On the Duty of Diligence of our Corporate Executives—Beginning with the Understanding of Article 180 of Draft Amendments to the Companies Law

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Abstract

The separation of company ownership and management rights is a common practice for enhancing corporate governance within the modern enterprise system. The trend of "cannibalism" and loyal people, along with the development of the separation of powers, necessitates the establishment of a more standardized corporate governance mechanism for supervision. Therefore, accelerating the enhancement of the obligation system of corporate management will become an urgent problem to be addressed. Since the initial introduction of the "duty of diligence" in China's Company Law in 2005, its meaning has not been defined. This lack of clarity has created loopholes in judicial practice when determining whether a company's behavior violates the duty of diligence. While the current draft amendment to the Companies Act makes a breakthrough in Article 180 by defining the duty of diligence of directors and supervisors, the definition is still somewhat abstract. Therefore, in the subsequent revision process, the definition should be specific at the legislative level to enhance the diligence obligation of company management. This will provide clear legal guidelines for judicial practice to follow.

Keywords

Senior Management, Duty of Diligence, Draft Amendments to the Companies Law

1. Overview and development course of duty of diligence

1.1 Overview of the duty of diligence

"Duty of diligence" comes from the provisions of Article 147 of the Company Law of our country, which originally comes from the provisions of "fiduciary duty" in the Anglo-American law system, and is an indispensable content of fiduciary duty. And "Fiduciary Duty" has also been translated by some scholars as fiduciary duty, which generally refers to the duty of kindness, loyalty, and justice borne by the fiduciary for the beneficiary. At the same time, the fiduciary is also obliged to engage in certain acts selflessly for the benefit of the beneficiary, and cannot use the advantage to the detriment of the beneficiary.

Therefore, based on the perspective of fiduciary duty, the duty of diligence of senior executives in China can be briefly summarized as that senior executives, as fiduciary persons, should put the interests of the company first in the process of managing the company, operate the company with a down-to-earth and diligent attitude, maintain due attention and caution to the operation of the company's business, and take reasonable measures when necessary to prevent the interests of the company from being damaged.
1.2 The development process of the duty of diligence

In China, the "Duty of Diligence" first appeared in the "Guidance on the Articles of Association of Listed Companies" in 1997, that is, "Directors of listed companies should exercise the rights granted by the company carefully, conscientiously and diligently." It was only after the revision of the Company Law in 2005 that companies began to use it (Fu Qiong, 2022). However, for a long period of time after the duty of diligence was introduced into the Company Law, lawmakers have not defined its concept, even in the current Company Law, the concept is still not found. It was not until the draft Amendment to the Company Law in 2021 (hereinafter referred to as the Amendment draft) that the duty of diligence of directors, supervisors, and senior executives was defined as "the performance of duties shall exercise reasonable care normally due by managers for the best interests of the company" that the meaning of the duty of diligence tended to be clear.

2. Refine the necessity of the diligence duty of company executives

At the beginning of the establishment of most companies, because of their small business volume, the company generally maintains a "small workshop" operating system, and its business management is almost carried out by the founders themselves. With the increase in business volume and the expansion of company scale, founders are unable to do everything personally in the face of increasingly heavy business volume. In order to better manage the company, they usually hand over their own management rights to people with more professional knowledge. In this process, some people with managerial talent are also slowly emerging. Based on the concept of "specialization", founders will gradually delegate power to these professional managers and gradually change into the role of behind-the-scenes bosses (Zheng Jianing, 2022). But then comes the question of whether the authorized managers can properly exercise their authority. It is precisely because of the increasing violation of the duty of loyalty and diligence by company managers during their performance in judicial practice (see Figure 1, data from "Laws & Regulations Database-China lawinfo") that the Revised Draft begins to pay attention to the obligations of directors, supervisors and senior executives, and stipulates that directors and supervisors should pay reasonable attention to the best interests of the company.

Figure 1. Trends of cases of violation of the duty of diligence.

In addition, as the backbone of the company, the higher the position of the senior executive, the more power and freedom (Wu, Desheng & Xu, Jian, 2021). As the people who are most closely connected with the company's business, executives generally know more about the actual operation of the company than other personnel, and it is easier to find potential system loopholes in the company's operation. Therefore, once the supervision mechanism designed by the company is flawed or there is a deficiency in its use, it will be difficult to avoid executives taking advantage of the loophole and plundering the company's interests without any scruples. Therefore, it is understandable that the Draft Amendment refines the provisions on the duty of diligence from the legislative level and requires senior executives to give due reasonable attention in the process of performing their duties.

