

# *Reconstruction of the Independent Director Responsibility System under Board-Centric Governance*

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**Abstract:** The second amendment to the Company Law involves several aspects of the independent director system. The existing corporate legal framework and judicial practices are currently inadequate for the evolving corporate governance model under board centralism. Consequently, the liability system for independent directors requires urgent improvement. This paper explores the theory of board centralism and the roles of independent directors, integrating these concepts with the construction of relevant systems beyond regional boundaries. In line with the responsibility of independent directors to oversee and safeguard the interests of minority shareholders, this paper advocates for clear legislative definition of the duty of diligence. It proposes revisions to judicial accountability and restructuring of the independent director liability system through enhancements to their incentive mechanisms, thereby aligning it with the development of a board centralism system tailored to the market economy of China with its unique characteristics.

## 1. Introduction

On December 30, 2022, the draft of the second amendment to the Company Law was reviewed by the Standing Committee of the National People's Congress. The draft indicates a shift towards a board-centric governance model. Article 69 of the draft clarifies the significant position of the board of directors and its audit committee, heralding the arrival of the highly anticipated board centrism, with an expansion of the board's powers now a reality. Based on principles of accountability and balance of interests, the draft specifies the fiduciary duties of directors, supervisors, and senior management, intensifying directors' responsibilities and complicating the position of independent directors. On one hand, as a counterbalance to the increasingly dominant board of directors, independent directors urgently need better institutional support to perform their supervisory functions. On the other hand, with the revision of the Securities Law, independent directors must bear legal responsibilities for the disclosure of information by listed companies; Article 180 of the draft adopts objective criteria for the duty of diligence of independent directors, without subjective defenses or exemptions from liability. This legislative change undeniably strengthens the legal responsibilities of independent directors. Why has the system design of independent directors, which serves a unique function, been widely adopted and proven effective in other countries? Why are independent directors

in China burdened with "various shackles," facing harsh scrutiny both legislatively and judicially? This is related to significant flaws in China's current independent director liability system: the ambiguous status and functions of independent directors; the vague and operationally challenging determination of whether independent directors diligently fulfill their duties, a lack of specific rules for assessing the duty of diligence, and legislative avoidance of the nature of the duty of diligence; an overly simplistic attribution principle that focuses solely on "signature-based accountability," ignoring the subjective intentions and individual expertise of the independent directors, with virtually no grounds for exemption from liability. Furthermore, the absence of relief mechanisms for independent directors after they assume responsibilities makes it difficult for them to perform their duties with peace of mind.

## **2. The Theoretical Basis of Board Centrism and the Functional Choice of Sole Directors**

### **2.1 Practical and theoretical foundations of board-centrism**

It is commonly believed that the governance structure of board centrism originated in the United States as a solution to significant flaws in the traditional shareholder-centric governance structure. This approach was first legislated in the Delaware General Corporation Law of 1899, which stated that, unless otherwise specified by law or corporate charter, all corporate business and affairs should be managed and directed under the board of directors. This effectively addressed issues of major shareholders infringing upon the interests of minor shareholders and shareholders "free riding" or "voting with their feet." Subsequently, the Model Business Corporation Act stated: "The board of directors shall exercise or authorize the exercise of all corporate powers and shall direct the business and affairs of the company." This formally placed the board of directors at the core of corporate governance. The theoretical foundation of board centrism stems from the "separation of ownership and control" theory mentioned in the seminal work "The Modern Corporation and Private Property" by Berle and Means. They argued that as economic activities evolved and specialized, shareholders gradually withdrew from corporate management, delegating to professional managers familiar with transaction regulations and corporate operations. This shift moved the focus of corporate governance from the shareholders' meeting to the board of directors, which effectively controlled the company, with the shareholders' meeting having no right to interfere or veto decisions made by the board based on its authority. On the other hand, the trend of separatism led to the continuous expansion and even magnification of corporate size, placing higher demands on efficiency and effectively limiting shareholders' rights, thus expanding the powers of the board of directors under board centrism, necessitating restrictions on directors within this system [3].

### **2.2 Functional choices of independent directors under board centrism**

#### **2.2.1 Functional choices for the monitoring function of independent directors**

The "separation of powers" has increased agency costs and exacerbated two major agency problems in corporate law. The first is the conflict of interests between company owners and managers—how to protect the interests of owners and prevent managers from engaging in opportunistic behaviors. The second problem involves conflicts of interests between controlling shareholders and minority shareholders—specifically, how to reduce the manipulation of the board by controlling shareholders to the detriment of minority shareholders. To address the first agency problem, it is increasingly demanded that all or part of the members of the company's board of directors should not be occupied by company executives. The independent director system emerged as a response: it aims to eliminate the incentive for directors to sacrifice the interests of other groups

for those of the company management. A prominent example is the U.S. Sarbanes-Oxley Act, which mandates that listed companies establish audit committees composed entirely of independent directors, marking the formal legal recognition of the supervisory role of independent directors[4].

