework for Chinese enterprises to assume a corporate structure, it is silent on how and whether the ownership of the enterprises is to pass from state hands into private ones. Perhaps the most significant failure of the Company Law is that while it provides a mechanism for the incorporation of existing Chinese enterprises, it is silent on how these same enterprises would transform from state ownership to private ownership.\footnote{In fact, the Law specifically contemplates enterprises which are wholly state owned and sets out rules on how it becomes a limited liability company under the Law. \textit{See Company Law, supra} note 5, arts. 7, 21, 66-69, 72.} Until privatization is achieved, the state as the owner must entrust management to the same bureaucrats who still cling to the tradition of life long employment and who lack economic incentives to operate the enterprise efficiently. While the possibility of privatization exists in the Company Law,\footnote{In all of the literature accompanying the Company Law as well as the related regulations, the Chinese authorities have never indicated that privatization was a goal. Rather, the Company Law is treated as the means to reorganize the state-owned enterprises to face market challenges. \textit{David Ho, China's New Company Law: Something Concrete to Go By}, \textit{EAST ASIAN EXECUTIVE REP.}, Feb. 15, 1994, at 9.} the means to achieve it are absent. Since China has not demonstrated a willingness to hand out shares of the state-owned enterprises free, the desirability of investing in these state-owned Chinese enterprises must be examined. Numerous aspects of the Company Law makes investing in these enterprises unattractive.
A. Increase in Stock Price

To have a truly market-oriented, privately-owned enterprise, owners must have an incentive to invest in the company. At present, private investment in China takes the limited form of individuals buying shares of stocks traded on China’s stock exchanges. The issuance of such shares are limited and are carefully scrutinized by the government before the public offering. The Chinese investor’s mentality is rarely one of investing in a company for its future growth. Rather, investment in China’s stock market is very speculative and is intended to take advantage of the phenomenon that the demand for shares far exceeds the availability of shares. Therefore, artificial speculations tend to push up the prices of the stocks well beyond their worth. It is not uncommon for a stock that has been issued at ten yuan (about US$1.25) to increase its value ten fold or 100 fold within a few days due to excessive demand. With such hyperactivity, inevitably, the stock will drop in value just as quickly as it rose. Incidences of suicide by unsophisticated investors who have lost their life savings are becoming more common in China.

It is believed that average Chinese households have tremendous savings which would allow them to invest the savings as capital in

150 See Andrew Browne, China Goes Slow on Stock Expansion, REUTER ASIA-PACIFIC BUS. REP., Nov. 28, 1994 (indicating 288 listed companies with a total market capitalization of approximately 90 billion yuan).

151 See Roller-Coaster Ride, China is Trying to Curb Volatility and Entice More Investors, ASIA WEEK, Nov. 30, 1994, at 49 (supporting “volatility” as the byword for China's stock markets because of their vulnerability to manipulation by large institutional investors who ferment speculation, spread rumors, and distort government pronouncements and policy).

152 See Hisakuni Yonekuri, Shanghai Stock Market in Vanguard of Chinese Reforms, JAPAN ECON. NEWSWIRE, July 20, 1992, available in, LEXIS, ASIAPC library, JEN file (reporting the market increased twenty times over one and one-half years, with some shares rising as much as 100 fold).


154 See Andrew Browne, China Stocks Surge as Rescue Package Unveiled, REUTER ASIA-PACIFIC BUS. REP., Mar. 14, 1994, available in LEXIS, ASIAPC library, REUAPB file (discussing the media reports of suicides as a result of despair over market losses); China's Shanghai Bourse Claims Second Suicide, REUTER ASIA-PACIFIC BUS. REP., July 1, 1992, available in LEXIS, ASIAPC library, REUAPB file (stating the speculation resulting in on suicide in May 1992 and another in July 1992); Chinese Woman Commits Suicide Over Stock Losses, AGENCY FRANCE PRESSE, Nov. 11, 1994, available in LEXIS, ASIAPC library, AFP file (reporting woman lost life savings speculating in stocks); Failed Chinese Investor Leaps to His Death, REUTER ASIA-PACIFIC BUS. REP., Nov. 8, 1993, available in LEXIS, ASIAPC library, REUAPB file (confirming suicide of investor after serious losses in stock market).
enterprises. Unfortunately, these same investors lack the sophistication and the knowledge about investment for the purpose of growth as opposed to speculation. Instead, most Chinese would rather put their money into something tangible such as gold than in a company they can neither touch or hold. Until a pool of true "capitalists" emerges at the core level of Chinese society, investments in corporations will continue to come primarily from government sources and foreign investors. As a result, the type of enterprises that these investors would most likely support will continue to be skewed toward government priorities and exports rather than the needs of the Chinese domestic market.