3. The current quo of the duty of diligence of Chinese companies

3.1 Current status of legislation

The provisions of the current law on the duty of diligence of company directors are mainly reflected in the Company Law, the Securities Law, and the Enterprise Bankruptcy Law, for example, Articles 147 and 149 of the Company Law, Articles 82 and 84 of the Securities Law, and Article 125 of the Enterprise Bankruptcy Law, but for the concept
of the duty of diligence itself, these laws are still not clearly defined (Weng Xiaochuan, 2021). It was not until December 2021, after the release of the Draft Amendment, that the concept of duty of diligence was determined from the legislative level, that is, "directors, supervisors, and senior managers have a duty of diligence to the company, and the performance of their duties should exercise reasonable care normally due to managers for the best interests of the company."

3.2 Current status of the judiciary

3.2.1 Summary of the study methods

As the cases of directors, supervisors, and senior executives violating the duty of loyalty and diligence are generally classified as "liability disputes for harming the interests of the company" in judicial practice[1], the author takes the judgments made by intermediate people's courts from January 1, 2021, to January 1, 2023, as samples, and takes "liability disputes for harming the interests of the company" as the cause of action on "China Judgements Online". With "civil case" as the case type, "judgment" as the document type, "civil second instance" as the trial procedure, and "duty of loyalty and diligence" as the keyword, a total of 38 judgments were retrieved.

3.2.2 Analysis of the subject matter of the defendant's liability

After sorting through these 38 judgments, the author found that there were 16 judgments in which the court ruled that the defendant was liable for violating the duty of loyalty and diligence. Of the 16 judgements, most involved a breach of duty of loyalty, while only one individual case involved a breach of duty of care (see Table 1).

<table>
<thead>
<tr>
<th>The reason for assuming legal liability</th>
<th>quantity</th>
<th>proportion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupation of company property</td>
<td>4</td>
<td>25%</td>
</tr>
<tr>
<td>Engaged in the same business as the company, to seek business opportunities</td>
<td>3</td>
<td>18.75%</td>
</tr>
<tr>
<td>Misappropriate company funds</td>
<td>2</td>
<td>12.5%</td>
</tr>
<tr>
<td>Violation of duty of diligence</td>
<td>1</td>
<td>6.25%</td>
</tr>
<tr>
<td>Store the company's funds in the name of an individual</td>
<td>1</td>
<td>6.25%</td>
</tr>
<tr>
<td>Violation of the company's property to provide security for others</td>
<td>1</td>
<td>6.25%</td>
</tr>
<tr>
<td>Others</td>
<td>4</td>
<td>25%</td>
</tr>
</tbody>
</table>

4. The deficiency of the duty of diligence of Chinese companies

4.1 Legislative level

Although the revised draft defines the duty of diligence, the term "reasonable care" is still a principle provision in nature and has strong subjectivity. Therefore, people with different value positions have different understandings of "reasonable attention". Just as Mr. Xie Juezai, a famous jurist of our country, said in his book The Procedures for Formulating the Fundamental Law of Autonomy: "Law is a kind of special knowledge. Although we all have the right to make laws, we cannot all have the knowledge to make laws." Therefore, due to the certain abstractness of the judgment standard of "doing all the reasonable attention usually due to managers", it is difficult in the current judicial recognition and application level.

4.2 Judicial level

The Draft Amendment defines the duty of diligence of directors, supervisors, and senior executives as "holding reasonable care normally". However, due to the differences in business scope, business scale, and development speed of various companies, the scope of "reasonable care" required by different companies for senior executives is bound to be different. Therefore, the law cannot provide a comprehensive provision on the content of reasonable care of senior executives. Therefore, in the absence of specific provisions, judges often have greater discretion.

