

Counter-Arguments to the Notion of Confucianism as a Fundamental Cure for China's Corporate Governance Problems

Tianshu Zhou*

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Introduction

One longstanding corporate governance theory raises serious doubts regarding the global convergence of corporate governance.¹ Specifically, it is difficult, if not impossible, for corporate governance to formally converge across different jurisdictions, because corporate governance is context-specific. Governance is determined by political institutions and the cultural background of a particular jurisdiction.² Accordingly, the combined forces of globalisation will prompt different corporate governance regimes to become divergent rather than convergent. Jurisdictions must achieve global best practice by implementing different legal rules.³ In accordance with the above theory, an emerging line of scholarship suggesting that China's corporate governance reform can rely on its own cultural heritage—namely, self-management based on Confucianism—has become increasingly prevalent in academia.⁴ The core argument of this emerging notion is that compared with law and regulations, traditional Confucian ethics provide a better fit within China's socio-cultural context. Therefore, Confucianism is expected to be more powerful in curing China's corporate governance problems than law and regulations. Two specific ideas support this argument. First, these authors indicate that formal legislation and regulations cause serious problems in China because of

the weak enforcement regime; therefore, their functions should be partially replaced by Confucian ethics. Secondly, the authors suggest that Confucianism can promote sound commercial practices by reducing the corruption in large public companies and by correcting managers' behaviour. Although this argument is insightful, it possesses several serious loopholes that will be examined in this article using different perspectives. First, this article introduces the path dependence theory. By applying this theory in the context of China's corporate governance, this article suggests that it is difficult for China's existing corporate governance regime to be partially replaced by the proposed self-management based on Confucianism. Moreover, it is even difficult for Confucianism to co-exist with the current regime. Secondly, by recognising the complexity of Confucianism, this article examines the second idea of the argument regarding whether Confucianism reduces corruption and improves managerial behaviour.

Is Confucianism capable of replacing or co-operating with formal law and regulation?

The essence of the path dependence theory⁵ is to emphasise the “lock-in” effect and “self-reinforcing” consequences of the development of a system. In an economic sense, path dependence results in “lock in” and “self-enforcement” effects through positive feedback and increasing returns.⁶ The cost of switching to a previously discarded alternative accumulates over time, rendering whole change less and less likely.⁷ Economic considerations, such as “fixed cost”, “learning effects” and “network effects” make an existing institution “extremely difficult to abolish”.⁸ The path dependence theory plays an important role in moving the discussion of institutional stability beyond the unassailable notion that “history matters”.⁹ According to Bebchuk and Roe, path dependence in the context of corporate governance can be divided into two levels. One is “structure-driven path-dependence”. The other is “rule-driven path-dependence”.¹⁰ This article focuses on the rule-driven path dependence theory, which effectively explains why

* Tianshu Zhou, LL.M (London) PhD in Law (Edinburgh), Assistant Professor in Law and Economics Centre of China University of Political Science and Law; email: tianshu0214@hotmail.com.

¹ William Bratton and Joseph McCahery, “Comparative Corporate Governance and the Theory of Firm: The Case Against Global Cross Reference” (2000) 38 *Columbia Journal of Transnational Law* 213, 214; Douglas Branson, “The Very Uncertain Prospect of ‘Global’ Convergence in Corporate Governance” (2001) 34 *Cornell International Law Journal* 321.

² See Mark Roe, “Political Preconditions to Separating Ownership from Corporate Control” (2001) 53 *Stanford Law Review* 539; Amir Licht, “Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform” (2004) 22 *Berkeley Journal of International Law* 195.

³ Lucian Bebchuk and Mark Roe, “A Theory of Path Dependence in Corporate Ownership and Governance” (1999) 52 *Stanford Law Review* 127; Ronald Gilson, “Globalizing Corporate Governance: Convergence of Form or Function” (2001) 49 *American Journal of Comparative Law* 329.

⁴ Charles Lam and S.H. Goo, “Confucianism: A Fundamental Cure to the Corporate Governance Problems in China” (2014) 35 *Company Lawyer* 52; Angus Young, Grace Li and Alex Lau, “Corporate Governance in China: the Role of the State and Ideology in Shaping Reforms” (2007) 28 *Company Lawyer* 204. For some relevant points, also see Jingchen Zhao and Shuangge Wen, “Gift Giving, Guanxi and Confucianism in a Harmonious Society: What Chinese Law Could Learn from English Law on Aspects of Directors' Duties” (2013) 34 *Company Lawyer* 381.

⁵ For a general conceptual discussion of path dependence in the context of corporate governance, see Mark Roe, “Chaos and Evolution in Law and Economics” (1996) 109 *Harvard Law Review* 641.