B. Reserve Funds/Dividends

A unique feature of operating as a Chinese company is the requirement that the company allocate a certain percentage of its profits into a mandatory accumulation fund and a fund for "official public welfare." The Law requires almost twenty percent of profits be put into these accumulation funds. Therefore, an investor in a Chinese company may need to wait much longer for significantly smaller dividends than an investor in a similarly profitable company in the United States.

The Chinese Company Law is also quite conservative regarding the declaration of dividends. All past losses must be paid up before any dividends may be paid. Nimble dividends are not allowed.


156 See Tony Walker, The Chinese Go for Gold: Why the Authorities are Encouraging the Traditional Love of the Most Precious Metals, FIN. TIMES, Feb. 19, 1994, at 3 (since 1984 gold consumption has increased an average of 20% per year, and the Chinese are encouraged to purchase gold as a form of savings); Richard Warren, Demand Tails Off as Price Rises, S. CHINA MORNING POST, June 18, 1994, at S1 (demand in Greater China increased for the second successive quarter despite gold prices).

157 This accumulation fund is much like an earned reserve account, with the difference that the reserve is mandatory until the fund is in excess of 50% of the company's registered capital. COMPANY LAW, supra note 5, art. 177.

158 COMPANY LAW, supra note 5, art. 177.

159 While there is no requirement that a profitable United States company distribute its profits in the form of dividends, companies will generally do so to keep investors satisfied and stock prices high.

160 COMPANY LAW, supra note 5, art. 177.
Interestingly, the distribution of profits in a limited liability company is almost like a limited partnership in the United States. The distribution of profits is according to the percentages of contributed capital by the shareholders, not according to their shareholdings. For example, if one party contributes more capital and receives the same number of shares as the other, profit distribution would be in accordance with that individual's contributed capital as opposed to the number of shares received. For companies limited by shares, distribution is in accordance with the shareholders' shares.

China's Company Law lacks the flexibility of its United States counterparts in that it does not provide for different classes of stock with different voting or dividend rights. The Law is silent regarding the corporate ability to issue preferred shares and common shares. The absence of different share issues further discourages certain investors who prefer a more certain (albeit potentially lower) return on their investment.

The Company Law also places significant restrictions on shareholders' ability to transfer their interest in a Chinese limited liability company. In this respect, a Chinese LLC is much like a closely held corporation in the United States. Unlike the close corporation in the United States, however, the Chinese company does not have a choice in opting out of these restrictions on transfer.

China's enterprises are unaccustomed to the notion of payment of dividends based on performance. Instead, many stocks traded in China pay a fixed rate of interest, similar to bonds in the United States. The Company Law lacks rules specifically mandating distributions to shareholders, and the Law's rules on dividends and distributions are very conservative. Without dividends, the incentive to invest is further diminished.

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161 Some states in the United States, such as Delaware, allow corporations to make a distribution in a year where there is current earnings. The amount of the distribution can be up to the amount of current earnings and there is no need to make up for previous year's losses. General Corp. Law of Delaware § 170.
162 COMPANY LAW, supra note 5, art. 177.
163 COMPANY LAW, supra note 5, art. 177.
164 Generally, preferred shares in a United States corporation will receive dividend payments before common shareholders and have priority in liquidation but preferred shares may also have some voting rights. Larry C. Sauvain, Preferred Stock, in THE HANDBOOK OF FIXED INCOME SECURITIES, 333, 336-37 Frank J. Fabozzi & Irving M. Pollack, eds., 1983.
165 COMPANY LAW, supra note 5, art. 35.
166 See supra note 161 on dividends.
167 See supra note 161 and accompanying text on dividends.
C. Transferability

Limited liability companies in China are not freely traded on the stock exchange,\(^{168}\) thus eliminating investment incentives resulting from the possibility gains when the stock is sold. Since Chinese LLCs, like close corporations in the United States, face significant restrictions on the transfer of shares, investors cannot easily recoup their investment by privately selling the shares to another investor.

Furthermore, limited transferability means that once investments are made, even the most efficient enterprises cannot easily attract investors away from less efficient enterprises. In a capitalist market, the most powerful tool a shareholder has to combat inefficient management is the ability to sell his share in the company and invest elsewhere.\(^ {169}\) Where transfer is limited not by choice of the investors but by government regulations, the investor’s ability to seek out the enterprise offering the best returns is taken away.\(^ {170}\) This lack of liquidity discourages potential investors.