### **2.2.2 Functional choices of the sole director to protect the interests of small and medium-sized shareholders**

The original intent of board centrism was to place the board at the core of governance, focusing on motivating the management layer. Ideally, unlike shareholders who focus solely on maximizing their own interests, directors prioritize maximizing the overall interests of the company, including the interests of creditors, employees, and the company's social responsibilities. However, in China, most listed companies have concentrated ownership, with major shareholders or actual controllers being prevalent. Article 46 of the Company Law explicitly states that the board is accountable to the shareholders' meeting, which has significant power over the appointment and removal of directors. This makes it easy for controlling shareholders or actual controllers to manipulate the board for related transactions, damaging the interests of minority shareholders. At this point, independent directors, who are independent of all stakeholders, carry the critical function of protecting the interests of minority shareholders[5].

## **3. Sole director liability system under extraterritorial company law**

### **3.1 Applicable soil for sole director liability**

In the commercial practice of the United States, the degree of concentration of company equity is extremely dispersed, belonging to a system of dispersed ownership, and the United States is a typical country where ownership and control are separated. The model of independent directors as supervisors of management has become a major feature of corporate governance in the United States, where the majority of directors of listed companies are independent of management. In these countries, independent directors are more likely to be seen as defenders of small shareholders or non-shareholder interest groups. Their application soil lies in the second type of agency problem mentioned earlier, which is the conflict between controlling shareholders and minority shareholders. In other words, in the United Kingdom and European Union countries, the scope of responsibility of independent directors is broader, encompassing both the first and second types of agency problems. This inevitably leads to more cost issues, and the independence of independent directors and their understanding of the company show a mutually exclusive relationship. As mentioned earlier, China is a country with relatively concentrated equity ownership, deeply entangled in the second type of agency problem and, like the aforementioned countries, institutional shareholders hold a strong position, and the financial media maintains sensitivity to corporate governance affairs.

### **3.2 Determination of the behavior of independent directors' duty of diligence**

In Anglo-American jurisdictions, the "duty of diligence" is referred to as the "duty of care." The U.S. Model Business Corporation Act (MBCA) describes its essence as the "reasonable care (standard) of a person in a similar situation." This includes, firstly, using the standard of care of an ordinarily prudent person, which presents considerable objectivity. Secondly, it also implies a subjective requirement for directors, namely good faith, which in specific actions translates to informed decision-making. Lastly, it encompasses reasonably believing in acting in the best interests of the corporation, as judged through specific participatory actions. The debate between subjective and objective standards in the duty of diligence is influenced by its similarities with tort liability, where

the duty of care in tort law has been adopted as a model. However, foreign legislation differentiates between these, treating the former as an objective standard and the latter as subjective, based on the different natures of commercial and civil actions. The UK Insolvency Act adopts the standard of a "reasonably diligent person" to assess directors' duties, aligning with U.S. regulations, which require directors to possess general knowledge, skills, and experience reasonably expected of them. Continental legal systems, represented by Germany and Japan, also show variations in the behavioral determination of independent directors' duty of diligence. Specifically, Article 330 of the Japanese Companies Act applies Article 644 of the Japanese Civil Code concerning the "duty of care of a good manager" to directors' rights and obligations. This focuses on the duties a trustee owes to a principal, emphasizing the trustee's own efforts and level of care. The standard tends toward a personalized criterion of a "good manager," which differs significantly from the system of independent director responsibilities designed based on agency relationships in U.S. law. German regulations, reflected in Section 93(1) of the Stock Corporation Act, dictate that directors must exercise the care of a typically diligent and conscientious business manager. Chinese scholars have summarized this standard as that of "an honest, diligent manager," which concretizes it at the level of professional managers[6].

### **3.3 Recognition of responsibility for the sole director's duty of diligence**

The standards for determining the duty of diligence serve as guidelines during an independent director's tenure. However, in judicial practice, more emphasis is placed on determining responsibilities post-facto. This approach is due to the inherent risks in commercial practice; having a complete set of responsibility determination standards allows independent directors to innovate and make decisions without concerns. Additionally, the judiciary should maintain a clear distinction from corporate autonomy, respecting commercial practices. In the common law system, the U.S. constructs liability determination for the duty of diligence through a combination of the presumptive (negative) business judgment rule and expressly provided exculpatory causes. Procedurally, it is presumed that independent directors fulfill their duty of diligence, and post-facto, the absence of "gross negligence" in their decision-making is evaluated to assess whether they have diligently fulfilled their duties. However, the standard of "gross negligence" is extremely vague in Anglo-American law, making it very difficult to define, inherently uncertain, and subject to considerable discretion. Additionally, the plaintiff bears the burden of proof to demonstrate that the independent director breached the duty of diligence, which can be challenging. The "gross negligence" standard, coupled with the plaintiff's burden of proof, objectively relaxes the responsibility determination for independent directors, hence even in Anglo-American jurisdictions, the application of this part is highly contentious. In the U.S. Model Business Corporation Act, Section 8.30(b) provides that independent directors are entitled to rely on the opinions of company executives, legal advisors, and auditors among other professionals. This defense also needs to be considered under the previously mentioned "reasonable standard of a person in a similar situation[7]."