⁶ Taylor Boas, “Conceptualizing Continuity and Change: The Composite-Standard Model of Path Dependence” (2007) 19 *Journal of Theoretical Politics* 33, 37.

⁷ See Boas, “Conceptualizing Continuity and Change” (2007) 19 *Journal of Theoretical Politics* 33, 37.

⁸ James Mahoney, “Path-Dependence in Historical Sociology” (2000) 29 *Theory and Society* 507, 515.

⁹ See Boas, “Conceptualizing Continuity and Change” (2007) 19 *Journal of Theoretical Politics* 33, 34.

¹⁰ Bebchuk and Roe, “A Theory of Path Dependence in Corporate Ownership and Governance” (1999) 52 *Stanford Law Review* 127.

it is difficult to replace the current corporate governance regime based on law and regulation with Confucian moral standards.

Once a system has entered into path dependence, any substantial reform is difficult to justify because the cost of reform overwhelmingly exceeds its benefit. As Siems argues:

“Legislators have mostly already attained a local optimum (graphically, a local hill). To be able to improve the law further in the direction of an overall optimal, they would however first have to come down from their ‘local hill’. Legislators are, however, often not willing to do so.”¹¹

After understanding the theory of path dependence, the question concerning “to what extent China’s legal regime of corporate governance enters into a strong version of path dependence” will be approached using three different perspectives, namely, sunk adaptive cost, learning by using and network effect.

Sunk adaptive cost

“Sunk adaptive cost” indicates the phenomenon whereby once costs are sunk into an existing system without the existence of any better alternatives, maintaining this system is efficient.¹² A large number of Western rules from civil law and Anglo-American systems have been introduced into China’s company law regime. At this juncture, it is useful to utilise anti-director¹³ and anti-block-holder indexes¹⁴ to illustrate generally how China’s formal legislation is used to regulate the securities market. Anti-director and anti-block-holder indexes are two sets of standards developed by a group of law and finance scholars. The anti-director index developed by La Porta, Lopez de Silanes, Shleifer and Vishny (“LLSV”) seeks to evaluate the quality of shareholder protection against directors or managers’ managerial misconduct in a given jurisdiction. This index implies

that the quality of the law on the statute books has high explanatory power regarding financial market development.¹⁵ However, as Shleifer and Vishny argue:

“[I]n large corporations of most countries, the fundamental agency problem is not the Berle and Means conflict between outside investors and managers, but rather that between outside investors and controlling shareholders who have nearly full control over the managers.”¹⁶

In response to the agency cost between outside investors and controlling shareholders, Pistor et al. have also developed the anti-block-holder indexes, which can be regarded as an extension of LLSV’s index.¹⁷

Table 1: Shareholder protection regime in China

Shareholder protection regime (China)		
<i>I. Shareholder protection against executives</i>	<i>Company Law 2005 Securities Law 2005</i>	<i>Market Regulator’s Regulations</i>
<i>Anti-director index</i>		
(a) Shareholder can email their vote to the company	No relevant rule	Yes ¹⁸
(b) Shareholders are not required to deposit prior to the AGM	No relevant rule	No relevant rule
(c) Cumulative voting or proportional representation of minorities in the board of directors is allowed	Yes ¹⁹	Yes ²⁰
(d) An oppressed minorities mechanism is in place	Yes ²¹	Yes ²²
(e) The minimum percentage of capital that is necessary for a shareholder to call an extraordinary general meeting is equal to or less than 10%	Yes ²³	Yes ²⁴
(f) Shareholders have pre-emptive rights that can only be waived by shareholder votes	Yes ²⁵	No relevant rule
<i>II. Minority protection against block holders</i>		
<i>Anti-block holder index</i>		

¹¹ Mathias Siems, *Convergence in Shareholder Law* (Cambridge University Press, 2008), p.295.

¹² Chih-Wei Huang, “Worldwide Corporate Convergence within a Pluralistic Business Legal Order: Company Law and the Independent Director System in Contemporary China” (2008) 31 *Hastings International & Comparative Law Review* 370.

¹³ Rafael La Porta, F. Lopez de Silanes, A. Shleifer and R.W. Vishny, “Law and Finance” (1998) 106 *Journal of Political Economy* 1113.

¹⁴ Katharina Pistor, Martin Raiser and Stanislaw Gelfer, “Law and Finance in Transition Economy” (2000) 8 *Economics of Transition* 325, 360. This table does not contain the variables of the anti-block index that overlap with the LLSV index.

¹⁵ See Pistor, Raiser and Gelfer, “Law and Finance in Transition Economy” (2000) 8 *Economics of Transition* 325, 326.

¹⁶ Andrei Shleifer and Robert Vishny, “A Survey of Corporate Governance” (1997) 52 *Journal of Finance* 737.

