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RESEARCH ARTICLE

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On legal issues of independent directors

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Abstract In order to avoid independent directors from being against minority shareholders, and urging them to play the role of checking up big shareholders and insiders with full power in listed companies, the rules for independent directors shall be amended gradually. Currently, the reform on the independent director regime shall be made in some aspects. First, the positions of independent directors shall be held by qualified professionals; Second, independent directors shall pass the exam for such posts; Third, independent directors shall take full-time jobs; Fourth, the firms of independent directors shall be established with limited partnership liability; Fifth, independent directors shall undertake joint liabilities.

Keywords independent director, shareholder, listed company, joint liability

摘要 为避免在上市公司中聘请的独立董事成为应付中小股东的装饰品，使独立董事真正发挥对控股股东和内部人控制的制衡作用，应持续完善独立董事规范，应从以下几方面对独立董事制度予以改革：第一，独立董事应当由懂行的人士充任。第二，独立董事应当通过考试取得从业资质。第三，应当由专职人士充任独立董事。第四，设立对外承担有限合伙责任的独董事务所对外提供独董服务。第五，独立董事应承担连带责任。

关键词 独立董事，股东，上市公司，连带责任

1 Legal status of independent directors

The independent director regime originated from the US external corporate governance system. At that time, insider control was popular in the US companies

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and professional managers made use of their opportunities of controlling companies to gain private benefits to the detriment of corporate interests more or less. For the purposes of systematically preventing insider control and reducing losses to other shareholders caused by misuse of power by corporate management, the regulatory department of the US provides that public companies shall set up non-employee directors (namely, independent directors) (Xie, 2004)[1] to restrain insider control in the US companies by use of the independent position of independent directors, which has contributed much to maintaining the interests of non-management shareholders. Since the US has created the independent director regime to reduce the members of corporate management, many industrialized countries have learned from the US experience, and independent directors have been popularly established in public companies (in the Anglo-American law system) and listed companies (in the civil law system).[2]

After the securities market had taken shape by the end of the 1990s in China, insider control occurred in the governance of listed companies and transfer of corporate properties by insiders became fiercer, and quite many boards of directors were completely manipulated by controlling shareholders who transferred to their pockets a great deal of corporate interests, which resulted in the loss of confidence in the securities market among numerous non-management investors. In 1999, the independent director regime was initiated at home in the *Opinions on Further Promoting Standard Operations of Overseas Listed Companies and Deepening Their Reforms* promulgated by China Securities Regulatory Commission (CSRC) and State Economic and Trade Commission. And in 2001, the CSRC issued the *Guiding Opinions on the Establishment of Independent Director Regime of Listed Companies*, which provided that all listed companies must set up independent directors, and thus expressly regulated the domestic independent director regime. Then in 2005, the amended *Company Law* officially determined the establishment of the independent director regime

[1] This book states that: in the 1930s, the US SEC started to recommend public companies to set up "non-employee directors", and provided in the *Securities Exchange Act* that the board of directors in listed companies shall introduce "non-employee directors". The *Investment Company Act of 1940* provided that "at least 40% directors shall be independent persons". As for companies other than investment companies, especially listed companies, the board of directors was basically controlled by internal directors prior to the 1970s.

[2] Under the requirements of Section V (E) of the *OECD Principles of Corporate Governance Structure*, the board of directors, when making objective judgment of company matters, shall be independent of the management, and set up sufficient number of non-executive directors to make independent judgment in connection with the items which are likely to bring about conflicts (such as financial reports, nominations, chief executives and the remuneration of directors).

in listed company, which indicated the affirmative attitude of Chinese legislature towards the independent director regime in the governance of listed companies and its hope that such system may improve the scientific and fair decision-making level of the board of directors and change the popular situation of domination by one class of majority shares and insider control in listed companies. The government expects to perfect the governance of listed companies by legislation. There are high expectations for legislation and broad investors also have high expectations for the participation of independent directors in the governance of listed companies to change the situation of insider control. This makes the independent director regime a very outstanding focus in the corporate governance. And people feel that not only the independent director regime shall be perfected in practice, but also the basis for the generation and exercise of power of independent directors shall be clarified in theory, hence enabling such regime to become really an effective component of the governance of listed companies.