D. Emphasis on Profitability

China’s Company Law provides that certain companies may become publicly listed companies.\(^ {171}\) In addition to privately held companies, the Law envisions that a company established by a state-owned enterprise may transform itself through a public offering if it is profitable enough.\(^ {172}\) This profitability requirement represents a strong theme running through China’s listing requirements. Any company wishing to list its stock publicly needs

\(^{168}\) COMPANY LAW, supra Note 5, arts. 143-50 (P.R.C.). Although “there is no universally recognized definition of a close corporation, there is general agreement as to its major attributes.” JESSE H. CHOPER, JOHN C. COFFEE, JR. & C. ROBERT MORRIS, JR. CASES AND MATERIALS ON CORPORATIONS 683 (3rd Edition, 1989).

\(^{169}\) The ability to freely transfer creates an external monitoring system to keep management honest and effective. See Easterbrook and Fischel, supra note 120 at 1431-1432.

\(^{170}\) While a “close corporation” in the United States may also limit transferability, the initial choice of entity is decided by the investors and the restrictions on transfer are often based on consideration of compatibility of investors and maintenance of control by a specific group. The restrictions in China’s Company Law govern all corporations unless a corporation is publicly traded. Restrictions are mandatory and the investors may not opt out of the restrictions as they are able to in the United States. COMPANY LAW, supra note 5, art. 35.

\(^{171}\) COMPANY LAW, supra note 5, arts. 151-52.

\(^{172}\) COMPANY LAW, supra note 5, art. 152.
to be profitable, which the Law defines as a company which must not "have incurred losses over the last three consecutive years." Such a requirement essentially eliminates the ability of a growing company to access capital for funding research and development. There are numerous examples of companies in the United States which operate at a loss for many years, but nevertheless are publicly listed in order to gain access to needed capital. A profitable track record is only one indicator of the success of a company, so China's rather paternalistic requirement that only profitable companies be listed points out what may be an inherent misunderstanding of the nature of public capital markets. It may also reflect the Chinese authorities' cautious approach to capitalist practices.

E. Lack of Disclosure Requirement

While China has two functioning national stock exchanges, one in Shanghai which opened in 1990, and one in Shenzhen since 1991, regulations on share issues and trading on these exchanges have been locally formulated. Each exchange has different standards for listing and trading. Currently, a national securities law remains drafted but unissued. Disclosure requirements and anti-fraud provisions, while available, remain vague and the penalties for violations are limited to fines. Most importantly, while the provisional regulations call for fines to be imposed on inside traders and others who commit fraud in relation to stock transactions, shareholders have only limited remedies available to them. The law does not provide for direct private suits or derivative suits against the violators. Without a national law which clearly protects

173 COMPANY LAW, supra note 5, art. 157(4)
175 The two exchanges separately issued rules under the guidance of the local branches of the People's Bank of China. The two sets of regulations were inconsistent and independent. Jacob P. Alpren, China Issues Class B Share Rules in Effort to Set Unified Standard, ASIA WALL ST. J.R.L., Jan. 3, 1996, at A20.
176 Id.
178 Interim Regulations, supra note 177, at art. 72.
shareholders' rights and provides them with effective remedies, investors in China's stock market should remain wary.

V. LEARNING FROM THE PAST: THE NEXT STAGE

Beginning around 1978, China officially recognized the need to introduce into its economy more market mechanisms to correct intrinsic inefficiencies. China began to implement fundamental policy changes to its strict state-planned economy in several phases. The first change was to move from "directive planning" to "guidance planning" (Zhidao Jihua) through a "contract responsibility system." Production targets were given to the enterprises not as goals but merely as guidelines. Enterprises which produced more than the goal were allowed to sell the excess and retain some of the additional profits. China first introduced this change in the agricultural sector and has since expanded it into many industrial operations.