¹⁷ See Pistor, Raiser and Gelfer, “Law and Finance in Transition Economy” (2000) 8 *Economics of Transition* 325.

¹⁸ ZhongguoShangshiGongsiZhiliZhunze [Corporate Governance Guideline 2002] art.8.

¹⁹ Company Law 2005 art.106.

²⁰ Corporate Governance Guideline 2002 art.31.

²¹ Company Law 2005 art.152.

²² Corporate Governance Guideline 2002 art.32.

²³ Company Law 2005 art.102.

²⁴ Corporate Governance Guideline 2002 art.43.

²⁵ Company Law 2005 art.35.

Shareholder protection regime (China)		
(a) Shareholder may take judicial recourse against a decision taken at a shareholder meeting (SHM)	Yes ²⁶	Yes ²⁷
(b) At least 50% of total voting shares must be represented at a SHM for it to take a binding decision	Yes ²⁸	Yes ²⁹
(c) Mandatory takeover bid	Yes ³⁰	Yes ³¹
(d) Acquisition of larger blocks of shares triggers mandatory disclosure	Yes ³²	Yes ³³

As Table 1 shows, the current legal regime adopts nearly all the international standards for shareholder protection. It can be argued that some of these transplanted rules may not work well in China and may even cause some problems. However, it would be inefficient to abolish these rules at a time when they are developing into an integrated system, given the significant investments made in creating this system. All companies aligned their business forms and management structures with this legal framework. Both market participants and legal end-users have invested time and effort into learning, and adapting to, this system. Consequently, the cost of change could outweigh any advantages accruing from such change. The rational solution therefore appears to be, as Roe's phrases it, to "resurface" rather than "revolutionise" the existing system.³⁴

Learning by using

The "learning effect" refers to the phenomenon whereby the more one model is used, the more its efficiency can be improved vis-à-vis other alternatives.³⁵ This theory usually applies in the context of technology diffusion.³⁶ This theory also has an explanatory power to legal reception. Chinese legal end-users have already made great efforts in learning the Western legal theories (not only the company law theories) so as to solve Chinese problems. The "learning effect" is not limited to the legal end-users, who use the law in their daily work, but extendable to the people who work under the regulation of the laws. If the laws change fundamentally, the market participants are not only forced to re-invest their efforts

to learn the new law, but also compelled to change existing business customs. All these activities increase the costs of judicial and business practice.

The "learning effect" takes place in China in two trajectories. First, it arises from "bottom to top". Liebman's recent empirical research has already shown that when Chinese judges hear difficult cases, they routinely research how any similar such case has been dealt with in developed jurisdictions for guidance.³⁷ In practice, Western law and jurisprudence assists judges and lawyers to localise transplanted legal rules. For example, the experience of US securities litigation plays a vital role in the Chinese judicial practice. *Basic Inc v Levinson*³⁸ adopted the "fraud-on-the-market" theory to deal with the "systemic risk defence" in litigation relating to corporate misrepresentation. This US approach is appropriately used by Chinese local courts to solve problems in Chinese securities litigation.³⁹ A more recent example is the Chinese judges who deal with the fiduciary duties cases (in which directors who have resigned run a business similar to that of their former employer) by interpreting the law in an Anglo-American approach even without the support of formal legislation.⁴⁰ Secondly, a "top to bottom" evolution might also be expected where Western experience is accessible. The Chinese Supreme Court encourages judges to widen their horizons by learning from foreign legal theories. For example, the Supreme Court recently issued a series of Official Interpretations (the Interpretations) of the 2005 Company Law.⁴¹ It also published Guidance⁴² to assist judges in understanding and applying these Interpretations. This Guidance explores every article of the Interpretations in three dimensions; namely background, relevant foreign legal theories and judicial practice. In relation to the first two dimensions, many important Anglo-American legal theories and legislative provisions are employed to explain the rationale behind the articles of the Interpretations.⁴³

Network effect

The "network effect" in economics indicates that the demand for a technology and its value to each current user increases with each additional unit sold.⁴⁴ In respect of China's corporate governance reform, this "effect" can

²⁶ Company Law 2005 art.22.

²⁷ Corporate Governance Guideline 2002 art.4.

²⁸ Company Law 2005 art.104.

²⁹ ShangshiGongsiZhangchengZhiyin [Guideline for Public Company's Article of Association] art.75.

³⁰ Securities Law of the Peoples Republic of China 2005 art.88.

³¹ ShangshiGongsiShougouGuanliBanfa [CSRC's Takeover Provisions] art.24.

³² Securities Law of the Peoples Republic of China 2005 art.86.

³³ CSRC's Takeover Provisions art.13.