2 Necessity of establishing independent director regime

Seen from the practice of recent years, independent directors have played certain active roles in the governance of listed companies as recognized by the industry. Nonetheless, the functions of independent directors have not been brought into effective and full play with respect to appropriate corporate governance due to insufficiencies in the design of the regime. The purpose of many listed companies when employing independent directors is not to improve the level of corporate governance but to cope with regulatory authorities and non-management shareholders. Although the conduct in the decision making of the board of directors is some better after independent directors are employed in some listed companies, many material matters of some companies are still determined by the management of the companies before meetings; meeting procedures are simply performed, if any. Such kind of decision-making procedure before meetings is one of the basic conditions for the occurrence of insider control, and if there is no democratic decision making, it may provide opportunities for black-box operations. It may be easy for controlling shareholders to transfer successfully corporate interests, and non-management shareholders, even objecting, cannot stop controlling shareholders from making private gains at the public expense (Lin, 2005). In consideration of such kind of situation, the independent director regime in China adopts the one-vote veto system or the dissenting announcement system in the voting of the board of directors involving important corporate interests. The motives of such practice are good and proper with intent to prevent

the domination of any one class of majority shares, restrain insider control[3] and reduce the opportunity of causing losses to corporate interests. However, to some certain extent, such practice also has an impact on the efficiency of corporate decision making. In the event that independent directors were bought over by competitors, the method of one-vote veto would bring corporate interests into a dangerous situation. Moreover, the majority of independent directors are not elites with good understanding of corporate operation and management, and therefore it is hard for them to state their positions on specific matters in a short time during the meeting of the board of directors. Since they are ignorant of the motions and they are not sure whether they shall vote for or against them, they tend to abstain intuitively from voting. However, abstention is not the original intention of establishing the independent director regime, and when establishing such regime, the legislative body hopes independent directors are able to safeguard corporate interests at the meeting of the company and against the motions obviously detrimental to corporate interests. If independent directors often abstain from voting, what is the significance of the intention to set up the independent director regime? Therefore, according to the legislative purposes, independent directors shall have their own definite points of view of a motion and cannot abstain from voting when knowing about the actual situation of the motion. In contrast, when they have to abstain from voting if not knowing about the actual situation, such case shall be taken as a material event of the listed company, for which prompt temporary announcement on material events shall be published for the purpose of market disclosure. Such disclosure has two advantages: first, it may enable investors to know the relationships between such motion and the property safety of the listed company in a timely manner; and second, it may enable non-management shareholders to know the quality and capabilities of independent directors, which may provide a factual basis for whether to elect such persons as independent directors or not in the next term.

[3] Yan Yan, Research on Several Legal Issues of Independent Directors, 2005 CUPSL Master Thesis, p. 16. It states that "'insider control' means that senior managers such as directors and managers hold and control the important rights such as the management and decision-making and the execution of businesses of the company, and dominate over the shareholders' meeting and the board of directors, and the power of the company is completely manipulated and controlled by such insiders as officers, which is represented as self-made policy, self operation, self supervision and self-fixed remuneration. In the event that the abuse of rights by insiders is not controlled effectively after they actually hold 'control of the company', then it may lead to the bad practices of insiders by abuse of the control of the company, hence the problem of insider control beyond control, resulting in damage to the interests of the stake-holders such as the company, shareholders and creditors.

3 Legal analysis on deficiency in the independent director regime

It is well-known that, the will of corporate management, to a large extent, is that of or must be under control of controlling shareholders; and in many circumstances, the will of corporate management is only the reflection of that of controlling shareholders. From social theoretical analysis, each shareholder, whether a natural person or a legal person, is the subject of his/her independent interests, and when his/her interests are in conflict with corporate interests, it is pretty difficult for him/her (including directors appointed by him/her) to sacrifice his/her own interests and follow corporate interests unselfishly. It is only the requirement of law and the beautiful wish of shareholders to claim that controlling shareholders attach more importance to corporate interests (Wu, 2001). We shall see the gap between wishes and realities and the actual circumstance is that independent directors cannot effectively check the selfish acts of controlling shareholders, whereby controlling shareholders have plenty of opportunities to pursue private gains at the public expense during the course of corporate operation and management by their own directors (actually the agents of controlling shareholders). Additionally, the supervisors of a listed company are usually its insiders who tend to turn a blind eye to violations of law and breaches of the corporate articles of association by the corporate management and let them be what they are, while, on the other hand, the limited number of independent directors do not have the ability to fight against the management because of the ignorance of the actual situation (Zhang, 1995). This always causes the loss of corporate interests, whereas the board of supervisors and independent directors has failed to play its roles in checking the corporate management. People cannot help asking why independent directors are unable to exert their role in restraining insider control. Through investigation on the functions of independent directors of listed companies, it can be found that the main reason for the failure of independent directors to play their appropriate checking role does not lie in the quality of individual independent directors, but in that there are no specific requirements and restrictive measures for independent directors in the current legal mechanism.