Later, in the 1980s, China introduced a financial accountability system, whereby some manufacturing enterprises became responsible for their own profits and losses. Profits were to remain with the enterprises, and taxes were to be paid to the government. Such financial accountability led to unexpected results: enterprises did begin to care about profits, but only short-term profits. In order to generate quick income, many Chinese enterprises raised their prices and lowered the quality of their goods, thereby boosting profits. Some companies engaged in speculative trade in raw materials rather than using their allocated resources to produce goods

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179 HSU, supra note 23, at 35.
180 Singh, supra note 20.
181 Under the Communist government, China's agricultural sector was based on the commune system. The communes were dissolved with the introduction of the "responsibility" system. Agricultural production was redivided amongst family as well as private groupings of farmers into collective and private enterprises. These new enterprises are now responsible for the profits and losses of the land assigned. The new allocation of land has brought significant improvements to agricultural production and prosperity to many individual farmers. ZHOU, supra note 3, at 5-8; see also GU, supra note 58 at 39-41; HSU, supra note 23, at 35.
182 See Chen, supra note 15, at 172-73; ZHOU, supra note 3 at 6-7. Mostly, these changes were restricted to light industries.
183 See generally Liu, The Reform of State-Owned Enterprises, in CASE STUDIES OF CHINESE ECONOMIC REFORM, supra note 141.
as originally intended. Then, as soon as profits were generated, large bonuses were distributed to workers and management so that less taxes would be paid to the government. Since everyone in China was aware that these economic and political policies might change at any moment, managers neglected to plan on a long-term basis or to reserve funds for future expansion.

This period of financial accountability actually generated high inflation and a lower quality of goods overall. Wages increased dramatically, but did not necessarily reflect a rise in prices or productivity. Black market trading in certain goods became prevalent, and corruption was rampant. To address the resulting chaos, the Chinese government reacted in 1988 with a policy of restricting growth through "austerity measures." Authority to control production and distribution

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185 See generally Liu, The Reform of State-Owned Enterprises, in CASE STUDIES OF CHINESE ECONOMIC REFORM, supra note 141.
189 See GU, supra note 58, at 167-69. Compare Dwight H. Perkins, CHINA: ASIA'S NEXT ECONOMIC GIANT? 65-67 (1986) (concluding that "corruption" is in many cases the critical rationalizing force which keeps China's system from grinding to a halt).
190 See LICHTENSTEIN, supra note 12, at 82-85. The twenty austerity measures are: (1) reduce investment in capital construction, (2) reduce group purchases, (3) keep growth and consumption funds under control, (4) stabilize financial markets, (5) adopt measures to increase savings, (6) consolidate administrative companies, (7) special management to farm capital goods, especially chemicals, fertilizers, and pesticides, (8) strengthening management of grain markets, (9) prevent hoarding and speculation, (10) increase management control of rolled steel and non-ferrous metals markets, (11) decrease exports of sought after commodities, (12) decrease imports of cigarettes and liquors, (13) increase pace of housing reform, (14) encourage enterprises to issue shares to workers in order to take the pressure off consumption, (15) increase workers "sense of responsibilities in loving their factories," (16) implement the rule which allows for the transfer of land use rights, (17) implement the rule which allows managers the right to make optimal use of labor, (18) conduct annual financial inspections, (19) enforce tax management, and (20) increase control over foreign debt. Id. at 83.
was markedly curtailed at the enterprise level. Central planning was re-emphasized to a limited extent.

The problems which occurred during China's "financial accountability" experiment demonstrates what can result when China introduces only one aspect of capitalism, such as financial accountability, into its socialist system without changing other factors which affect the economy. The affected organizations quickly learned how to squeeze maximum short-term advantage out of the change, knowing that loopholes and opportunities for personal profiteering would be shut down in subsequent changes in law and policy. The cumulative effect of the profiteering quickly became overwhelming, and the government was forced to take "corrective measures." These regular pendulum swings in Chinese government policy have become the one constant on which the citizenry can depend. A saying has emerged to describe this phenomenon: "Enterprises die as soon as they are controlled, there is chaos as soon as they are released, as soon as there is chaos they are controlled again, and as soon as they are controlled they die again." (Yi tong jui si, yi fang jiu luan, yi luan you tong, yi tong you si).

Success in the government's early experiments with a return to private ownership is evident in the service industry. Businesses such as restaurants, shoe repairs, tailors, and similar service industries are increasingly owned and operated as private enterprises. Most of these

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191 Some may argue that the control of production never left central government planning. Although China instituted the "Contract System" where the enterprises enter into contracts with the government for amount of production, the fact that the other party is the government led only to dependence on these contracts and the terms arrived at were often dictated by the government bureaus. At least two Chinese authors have argued that the contract system merely shifted control from central government to provincial and regional government. See generally Liu, supra note 141, at 98-99.


193 On March 6, 1995, China's leaders admitted that economic mistakes were made in recent years. Patrick E. Tyler, Chinese Leader Says "Mistakes" by Gov't Fueled Inflation, N.Y. TIMES., Mar. 6, 1995, at A1. In response, the government will take corrective steps to curb inflation. Id.