Before the release of the Draft Amendment, because the Company Law did not clearly define the duty of diligence of directors, supervisors, and senior executives, the court would have different criteria for determining what is the duty of diligence (Wang Zhenzhen, 2022). For example, the Suzhou Intermediate People's Court in Jiangsu Province once held that "senior managers of a company have a duty of loyalty and diligence to the company." The duty of diligence requires that the management activities of the company should be scrupulously due, dedicated, thoughtful, and to the level of management that ordinary and prudent peers should have in the same company, the same position, and the same relevant situation.[2][3] However, Yantai Intermediate People's Court of Shandong Province shifted its focus to the concept of reasonable care when determining the duty of diligence, that is, "the duty of diligence means that the directors, supervisors and senior managers of a company should perform their duties for the best interests of the company, have the care of a kind manager, and exercise the reasonable care of an ordinary prudent person."[3][4] In addition, when the court judges whether the company’s managers have violated the duty of diligence, it will also judge based on comprehensive factors such as the actual information the perpetrator has at the time, the decision-making ability he has, whether the decision-making conforms to the provisions of the company’s articles of association, and whether there is subjective fault.[4] For example, the Guangzhou Intermediate People's Court in Guangdong Province rejected the plaintiff's claim on the basis that the actor's decision complied with the provisions of the company's articles of association.[5]

Therefore, due to the lack of a specific definition in the existing legislation, judges will exercise discretion according to the general provisions of Article 147, paragraph 1, of the Company Law (Zhou Linbin & Wenyi Jing, 2014). In the long run, it will breed cases such as "human cases" and "relationship cases", which will destroy the fairness and justice of the judiciary.

5. Suggestions on improving the duty of diligence of Chinese company executives

5.1 Refinement of the duty of diligence provisions

5.1.1 Drawing on the duty of diligence provisions in relevant industry codes
Since the Draft Amendment only provides a preliminary conceptual definition of the duty of diligence, the author suggests that it can refer to the specific introduction of directors’ duty of diligence in Article 98 and the provisions of Article 125 of the latest revised Guidelines of Listed Companies' Articles of Association in 2022, and absorb it into the Company Law or judicial interpretation to improve the definition of executives' duty of diligence.

5.1.2 Giving companies a degree of autonomy over the definition of the duty of diligence
When determining the duty of diligence of company executives, the law cannot make detailed provisions, so the law may give companies certain independent decision-making power so that each company can set the duty of diligence to be borne by company managers through the company’s articles of association or special contracts according to its own conditions. It also gives the company and other shareholders the right to Sue directly against the manager's violation of the duty of diligence to protect their rights and interests. For example, the Intermediate People's Court in Xi'an, Shaanxi Province, has recognized that companies can agree with senior executives about their duty of care in the form of articles of association or special contracts[6].

5.2 Preventing undue extension of the scope of reasonable care
William Godwin said in A Theory of Social Justice, "Duty is a mode of action which requires the best use of the position of the individual for the good of the group." For executives, it is their duty to create and strive for the maximum benefits of the company. Therefore, while we emphasize how executives should exercise the usual reasonable care for the best interests of the company, we should also consider how to encourage executives to maintain a positive attitude while running the company's business and avoid depressing their enthusiasm by overemphasizing reasonable care. Therefore, the author suggests that in the follow-up review of the revised Draft, the reasonable scope of care in the duty of diligence should be carefully defined, so as to prevent excessive extension of the scope from

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causing excessive psychological pressure on senior executives and inhibiting their vitality.

5.3 Subdividing the obligations of diligence of different subjects

In view of the fact that senior executives manage the daily business activities of the company, as the actual "operators" of the company's business, compared with other people, they can more easily access a lot of information inside the company. In addition, senior executives usually work full-time and are more familiar with various affairs of the company, so more obligations and norms should be set for them to effectively supervise. Therefore, the author suggests that in the follow-up review of the Revised Draft, the duty of diligence of different subjects should be distinguished at the legislative level, such as in the form of judicial interpretation, rather than the duty of diligence of directors, supervisors, and senior executives in a unified provision.

6. Conclusion

As for the duty of diligence of company executives, China's Company Law from the beginning of its formulation to the current version has not been clearly explained from the legislative point of view, until the appearance of the revised draft, the concept of duty of diligence has been clear. Compared with the general provisions of the Company Law, the "reasonable attention should be paid to the best interests of the company" advocated in the Draft Amendment is indeed a significant progress in legislation. But "reasonable attention" is more from the attitude of the directors, supervisors, and senior executives put forward requirements, and because of its certain abstractness, whether this provision can play the ideal role of lawmakers, to be tested in judicial practice, the subsequent improvement also needs to rely on judicial practice experience and practical effects to give feedback (Li Jianwei, 2023).

References

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