The positions of many independent directors are currently held by prominent people who have accumulated large amounts of knowledge and experience in their own fields, achieved big success in society, and thus obtained wide recognition by the public. However, independent directors usually undertake numerous works and affairs; they are busy and burdened with full-time and part-time jobs; they may attend meetings of the board of directors in person or by proxy, which is not related to the direct interests of the operation performance of the company. Thus, they air their opinions as few as possible, and the less

to speak, the less to make mistakes, and there is absolutely no mistake if abstaining from voting. Naturally, independent directors play a very limited role in restraining insider control and maintaining corporate interests as required by law and non-management shareholders and thus some independent directors actually turn into honorary directors.

With performance downturn and heavy losses due to such reasons as bad management and insider control, some listed companies are suspected of manipulation and frauds by use of false information, which has destroyed the order of the securities market and caused losses to investors. While acting as the inspectors of the market order and the spokesmen of non-management shareholders of listed companies, independent directors cannot stop such kind of frauds and there is even lack of opportunities for them to express their objections. Since independent directors do not need to work in the company or engage in corporate operations and management, they have no knowledge of any fraud or misconduct of the management, hence resulting in the failure to live up to the expectations of a large number of non-management shareholders, as well as the expectations of state-owned assets management authorities in many circumstances, which indeed runs counter to the original intention of the establishment of the independent director regime.[4] We should admit that the failure to check against the inappropriate operation and management of the corporate management of listed companies is not a question of the personal capabilities of independent directors but due to deficiencies in the design of such regime. Hence, we shall examine the deficiencies in the mechanism. Only by locating these deficiencies can any improvement plan be proposed, hence enabling the independent director regime to become an integral part of the governance of listed companies indeed.

4 Relationships between independent directors and corporate governance

The company is the product of the economic democratic system. Shareholders' capital contribution forms a civil subject with independent will, which

[4] Lu Weijun, *Corporate Governance of State-owned Companies and the Issues of Insider Control*, 2003 CUPSL Master Thesis, p. 17. It states that "starting from 1995, the community of international economics put forward the concept of insider control when studying China and former USSR in economic transition. The phenomenon of 'insider control' was first proposed by Masahiko Aoki, economist of the University of California, USA. According to the definition in *Corporate Governance in Transitional Economies*, co-edited by Masahiko Aoki and Qian Yingyi, insider control refers to the situation where managers virtually or by law grasp the power of control, whose interests are embodied in corporate strategy and decision-making, which is usually done through conspiracy between managers and workers.

independently carries out operation activities, independently enjoys the right of corporate property and independently undertakes civil liabilities. The symbolic feature of the company as an independent civil subject is the possession of independent capacity for property and liability and an independent authority of will. Such kind of authority shall rely on the majority principle in forming resolutions and embody the corporate will through such resolutions, hence directing and regulating the production and operation of the management by resolutions. Namely, the company realizes its control by the resolutions of the authority of will and embodies the capacity of a civil subject (Jiang, 2001). During the course of the expression of will of the company, shareholders exercise the stock rights by virtue of their contributions or individually owned shares, including the exercise of the voting right in terms of material events of the company, and the shareholders express their wills in terms of the management and development of the company through shares of their voting rights. If the shares of their voting rights are too small, the shareholders cannot do anything but only feel in vain even if they clearly know that a resolution will damage the corporate interests, because controlling shareholders have sufficient voting rights to adopt a resolution in their own favor. Here, the will of the shareholders with minority voting rights is assimilated by the expression of the will of the controlling shareholders. Thus, the basic content of the corporate economic democratic system is that the resolution of the company is its expression of will, and even if the expression of the will of the shareholders with minority voting rights is reasonable, the will of the shareholders with majority voting rights shall prevail. Hence, it can be seen that the majority resolution is not necessarily democratic, which has its own limitations. Such limitations are being misused by some male fide controlling shareholders to damage corporate interests and the economic and democratic rights of other shareholders. One of the purposes of corporate governance is to avoid the unreasonable impact of majority resolutions.