194 See FEWSMITH, supra note 43, at 66.

195 It is difficult to calculate the precise percentage of the service sector which is in private hands. Chinese state owned enterprises have traditionally combined services such as repairs into manufacturing enterprises to avoid the appearance of exploiting others' labor. Singh, supra note 20, at 9. Under Marxism, repairs were accepted if the enterprise also produced the original item. "Pure" service, such as at a repair shop, would be unacceptable. Services such as cleaning and mending were virtually eliminated.
private enterprises are owned and operated either as sole proprietorships or family partnerships.\textsuperscript{196}

By moving relatively slowly and allowing the development of private enterprise only in strictly controlled sectors, the government has maintained tight control of the economy. For example, privately held companies may not engage in the defense industry, banking, dealing with goods under State monopoly, or any other operation which is prohibited by the State.\textsuperscript{197} Even in those sectors which have been allowed private ownership, the government has managed, through taxation and police activities, to keep private enterprises on a tight rein while enjoying the benefits of the owners' creativity and entrepreneurism.\textsuperscript{198}

In contrast, the largest and most important industries in China, such as transportation, telecommunications, and exploration of natural resource such as oil and coal, are still primarily under State control.\textsuperscript{199} As a result, they remained largely immune to recent moves towards marketization. The need to control this sector of the economy results from significant national concerns. While the author recognizes the desire of maintaining control over key industries, certain changes which could be implemented in non-vital sectors would go a long way towards a successful implementation of the Company Law. A list of remaining problems follows, together with some suggested changes for each sector.

\textsuperscript{196}Although China's Civil Code recognizes these forms of business, there is currently no specific law governing their formation, structure, or liability. \textit{CIVIL CODE OF THE PEOPLE'S REPUBLIC OF CHINA, reprinted in CHINA L. FOREIGN BUS. (CCH Austl.) § 19-150, arts. 4, 5 (1986)}.

\textsuperscript{197} \textit{PROVISIONAL REGULATIONS ON PEOPLE'S REPUBLIC OF CHINA PRIVATE ENTERPRISES, reprinted in CHINA L. FOREIGN BUS. (CCH Austl.) § 13-546 (approved by the State Council on June 3, 1988, promulgated on June 25, 1988, and effective July 1, 1988)}.

\textsuperscript{198} The existence of the private sector has not been without controversy. For a detailed discussion of the evolution of the private enterprise in China, see generally, Susan Young, \textit{PRIVATE BUSINESS AND ECONOMIC REFORM IN CHINA, supra note 135}.

\textsuperscript{199} Although there has been a steady shift from state-owned entities to other forms since 1978, the affected enterprises have been light industries such as textiles, food processing, arts, and crafts. Singh, \textit{supra} note 20, at 7.
If the allocation of labor remains controlled by government, new companies will have a difficult time attracting the necessary pool of talent. Similarly, state-owned enterprises converting into limited liability companies will have a difficult time ridding themselves of their excess labor force.

If price controls remain in place, an innovative enterprise will not have the incentive to spend money and resources developing new and better products. Similarly, if raw materials remain subsidized, the enterprise cannot accurately determine its true profitability.

If capital funding is not competitively based but remains based on government allocation, efficient enterprises may not get necessary capital while inefficient ones continue to be subsidized.

If each decision to expand or merge is not based on economic efficiency but rather based on political/bureaucratic lines of power, then economies of scale cannot be achieved.

If the population is not educated about the reasons for investment and investment returns are limited by restrictive dividend policies, restriction on the transferability of shares, onerous reserve fund requirements, and no legal protection from fraud, the pool of investors will remain limited.

If bureaucrats insist on exercising their powers over shareholder board or supervisory committees as granted under the Company Law, and ignore the advice of professional management, enterprises under their care will operate under the old system without any move towards market efficiency.

Clearly, China cannot simply legislate capitalism. It must instead provide the necessary ingredients for a market economy to flourish. To further this transformation to a more market oriented economy, the Chinese government must relinquish more control. While the following measures may be difficult because they require the government to relinquish some
control, they are necessary for the ultimate development and well-being of China.