³⁴ See Roe, "Chaos and Evolution in Law and Economics" (1996) 109 *Harvard Law Review* 641, 650.

³⁵ See Boas, "Conceptualizing Continuity and Change" (2007)19 *Journal of Theoretical Politics* 33, 37.

³⁶ Anthony Atkinson and Joseph Stiglitz, "A New View of Technical Change" (1969) 79 *Economic Journal* 573.

³⁷ Benjamin Liebman and Tim Wu, "China's Network Justice" (2007) 8 *Chicago Journal of International Law* 257, 291.

³⁸ *Basic Inc v Levinson* 485 U.S. 224 (1988).

³⁹ This "piggy-back effect" from the US to China in private securities litigation cases is more elaborately described in Huang Hui's article; Hui Huang, "Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment" (2013) 61 *American Journal of Comparative Law* 757.

⁴⁰ Guangdong Xu, Tianshu Zhou, Jin Shi and Bin Zeng, "Fiduciary Duties in China" (2013) 14 *European Business Organization Law Review* 57.

⁴¹ Zuigao Renming Fayuan Guanyu Shiyong Zhonghuarenminggongheguo Gongsifa Rougan Wenti de Guiding (I&II) [Supreme Court's Judicial Interpretations on China's Company Law 2005 I & II] Chinese text is available at http://www.chinacourt.org/llwk/show1.php?file_id=109879 [Accessed September 4, 2014].

⁴² See *Supreme Court's Judicial Interpretations on China's Company Law 2005 I & II*.

⁴³ See *Supreme Court's Judicial Interpretations on China's Company Law 2005 I & II*, pp.106–117.

⁴⁴ See Boas, "Conceptualizing Continuity and Change" (2007)19 *Journal of Theoretical Politics* 33, 37.

be divided into macro and micro levels. At a macro level, the network externality effect exists in the East Asian jurisdictions of company law reform. All the major East Asian jurisdictions, except North Korea, have Westernised their company law regime. Japan's commercial code has transplanted many important elements of US company law.⁴⁵ South Korea has also introduced some crucial institutions from Anglo-American legal systems into its company law regime.⁴⁶ Hong Kong's company law, needless to say, inherits many key doctrines and traditions from UK company law.⁴⁷ The movement toward Western law in East Asian jurisdictions has encouraged Chinese legislators to adopt a similar approach in reforming China's company law. First, adopting a similar rule of law can reduce the transaction cost of international business between Chinese companies and companies from neighbouring states. Secondly, the experiences of the legal practice of company law in other East Asian jurisdictions, especially Hong Kong, are valuable resources for China in improving its own company law regime. For example, stock exchanges' public criticism of listed companies was originally a product of the UK's stock market regulation. This regulating instrument was first transplanted into Hong Kong's stock market regulation. China's policy-makers then borrowed the revised version of this regulatory approach from Hong Kong.⁴⁸ The transplant of fiduciary duties into China is also an appropriate example to reflect the influence of network effect. The revised Company Law dedicates an entire chapter (Ch.6) to the qualifications and obligations of the directors, supervisors and senior managers of a company. Article 148 states that directors, supervisory board members and high-level management personnel should abide by laws, administrative regulations and the company articles of association, and have a duty of loyalty (*zhongshiyiwu*) and duty of diligence (*qinmianyiwu*) to the company. It seems that the formulation of the Chinese style of fiduciary duties is more similar to the US style than to the UK style.⁴⁹ The reason for this phenomenon can be divided into two parts. At a technical level, a foreseeable issue of transplanting fiduciary duties into the Chinese legal system is that its application is without any support of judiciary experience. In such conditions, it is necessary for the Chinese legislators to imitate this legal arrangement from the East Asian neighbourhoods,

which share a similar social, commercial and legal culture with China. Japan and Taiwan, which have more commercial litigation friendly legal systems than that of mainland China,⁵⁰ transplanted the US-style fiduciary duties into their commercial law systems before China did.⁵¹ With these similar contexts, they provide valuable implementing experience on certain transplanted rules. At a micro level, an emerging "complementary system" of corporate governance rules constitutes the other type of "network effect". For example, with the introduction of directors' duties of loyalty, derivative actions are necessarily introduced into China's legal system, as a complementary mechanism for enforcing the doctrine of the duty of loyalty. Similarly, sub-committees under the board of directors are necessarily implemented in order to facilitate the institution of an independent director. This gives directors a better understanding of their responsibilities. The function of a single transplanted rule, therefore, is enhanced by this complementary system.