Though companies are products of the democratic system, they may fall into profit-making tools of controllers, whereas the interests of non-controlling shareholders may be sacrificed in the so-called democratic procedure. The effective measures for improving such unfair situation are to impose necessary and appropriate limitations on the application of the majority resolution principle and restrict the misconduct of controlling shareholders. Independent directors simply originated from such background, the main role of which is to restrain the misconduct of controlling shareholders. If controlling shareholders manage to keep loyal to corporate interests without any doubt from other shareholders, it is unnecessary to establish independent directors. But currently, the center of corporate governance has shifted from shareholders' meetings to the board of directors, and the board of directors mainly holds in hand the corporate development and property interests. Provided that most of shareholders are

unable to participate in corporate management, controlling shareholders may easily manipulate the board of directors for private purposes, and those shareholders who do not assign or did not actually assign directors have few opportunities to know the situation or to speak on the board of directors. Therefore, it is necessary for them to assign proxies on the board of directors to air their opinions frankly. Such necessity shall be the foundation of the claims for shareholders' interests generated from the independent director regime, and from this point of view, the role of independent directors is mainly the voice at corporate meetings on behalf of non-management shareholders, offering those shareholders originally without rights for voice the opportunities to express their wills.

In view of the original intention of the establishment of the independent director regime, the relationships between independent directors and economic democracy are as follows. First, the undeniable reality is that listed companies are popularly controlled by a small number of shareholders and that it is impossible to restrain the misconduct of controlling shareholders effectively solely depending on the shareholders' meeting based on the method of majority capital. Second, it is also undeniable that the board of directors of a listed company may be controlled by insiders, and when controlling shareholders have enough power of control that is hard to restrain, it is easy for them to change public power into private tools, which results in the situation of insider control (Su, 2004). Third, independent directors are not appointed by shareholders but selected by the shareholders' meeting, where they are not corporate employees, but should stand on a neutral position to act fairly, voice their independent opinions on the motions of the board of directors and have the right to give a negative vote. Therefore, the existence of independent directors may decrease the possibilities of controlling shareholders to manipulate the board of directors to damage corporate interests and increase the cost of controlling shareholders in pursuit of private benefits at the public expense, hence reducing the possibilities of damage to corporate interests. Fourth, the independent speech and voting rights of independent directors shall be the effective tools to correct insider control on the board of directors (Li and Yang, 2003). Independent directors are not corporate employees, so they do not have to be worried about being dismissed or given a hard time in the company due to any careless speaking. Therefore, independent directors may argue based on facts and vote against any motion that is not in line with corporate interests. In addition, since a negative vote of independent directors shall be announced as a temporary material event, directors in pursuit of private purposes would care about their acts and dare not damage corporate interests brazenly. Correspondingly, such situations as controlling shareholders manipulating corporate dealings with themselves or

offering guarantees to affiliated companies or companies without clear identity may be decreased, and corporate interests may be maintained accordingly.

5 Issues on the authority of independent directors

5.1 Authority of independent directors shall be increased or reduced as required according to legislative procedures and increased by the articles of association

Independent directors have acquired high trust from non-management shareholders with the status of non-management shareholders, non-medium and majority shareholders and non-employees of the company. Non-management investors also have high expectations from them. Therefore, independent directors are endowed with clear authority by national legislative agencies in legislations that is totally different from that of ordinary directors, such as the rights of examination and veto on corporate affiliated transactions and the right of nomination for officers of other companies in which they are directors, the right of formulating remuneration of corporate officers and the right of one-vote veto of material corporate resolutions. With respect to the independent director regime in China, the *Company Law* affirms the legal position of independent directors of a listed company, the CSRC provides for the specific norms and code of the conduct of independent directors, and Shanghai Stock Exchange and Shenzhen Stock Exchange prescribe specific requirements for the independent directors of their listed companies constantly. On this level, the statutory requirements in the independent director regime are increasingly perfect, while there are plenty of problems to be solved, which requires for regulatory authorities to make timely adjustments and supplementary regulations in consideration of actual circumstances of corporate governance.