- China can gradually eliminate price control or restrict price control to only the most scarce and vital commodities. This would give enterprises the ability to accurately predict their cost of goods and price goods accordingly. Chinese products would then be sold competitively, with the quality of goods and services reflected in their prices and with the demand for goods determined by the market. These changes do not require that the Chinese government end all price control, but to the extent that goods undergo significant processing, the elimination of price control would allow goods to be sold at prices closer to their "true" value.\(^{200}\)

- China needs to free up its labor assignment system. Obviously, with a population of over one billion, job placement cannot be instantly transformed into a market system of free choice. However, close matching of the individual's training with job requirements would be a good first step. Mobility after initial placement should also be encouraged. True mobility, however, is unlikely to occur until China implements a social security system which provides unemployment and retirement benefits that are not controlled by employers. Enterprises should be encouraged to shatter the iron rice bowl. Pay and promotion should be based on merit.

- Political interference in management decisions must be eliminated or reduced as much as possible. Efficient management decisions cannot be made if managers are constantly in fear of being second guessed by bureaucrats who

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\(^{200}\) Elimination of price controls would, generally, cause inflation. Usually, in economies which have engaged in prolonged periods of price control, there has been artificial depression of the prices. (For a few goods, this concept may have been the reverse.) Along with price decontrol, the assumption is also that government subsidy of other inputs, such as energy and labor, would be reduced, thereby placing more inflationary pressure on the economy. For a discussion of the economic implementation of price decontrol see Kazimierz Laski, *Transition from Command to Market Economies in Central and Eastern Europe: First Experiences and Questions*, in *The Transition from Command to Market Economies in East-Central Europe* 37-40 (Sandor Richter ed., 1992).
consider political rather than economic consequences of every decision.

- Banks and other sources of capital must also be freed from political pressure. Decisions to invest or lend money must be based on business plans and not on political agendas. This is the one way in which capital allocation will benefit the efficient enterprises.

- China must eliminate inefficient enterprises by enforcement of bankruptcy statutes.²⁰¹

Without these changes, the enterprises operating under the Company Law will be saddled with excess labor allocations based on past practices, price structures reminiscent of the old system, outmoded technology, and outdated management concepts. These steps may not be easy for a government facing political challenges in the post-Deng era. However, the China’s leaders should bear in mind that while regressing to a planned economy may allow for temporary control, ultimately it is a formula for losing power. Having tasted the benefits of marketization on a limited scale, the Chinese people are unlikely to willingly relinquish their economic gains.

Perhaps the single greatest obstacle to a successful transformation of the Chinese economy is whether political reform can keep pace with economic reform. If there is significant retrenchment of economic growth due to ideological or political struggle in a succession bid, the stability and prosperity of the economy will be in genuine doubt. On the other hand, if the post-Deng succession is accomplished with all of the participants focused on retaining past gains, then China’s future will remain bright and the promise of becoming one of the world’s greatest economies will be within reach.

²⁰¹ Although the Company Law recognizes the possibility of bankruptcy, it does not specify what constitutes bankruptcy except as the “inability to pay its debts when due.” COMPANY LAW, supra note 5 art. 189. While China does have a set of Bankruptcy Rules in the Law of the People’s Republic of China on Enterprise Bankruptcy (Trial Implementation), reprinted in CHINA L. FOREIGN BUS. (CCH Austl.) § 13-522 (1986), there have only been a few hundred cases of bankruptcy since the Rules were adopted and even fewer by state-owned enterprises. Carrie Lee, Bankruptcy Rules Need Overhaul, S. CHINA MORNING POST, Jul. 2, 1994, at 3.
VI. CONCLUSION

China's Company Law takes a giant step forward by recognizing private ownership and the need for structural and organization change at the enterprise level. However, it does not go far enough to allow these newly formed companies the ability and the incentive to operate independently and make economically efficient decisions. So long as the great majority of the Chinese economy and its bureaucracy operate in a socialist mode, the new enterprises formed under the Company Law will not be able to make decisions based entirely on market factors.

For China to fully enjoy the fruits of marketization, it must allow companies to operate as independent economic units able to make decisions based on the well-being of the company, rather than other, extraneous factors. The government's role is to ensure the overall welfare of the society, but when these public policy considerations are manifested by micro-managing companies through existing bureaucratic lines, the result is a formula for inefficiency. Chinese companies must be able to make decisions free from bureaucratic interference. Enterprises must be allowed to succeed or fail on their own, without government subsidy or interference.

As the enterprises become more experienced at accumulating and digesting market information, they will make better decisions. Those who make the right decisions will succeed and others will disappear. The next critical step for China's transition into a true market economy is to privatize as much of the government owned enterprises as possible. Only then will China reap the full benefits of the Company Law. Until privatization occurs, the best chances of these companies successfully operating in China's current economy is for the government to exercise maximum restraint and refrain from interfering at the micro level.