Research on "efficiency-driven path dependence" illustrates that China's case is complicated. Owing to "sunk adaptive cost", the "learning effect" and the "network effect", China's corporate governance regime based on transplanted rules from Western jurisdictions has become a self-reinforced, complementary and autonomous system. This self-sustaining system will substantially resist any integration with moral standards from other cultural systems. For example, great technical difficulties of integrating Confucian moral standards into existing US style fiduciary duties are foreseeable.⁵²

Weak co-ordination between the current system and Confucianism

First, compelling historical evidence has shown that Confucianism discourages the development of commercial law and imposes substantial bias on commercial activities. These characteristics make it difficult to co-ordinate with the current corporate governance regime based on Western legal rules. For example, with respect to Chinese company law in ancient times, Kirby states:

"Prior to the Company Law of 1904, very little in written Chinese law addressed the regulation of private economic activity. Qing China had no commercial code, nor, really, a civil code. What it

⁴⁵ Ronald Gilson and Curtis Milhaupt, "Choice as Regulatory Reform: The Case of Japanese Corporate Governance" (2005) 53 *American Journal of Comparative Law* 343.

⁴⁶ Jongmoo Jay Choi, SaeWoon Park and Sean Sehyun Hoo, "The Value of Outside Directors: Evidence from Corporate Governance Reform in Korea" (2007) 42 *Journal of Financial and Quantitative Analysis* 941.

⁴⁷ John Farrar, "Developing Corporate Governance in Greater China" (2002) 25 *University of New South Wales Law Journal* 474.

⁴⁸ Benjamin Liebman and Curtis Milhaupt, "Reputational Sanction in China's Securities Market" (2008) 108 *Columbia Law Review* 929.

⁴⁹ In the UK, fiduciary duties and duty of care and skill belong to different systems. Fiduciary duties come from the system of equity. The duties of care and skill rest, in contrast, on the principles of the law of negligence which belong to the common law system. However, according to US corporate law, fiduciary duties fall into two broad categories: the duty of care and the duty of loyalty. In other words, the duty of care is within the fiduciary duties system in the US. For the above point, see *Gower and Davies's Principles of Modern Company Law*, 8th edn, edited by Paul Davies (London: Sweet & Maxwell, 2008), p.488; Melvin Eisenberg, "The Divergence of Standards of Conduct and Standards of Review in Corporate Law" (1993) 62 *Fordham Law Review* 437.

⁵⁰ World Bank, "Doing Business" (2013), <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf> [Accessed September 4, 2014]. According to World Bank's statistics with respect to settling commercial disputes, Taiwan and Japan rank 16 and 24, respectively, among 185 countries. China ranks only 91, according to the report.

⁵¹ Japan and Taiwan transplanted the US style of fiduciary duties into their legal systems in 1950s and 2000 respectively. Both Japan and Taiwan's fiduciary duties follow the US-style formulation, which includes both of duty of loyalty and duty of care. See Hideki Kanda and Curtis Milhaupt, "Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law" (2003) 51 *American Journal of Comparative Law* 887, 897; Christopher Chen, "Transplantation of Fiduciary Duties into Civil Law Jurisdiction: Experiences from Taiwan" (2011) <http://ssrn.com/abstract=1878204> [Accessed September 4, 2014].

⁵² e.g. SiuYeung Chan, Daniel Ho and Angus Young, "Rethinking the Relevance or Irrelevance of Directors' Duties in China: The Intersection between Culture and Laws" (February 2014) *Asian Journal of Law and Society* 1.

did have, in the form of the Great Qing Code, was primarily a penal code, pre-eminently concerned with the regulation and punishment of officials.”⁵³

In respect of commercial law related elements, the Great Qing code only included civil activities, such as marriage and the succession of property, which were important for the Confucian family system. Furthermore, there was not even a formal institution for settling commercial disputes.⁵⁴ This shortage of local knowledge of commercial litigation can be partly attributed to Confucian moral standards. Confucius once said: “The superior man cares about virtue; the inferior man cares about material things. The superior man seeks discipline; the inferior man seeks favours.”⁵⁵ Again, on another occasion, Confucius told a student that “the superior man is aware of rightness, the inferior man is aware of benefit”.⁵⁶ It is understandable that ancient Chinese officials, who were trained in Confucian philosophy, were reluctant to be involved in commercial disputes, as pursuing profit was morally suspicious under Confucianism, not to mention the disputes triggered by seeking personal benefit.⁵⁷ The legal gap, at that time, was filled by private force. According to Kirby’s observations, commercial dispute resolution was usually dealt with by local notables, based on the detailed regulations of guilds and families as well as on longstanding custom. However, decisions would normally be based on a considerable degree of personal comprehension of local practices on the part of the decision-maker.⁵⁸ The lack of a uniform commercial code and a heavy reliance on personal understanding and comprehension severely undermined the justice of each decision.