Besides the provisions on the authority of independent directors by legislative agencies, the articles of association may also provide for their authority. It shall be specified that the statutory authority of independent directors may not be modified or reduced, which shall, within the category of the *Company Law*, be statutory provisions, where the shareholders' meeting of a listed company may not reduce or limit the authority of independent directors by amending the articles of association. However, the shareholders' meeting may appropriately expand the authority of independent directors according to the need of the company or the scope of their authority may be specified with the clarification of their rights in the contract of the engagement of independent directors signed with independent director firms (Brian, 1997).

The authorities of independent directors may be verified according to the need of corporate governance, and the most important two of which are: the right of one-vote veto, and the right of temporary motions.

5.2 Issues on the right of one-vote veto of independent directors

The right of one-vote veto is the veto by independent directors of a motion agreed by majority directors on the board of directors, the reason for which shall be limited to maintaining the security of corporate property, such as corporate guarantee, opaque affiliated transactions of the company, remuneration and awards of corporate officers beyond reasonable ranges and material investment of the company in unfamiliar fields. However, the specific scope of the right of one-vote veto enjoyed by independent directors shall be specified in the legal regulations of independent directors so as to reduce the dispute between the company and independent directors in terms of administrative aspects. Though the right of one-vote veto is of unique benefit in maintaining the security of corporate property, but it is likely to have great side effects, especially in the event that independent directors are bought over by competitors where, if they misuse the right of one-vote veto, extremely adverse effects may be produced on the normal operation and investment of the company. Therefore, remedies for objections by the company and other directors who are dissatisfied with the exercise of veto by independent directors shall be specified in the legal regulations of independent directors, including the establishment of summary dispute procedures of judgment in the judicial remedies where the court shall judge a dispute within several working days at the request of the company. If the court holds that the veto of independent directors is not reasonable, it shall require the proposing directors, the guaranteed party or the beneficial party of affiliated transactions to provide guarantees ensuring that the company where independent directors serve will not be affected by the guarantee or the affiliated transactions. Otherwise, the court may not judge against the veto of independent directors with the purpose of maintaining the security of corporate property.

5.3 Right of temporary motions of independent directors

For the purpose of ensuring the order of corporate governance, the company laws of various nations unexceptionally provide for convening corporate meetings, and discussing and voting for or against motions in accordance with fixed procedures. After the introduction of the independent director regime in listed companies, independent directors become members of the board of directors and enjoy the same rights as other directors, including the right of motions. Pursuant to the provisions of the *Company Law* and the articles of associations of listed companies, the directors shall formally put forward their motions to the board of directors prior to the prescribed number of days in order to be listed within the scope of the resolutions of the board of directors.

That is to say, the right of making motions of independent directors is the same as that of other directors, who shall put forward their motions prior to

the prescribed number of days. Though independent directors are usually not at the company and they have less understanding about the situation of corporate operations than other directors, much more are expected from them for maintaining the security of corporate property than from other directors. Moreover, there are in fact many obstacles against independent directors to exercise their right of gaining information on corporate affairs and thus it is rather hard for them to put forward motions before the date prescribed by the C*ompany Law* and the articles of associations under the circumstances that they have not actually understood corporate operations. As a matter of fact, independent directors may not usually know of the events which will take place in the company such as material appointments and dismissals, guarantees, affiliated transactions and investments until one or two days before the convening of the meeting of the board of directors or even until the day of the meeting and such events have not been listed within the range of voting at the meeting. Provided that independent directors at that time realize that those events are to threaten the security of corporate property, they shall be entitled to propose temporary motions requiring the board of directors to vote in order to give full play to the function of independent directors as policemen in maintaining the security of corporate property.

6 Basic legal issues on construction of the independent director regime

For the purposes of preventing independent directors engaged in listed companies from being decorations to stall off minority shareholders, and enabling independent directors to play the role of checking with the control by controlling shareholders and insiders, efforts shall be made to reform the independent directors regime from the following four aspects.