Secondly, enforcement problems could emerge even in a self-management context. For example, independent directorship is a widely accepted self-management approach that is intended to provide an outsider’s check and balance on the power of corporate insiders. However, public authorities still must establish basic motivations to encourage independent directors to perform their functions. When directors work without diligence and loyalty, public authorities should impose a fine or ban them from the markets.⁵⁹ Similarly, intensive enforcement is necessary to force directors to comply with notable Confucian teachings at least in the early stages of this reform. In addition, this enforcement requires support from legislators and legal end-users. As Foster argues,

commercial law is not necessarily bound to, or dissociated from, culture or social processes: whether or not it is “culture-specific” depends on the attitude towards it of those in a position to influence its successful reception.⁶⁰ In respect of adopting and enforcing certain rules or self-management regimes, local lawyers’ attitudes are always important. However, Chinese commercial lawyers’ attitude toward traditional legal culture based on Confucianism is unlikely to be positive. Local customary law and practice similarly are usually dismissed in China’s legal reform as being “backward” or “old and bad habits”, impeding economic and legal development rather than enhancing them.⁶¹ By contrast, lawyers have a more positive attitude towards rules or institutions transplanted from Western jurisdictions, which are more likely to occasion a fundamental structural change in the local context. For example, Tang in his article says that

“the new laws [China’s Security Law 2005 and Company Law 2005] have been widely applauded in China. The revision will raise China’s score in the shareholder protection index developed by La Porta and colleagues in their ‘Law and Finance’ article.”⁶²

Amid such conditions, it can be expected that lawyers will use significantly more resources to enforce formal legislation and regulations than Confucianism moral standards will provide.

Is Confucianism capable of curing corruption and correcting managers’ behaviour?

Clientelism and business corruption

Arguably, certain Confucian principles may have an effect on reducing agency costs in public companies.⁶³ However, because of the complicated nature of Confucianism, we must acknowledge that Confucianism may actually encourage corruption in commercial practice. As regards the role of Confucianism in socialist China, in 1974, the Communist Party released a document which required all Chinese to participate in a campaign of attacking Confucian philosophy (*pi lin pi kong*). In the Party’s eyes, Confucius represented feudalism and its traditions.⁶⁴ Yet, in recent years, there is said to be a revival of Confucianism in China. The literature often mentions the

⁵³ William Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China” (1995) 54 *Journal of Asian Study* 43, 44.

⁵⁴ David Faure, “Zhongguo Ziben Zhuyi De Mengya” [The Emerging Capitalism in Ancient China] (2002) 1 *Zhongguo Jingjishi Yanjiu [Journal of China’s Economic History]* 62.

⁵⁵ *Analects of Confucius*, <http://ctext.org/analects> [Accessed September 4, 2014].

⁵⁶ See *Analects of Confucius*, <http://ctext.org/analects> [Accessed September 4, 2014].

⁵⁷ See Faure, “Zhongguo Ziben Zhuyi De Mengya” [The Emerging Capitalism in Ancient China] (2002) 1 *Zhongguo Jingjishi Yanjiu [Journal of China’s Economic History]* 62, 62.

⁵⁸ See Kirby, “China Unincorporated” (1995) 54 *Journal of Asian Study* 43, 45; Susan Mann, *Local Merchants and the Chinese Bureaucracy 1750–1950* (Stanford University Press, 1987).

⁵⁹ Donald Clarke, “The Independent Director in Chinese Corporate Governance” (2006) 31 *Delaware Journal of Corporate Law* 125.

⁶⁰ Nick Foster, “Transmigration and Transferability of Commercial Law in a Globalized World” in Esin Orucu and Andrew Harding (eds), *Comparative Law in the 21st Century* (Kluwer Academic Publishers, 2001), p.69.

⁶¹ Jianfu Cheng, “The Transformation of Chinese Law: From Formal to Substantial” (2007) 37 *Hong Kong Law Journal* 689, 737.

⁶² Xin Tang, “Protecting Minority Shareholder in China: A Task for Both Legislation and Enforcement” in Hideki Kanda, Kon-sik Kim and Curtis Milhaupt (eds), *Transforming Corporate Governance in East Asia* (Routledge, 2008), p.150.

⁶³ See Lam and Goo, “Confucianism” (2014) 35 *Company Lawyer* 52, 55.

⁶⁴ Goldman Merle, “China’s Anti-Confucian Campaign, 1973–1974” (November 1975) *China Quality* 436.

importance of clientelism (“*guanxi*”), namely that family and social ties create trust and loyalty, without the need for the formal rule of law. Clientelism has long been present in Chinese society, originating from Confucian ideas of social harmony.⁶⁵ For example, one of the fundamental Confucian teachings is *Li*, which is usually translated as being a “moral rule of correct conduct and good manners”.⁶⁶ *Li* consists of five fundamental relationships which a Chinese person should properly engage in. These five relationships include: “ruler and subject, father and son, husband and wife, elder and younger brother, and friend and friend”.⁶⁷ From these five relations, it is apparent that Confucianism is founded on a clan-based, blood-related society. Indeed, in Confucian society, a large family usually provides educational, moral and material support to its members. In turn, family members are obliged by a moral obligation to pursue the interests of their immediate family or other family members, when they have power to do so. As Wang concludes,

“different from their counterparts in Western world, the rule of fair play is not the tradition for Chinese businessmen. In the Chinese business world, plain fact is that kinship determines property relationships”.⁶⁸

Compared with Western people, the Chinese rely heavily on kinship in doing business. In such circumstances, directors are more likely to facilitate a family member’s interests at the expense of their employers’ interests by undisclosed related-party transactions or insider trading.

To elaborate, clientelism refers to a close-knit society which is highly reliant on personal relationships, and networks of familial, personal and social connection. The network which facilitates the exchange of personal and knowledge-based resources, for mutual protection and for aid, can be traced back to the traditional nepotism of Chinese emperors, as well as the corruption and particularism of Chinese dynastic bureaucracy.⁶⁹ It is also said to play a key role in China’s political, social and legal life today. For example, Randall Peerenboom divides clientelism into two groups. “Horizontal clientelism” refers to the relationships between equal parties. By contrast, “vertical clientelism” refers to the patron-client relationship between supervisors and subordinates. Both horizontal and vertical clientelism involve a system of exchanging interests.⁷⁰ On the one hand, it can be argued that the transaction cost between parties is reduced by a business model in which personal relationships play an important role. This is because parties who do business

with their familiar partners will suffer less from the costs of asymmetric information.⁷¹ This reduction of transaction cost contributes to economic development. On the other hand, this interlaced personal network strengthens officials’ and corporate managers’ ability of rent-protection. In respect of corporate governance, horizontal clientelism may range from appointing an executive’s friend or relatives to be the company’s senior officer, to passing a corporate opportunity to an executive’s family member. Vertical clientelism in general is more harmful than the horizontal clientelism, as it usually involves government official or judicial corruption.⁷² Vertical clientelism may range from local government administrative intervention in a lawsuit against a local firm to leaking official confidential information to a market participant. Both horizontal and vertical clientelism involve a system of exchanging interests. Imagine a purchasing manager deciding to buy overpriced supplies from a personal acquaintance who in turn helps the manager’s son into a prestigious school. Imagine also a government official giving a preferential policy to a company in exchange for a position of senior executive with a handsome remuneration for his son. In the first scenario, the purchasing manager realises his personal interests at the expense of shareholders’ interests. In the second scenario, the governmental official gains personal benefits from his governmental authority. In both cases, the persons in power, whether economically or politically, have strong rent-creating and rent-seeking ability in this cultural environment. Most interest-exchange activities in China are not so severe, being often at the edge of legality without necessarily breaching the law. Nonetheless, it cannot be doubted that clientelism is supported by a “rule of man” regime, as opposed to a “rule of law” regime which would keep it in check.

“Clientelism” and “state control of public company”

Clientelism may be mutually reinforced with “state control” in China’s “rule of man” regime. With a strong tradition of totalitarianism, China survives by maintaining an accomplished hierarchical system, which can be traced back to the influence of Confucianism.⁷³ As early as the late 19th century, when the concept of a “company” was first introduced into China, the Qing government attempted to control corporate practice by establishing a number of government-controlled companies. In these

⁶⁵ See Jilong Zhang and Nattavud Pimpa, “Embracing Guanxi: The Literature Review” (2010) 1 *International Journal of Asian Business and Information Management* 23.

⁶⁶ Luke Lee and Whalen Lai, “The Chinese Conception of Law: Confucian, Legalist and Buddhist” (1978) 29 *Hastings Law Journal* 1307, 1308.

⁶⁷ Charles Rarick, “Confucius on Management: Understanding Chinese Cultural Values and Managerial Practices” (2007) 2 *Journal of International Management Studies* 22.

⁶⁸ Ding Ding Wang, *Shichang Jijin de Daode Jichu* [Market Economy and Its Morality] (Shanghai Renmin Chubanshe, 2007) [People’s Publisher Shanghai, 2007], pp.62–63.

⁶⁹ Emanuela Todeva, “Business Network in China: Legacies and Practice” in Stewart Clegg, Karen Wang and Mike Berrell (eds), *Business Networks and Strategic Alliances in China* (Edward Elgar, 2007), p.256.

⁷⁰ See Randall Peerenboom, *China’s Long March toward Rule of Law* (Cambridge: Cambridge University Press, 2002), p.466.