6.1 Eligibilities of independent directors

The company is a profit-making organization and for the purpose of acquiring maximum profits, the corporate operations shall be handled by persons who know business. The function of directors is essential to the corporate governance structure that popularly adopts the board of directors as the center in the existing market (Fukao and Mirie, 1997). If directors do not know the business, corporate governance will make no sense and it is easy for the management to seek for private gains by the abuse of power. Therefore, directors shall be professionals who may better adapt themselves to the requirements of management. In case of non-public companies, the directors are not for public interests, so whether

they know the business depends on shareholders' will, and whether they are professionals is of little impact on society. By contrast, in case of public companies, whether the directors know the business is related to both corporate interests and public shareholders' interests; therefore, they shall be persons who know business. In the board of directors, independent directors have the power equivalent to that of ordinary directors, who exercise the right of decision making on material corporate operations, but the prerequisite for exercising such rights is to know proposed decision-making items. Suppose a person who knows nothing about finance, the production process of the main business of the company or commercial law serves as director, will he/she vote for or against a motion in the voting of the board of directors? No matter whether he/she gives an affirmative vote or a negative one, he/she shall know the reason thereof. Otherwise, such person simply echoes what others say without his/her own view of rights and wrongs, so he/she may not actually play his/her role in maintaining corporate interests. Thus it can be seen that independent directors shall be persons who know business. The extent of the so-called knowledge of business may refer to the qualification standards for persons who serve as officers in commercial banks, namely, the proposed independent directors shall have sound backgrounds in such specialties as economics (including management), finance (such as financial and accounting, auditing and taxation), law (mainly civil, commercial and economic laws) and the main business of the company concerned. The cope of such backgrounds may be defined through consultation with all the circles of society, but the principle that independent directors shall be professionals must be affirmed.

6.2 Independent directors shall acquire practice qualifications through registration

Both market practice and legal philosophy require independent directors to be professionals who know corporate management (at least the knowledge of part of the content of corporate management). In order to ensure that independent directors have certain capabilities for corporate governance, attention shall be paid to three issues as follows. First, the qualifications and conditions of independent directors shall be fixed by competent authorities; second, the principle of establishing independent directors is choosing among the best, whereby the positions of independent directors shall be granted to those persons who have the knowledge of necessary specialties through certain procedures; third, examinations are the feasible procedure for choosing among the best, that is, the qualifications of independent directors shall be acquired through public examinations; and fourth, with respect to the experienced officers of the company and the professionals of senior intermediaries, competent authorities may directly recognize their eligibility for independent directors.

Since they undertake the important task of taking care of corporate interests, besides the requirements of professional experience, independent directors also need to have enough time to find out problems, propose motions and then produce supporting evidences to vote for or against the motions on the board of directors. Accordingly, they shall take on such positions on a full-time basis.

Services provided by independent directors for listed companies are just like those provided by lawyers for their clients, where not only agreed services shall be provided for clients, but also no aspect of such services shall be vulnerable to criticism. In this aspect, the provisions of the Chinese lawyer system may be referred to: the person with lawyer qualifications may not engage in the work as a lawyer, but once determined to do such kind of work, he/she shall resign from his/her former public office and be a full-time lawyer so that he/she has enough time and professional knowledge to provide clients with good services. The same is true for independent directors. Independent directors shall be professionals with the purpose of providing the parties concerned—the company and non-management shareholders—with good services. In view of the experience of social practice, only full-time persons may have time and energy to provide companies with proper services. Through the above-mentioned deliberations, it may be concluded that independent directors shall mainly be professionals on a full-time basis in China, and other senior persons with good performances may also serve as independent directors. However, in a listed company, independent directors shall be on a full-time basis, and there may be only one exception that the positions of part-time independent directors may be taken by persons with good credibility records.