⁷¹ Ronald Gilson, “Controlling Family Shareholder In Developing Countries: Anchoring Relational Exchange” (2007–08) 60 *Stanford Law Review* 633.

⁷² U.C. Braendle et al., “Corporate Governance in China — Is Economic Growth Potential Hindered by Guanxi?”, Working Paper (April 25, 2005), SSRN, <http://ssrn.com/abstract=710203> [Accessed September 4, 2014].

⁷³ Yuwa Wei, “An Overview of Corporate Governance in China” (2003) 30 *Syracuse International & Comparative Law Journal* 23.

companies, the government had the power to dispose of the company's assets and appoint its directors and managers.⁷⁴

Clientelism provides cultural soil for the growth of extensive state control of commercial activities. The state grants strong administrative powers to governmental authorities and officials, which enables them to seek rents. Although adopted to protect the Party's totalitarianism, the culture of clientelism, in tandem with the relatively weak legal system, gives rise to rent-seeking activities which realise personal benefits for state officials rather than securing Party interests. A report issued by the State-owned Asset Supervision and Administration Commission highlights that there is a positive link between concentrated ownership and official corruption.⁷⁵ To elaborate, the greater the proportion of state ownership in a public company, the more serious an official's corruption becomes. Therefore, in a cultural environment based on clientelism, officials have strong incentives to lobby policy-makers to enhance "excessive state control". "State control" in turn reinforces the role played by clientelism within the institutional framework. In order to guarantee that all key positions are assigned to members who are willing to act in the Party's or government's interest, positions in state-influenced companies are assigned on the basis of personal connection rather than achievement. Gilson and Milhaupt's recent research supports this observation. They refer to:

"Princelings" (*taizi dang*)—children of influential party members, whose nickname derives from their quasi-hereditary privileges. The term is also used more broadly to refer to those closely connected to the Party establishment through marriage or collegial relationships. The Princelings operate outside of established hierarchies, wielding influence beyond and across the separate spheres of politics, business and the military. The links between party officials

and business managers are extensive and lucrative. In 2002, Newsweek reported on an internal Party survey indicating that ninety-eight per cent of senior officials had relatives in significant business or government positions.⁷⁶

This observation is supported by further empirical evidence. Indeed, one survey targeting 215 mid-rank officials in Nanjing province indicates that 56.9 per cent of interviewees acknowledged that personal relationships and social networks are the most important factors in securing their political promotion in the future.⁷⁷ Consequently, social networks based on Confucianism are likely to undermine the "rule of law" by obstructing its development and implementation.⁷⁸ Bestowing preferential treatment upon an individual who has a close relationship with persons in power violates the fundamental values of the rule of law, namely "fairness", "accountability" and "transparency". Consequently, over-reliance on Confucianism exacerbates commercial bribery and further damages the function of formal commercial legislations in the Chinese context.

Conclusion

This article offers several serious challenges to the argument suggesting that Confucianism should play a key role in China's corporate governance reform. First, from a path dependence perspective, it is difficult to replace the current regulatory regime based on formal legislation and regulation. Furthermore, even a basic level of co-ordination between Confucianism and modern legal rules or regulations is unlikely to occur. Secondly, certain Confucian teachings may actually encourage corruption and further enhance the unwelcome state control of large public companies. Consequently, unless the aforementioned problems are properly resolved, it is problematic to suggest that China's corporate governance issues can be substantially mitigated by Confucianism.

⁷⁴ See Chi-Kong Lai, "China's First Modern Corporation and the State: Officials, Merchants, and Resource Allocation in the China Merchants' Steam Navigation Company, 1872–1902" (1994) 54 *Journal of Economic History* 432, where the author finds that "[t]he [Qing] government had long been recruiting private entrepreneurial and material resources to launch various kinds of joint ventures, often adopting different approaches to what was called 'official supervised merchant enterprise' (*kuan-tushang-pan*)".

⁷⁵ SASAC research report, <http://www.sasac.gov.cn/n1180/index.html> [Accessed September 4, 2014].

⁷⁶ Ronald Gilson and Curtis Milhaupt, "Economically Benevolent Dictators: Lessons for Developing Democracies" (2011) 59 *American Journal of Comparative Law* 227, 266.

⁷⁷ Mai Tian "Chuzhang de ZhengzhiJingjixue" [Political-Economy of China's Mid-rank Officials], *Financial Times* (Chinese version), <http://www.ftchinese.com/story/001030741?page=2> [Accessed September 4, 2014].

⁷⁸ Randall Peerenboom, "Social Network, Rule of Law and Economic Growth in China: The Elusive Pursuit of the Combination of Private and Public Ordering" (2002) 31 *Global Economic Review* 1.