6.3 Establishment of independent director LLP

For purpose of ensuring the service quality of independent directors for listed companies, there must be an independent organization to accomodate independent directors and carry out autonomous management over them in order to help them undertake the business of serving as independent directors in listed companies and bind them to abide by the code of professional conduct, hence enabling independent directors to be indispensable professionals in the market as Certified Public Accountants (CPA) and Certified Tax Agents (CTA). In case that independent directors join in an independent director firm, it is likely that the undertaking of individual liabilities may be converted to the organization of the firm and the liabilities of natural persons of independent directors may be converted to institutional liabilities where the capacity of institutional liabilities is obviously stronger than that of individual liabilities and it is easier to obtain the trust of clients in the capacity of institutional liabilities. In practice, it is hard for individual professionals to undertake big practice work; and thus the

intermediary professionals all over the world form practice firms to develop business and augment their capacities of undertaking external liabilities by joint efforts to acquire clients' trust. For example, all international attorneys and accountants providing services for listed companies have formed large-size firms that undertake business and manage professionals.

It is a common market practice that agencies have more opportunities of engagements than individuals. The internal motives for certified public accountants, registered tax agents and attorneys to form professional firms are to grasp more opportunities of engagements and in turn, the engagements in the name of firms may provide clients with more sense of trust, hence providing clients with better services by performing contractual obligations in the name of firms. Therefore, the overwhelming majority of professionals join in professional firms to undertake activities. This is the necessary requirements of the situation development, and the independent director regime shall adapt itself to the situation development, where independent director services shall be provided for clients by establishing independent director LLP (limited liability partnerships). Such firms are composed of registered independent directors, accept the authorization of listed companies or state-owned assets management departments and sign contracts of independent director services with companies. Such contracts shall specify the rights and obligations of independent directors, collect service remunerations from client companies in the name of firms, and then distribute remunerations to independent directors. Economically, independent directors are completely independent of listed companies, without any employment relationship or payment relationship, whereby the probability may be greatly reduced that the independent exercise of powers by independent directors is controlled by others.

In case an independent director fails to perform his/her contractual obligations with losses caused to a company or its non-management shareholders, he/she shall bear joint and several liabilities with his/her independent director firm and other defaulting independent director partners. The joint and several liability is the logical result of breach or infringement; and it is a breach of contract that independent directors fail to perform their duties in accordance with the articles of association and their obligations prescribed by the contract of the engagement of independent directors, for which independent directors shall bear the liabilities, mainly property liabilities, including the stocks and option interests and other individual properties of the independent directors in the company.

6.4 Independent directors shall undertake property liabilities to the company

Listed companies and their shareholders are entitled to prosecute those independent directors who fail to perform their duties loyally and diligently for

breach of contract and in case property liabilities are involved, such independent directors shall undertake joint and several liabilities with the independent director partnership firms concerned. Because listed companies sign contracts for the engagement of independent directors with independent director firms, such firms hereby are liable for breach of contract. However, since such firms undertake the liabilities as limited by the property under their operation and management, when the property of the firms is insufficient to discharge their debts, such liabilities become limited liabilities. By contrast, the defaulting independent directors in the listed company shall undertake unlimited joint and several liabilities with all their personal properties. In such case, because other independent directors in the partnership firms have not yet provided the listed companies with services, they are not related to the losses. Pursuant to the provisions of the limited liability partnership system of *The Partnership Law of China*, the independent directors without fault shall not undertake any joint and several liabilities for the debts of their firm.

7 Relationships between remuneration and performance of independent directors

Independent directors shall have their own independent interests in listed company that are the fundamental economic conditions for performing their duties and making independent judgments.[5] If an independent director does not have his/her own independent interests, there would be lack of intrinsic economic logic for him/her to perform his/her duties loyally and diligently on the board of directors, and his/her acts would not necessarily be based on experience

[5] Yan Yan, Research on Several Legal Issues of Independent Directors, 2005 CUPSL Master Thesis, p. 35. It states that "the author holds that the independence of independent directors, by the above-mentioned theories of independence, may be divided into three levels. The first level is the elements of independence in the form required by the rules of law, which is the foundation of independence; the second level is the independence of their interests, which is the prerequisite for independent judgment, expression, and exercise of power by independent directors. The third level refers to independent judgment, which is the essential requirement for realizing the independence of independent directors. The realization of the independence of independent directors is a progressive process. Generally, at the beginning of the establishment of a system, what we see is the independence on the first level, when many issues may be exposed for exploration and argument by people. In the course of exploration, the people realize that it is necessary to create the second level of independence, that is, more attention will be paid to the operability of independence in the economic interests of independent directors within the framework of the regulations of law. The realization of independence on such level may guarantee the realization of the third level of independence, namely, independence in judgment.

or data but arbitrariness. In the event that the operation of the company is of no direct relationship with the personal interests of independent directors, it is likely to be a unilateral willing of the regulatory department to rely on the insistence of principle and justice by independent directors on the board of directors. In view of historical experience and actual circumstances, the independent interests enjoyed by independent directors shall be recognized. In order to ensure the feasibility of the independent interests of independent directors, it is not proper for a listed company to pay directly remunerations to independent directors, and the remunerations should be paid to the independent director firms where the independent directors work, and then such firms shall distribute the remunerations to the independent directors. If independent directors are completely independent of the management of the listed company economically, they may not be economically restrained by controlling shareholders. Because the contract of the engagement of independent directors is signed between the listed company and the independent director firm, if there is no act in breach of the articles of association and the engagement contract of independent directors, even if they are usually against the opinions of controlling shareholders at the meetings of the board of directors, the controlling shareholders may not dismiss the independent directors concerned by means of the majority capital resolution. It may be easier to achieve the purpose of settling insider control by the establishment of independent directors.

The comprehensive remuneration of independent directors shall be linked with corporate performance.[6] In addition to the basic remuneration from their

[6] Chen Zhijun, *Specific Suggestions on True Play of the Role of Independent Directors in Listed Companies*, School of Postgraduates of the People's Bank of China, from Issues 4 and 5, *Research on the Investment of An Hui Construction*, 2001, p. 51. It states that "the decision-making principle of independent directors, as rational economic persons, is to realize the maximum of their utilities. It is obviously too ideal for small and medium shareholders to put all their hopes on the good professional moral of independent directors. The incentive and constraining mechanism shall be established and perfected for independent directors. There are two kinds of incentive mechanisms of independent directors: reputation mechanism and remuneration arrangement. Reputation is a very important factor to be considered when choosing independent directors. For independent directors, if they can represent their independence on the board of directors, their reputation may be raised intangibly, which may broaden the opportunity for their future employment. But the labor market of independent directors has not taken shape at the current stage of China, and the spread of reputation is limited. Therefore, there are great limitations on the efforts of market restriction. Hence, the design of a proper remuneration system is of much practical significance for the encouragement of independent directors. But a principle shall be observed, that is an optimal balance shall be found between recognizing their contributions and not hurting their independence. Too high remuneration easily leads to the reliance of independent directors on listed companies economically, then their independence may not be guaranteed; while too low remuneration may not encourage independent directors to do their best to serve companies.

firms, independent directors may acquire certain pro rata remuneration based on the added value according to the distributable profits of companies, or be given certain stock options,[7] where if independent directors are able to perform their duties loyally and diligently, after the service year of agreed services, they may obtain certain pro rata stocks or shares based on the added value. Companies make use of such methods to encourage independent directors to devote themselves to corporate businesses and voluntarily perform their duties of loyally and diligently.

Upon establishing and perfecting the above-mentioned regime, it can be seen that full-time independent directors with good backgrounds of professional specialties and professional self-regulation, threatened by the deterrence of breach of contract and unlimited joint and several liabilities and attracted by the interest of stock options and the comfort of good reputation in society after success, independent directors may well get rid of the role as honorary directors as soon as possible, and provide efficient services for state-owned assets management departments and non-management shareholders with great care and diligence based on their professional knowledge, hence playing the real role of independent directors in restraining insider control and representing non-management shareholders in discussion and voting.

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[7] Yuan Wei, CSRC Chongqing Office, *The Perfection of Corporate Governance in Listed Companies by Option Incentive Mechanism*, from *Jinxin Securities Research*, p. 31. The stock option means the right granted by the enterprise to its operators for purchasing the agreed number of corporate shares at an agreed price in a fixed period. Such kind of incentive system is of double functions of "incentives of remuneration" and "incentives to owners". The most important content of the implementation of the option system consists of four basic factors: the beneficiary of stock options, the period of exercise, the price of exercise and the number of stocks subject to the exercise of rights. Essentially, the stock option is one of the contributions of the new economic growth theory to economics, the most important theoretical base of which is the concept of "the capitalization of human resources".

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