## **4. Reconstruction of the liability system for independent directors under board-centrism**

### **4.1 Construction of a liability system adapted to the functions of a sole director**

The revision to the Company Law adds Article 69, which grants independent directors oversight responsibilities over financial and accounting matters, reflecting the legislator's emphasis on the supervisory function of independent directors. However, the expansion of director powers, combined with the prevalent issue of "insider control," often results in merely meeting the regulatory form of supervision under board centrism, effectively nullifying the real function of independent director

oversight[8].

#### **4.1.1 Independence in the appointment and removal of sole directors**

It could be considered to entrust the appointment and removal rights of independent directors to minority shareholders, cutting off any direct ties between independent directors and major shareholders or actual controllers, thereby maintaining their independence. Minority shareholders, being numerous and loosely organized, are represented by newly introduced investor protection agencies under the new Securities Law, which are designed to protect their interests by exercising rights including, but not limited to, the appointment and removal of independent directors and exercising supervision rights, with appointments requiring the approval of more than half of the voting rights held by minority shareholders. Currently, the investor protection agency system is in its nascent stage, with specific regulations and resource support still unclear. For it to function effectively, further refinement of the supporting systems is necessary.

#### **4.1.2 Strengthening of the supervisory function of the sole director**

The capabilities of independent directors to supervise should manifest in several aspects: familiarity with the professional fields of the companies they intend to serve, a certain level of corporate management ability, and a good reputation from their career experiences. In reality, most independent directors possess only one or two of these qualities, making it difficult to achieve perfection. With the increasing severity of responsibilities for independent directors, there is an urgent need for them to shift their mindset from simply understanding matters to actively governing. Simultaneously, there is a societal need to improve the professional manager market and establish a comprehensive reputation system for professional managers. If independent directors perform their duties diligently, their future prospects and recognition in the business field will be higher, whereas negligence in duties could lead to dismissal, forcing independent directors to safeguard their professional integrity[9].

### **4.2 Clarifying the nature of the legislative duty of diligence**

Based on the practices of different legal systems and considering China's specific conditions, two approaches can be implemented. The first approach involves adopting abstract principles or general provisions from Anglo-American legal systems, where courts rely on a multitude of case laws to conduct post-facto reviews of whether independent directors have fulfilled their duty of diligence. The second approach also sets out principle-based provisions, but these principles serve as a basis for concrete standards, thereby making the specific content clear; it follows a top-down approach, starting from the function of the independent director system and emphasizing how behavioral determinations affect the performance of independent directors[10].

#### **4.2.1 Choice of approach to the standard for determining the conduct of the duty of diligence**

For the first approach: Currently, the Supreme Court has not issued any judicial interpretations related to the duty of diligence of independent directors, nor are there guiding cases; and, given the civil law system's emphasis on codified law, introducing a duty of diligence without defining its specific meanings leads to difficulties in legally interpreting and applying this norm. This method places more emphasis on the perspective of judicial determination, leaning towards establishing liability standards. Therefore, due to objective reasons, the first approach is not feasible, necessitating consideration of the viability of the second approach[11]. If the second approach is adopted, it is first necessary to define what general standards will be applied, and then determine specific standards

through the way independent directors perform their duties. The "professional manager" standard in German law seems more appropriate for general standards, as it emphasizes the directors' obligations to the company and provides protection for the interests of minority shareholders, thereby achieving equitable justice. The civil law tradition's understanding of the duty of diligence, which evolved from "mandate relationships" and is similar to the general view in China, shares a common origin. This standard corresponds with the enhancement of the supervisory function of independent directors through establishing a system of professional managers, facilitating the detailed implementation of the duty of diligence for independent directors.

#### **4.2.2 Specified Duty of Diligence for Sole Managers**

The concrete standards for the duty of diligence should be defined as specific guidelines that independent directors must follow according to their functions and the actual operations of the company, from static, dynamic, and developmental perspectives of the company. First, the supervisory duty requires sufficient attention, based on a thorough understanding of relevant information, and independent directors should hold themselves to a standard of care higher than that of an ordinarily prudent person, especially in decisions closely related to the interests of minority shareholders. This attention should also integrate their professional skills or specific knowledge, stemming from the "mandate" or even "agency" relationship[12]. Second, the duty of examination, mainly manifested in the form of independent directors' participation: In practice, most independent directors perform their duties by participating in board meetings and signing written confirmations for the company's periodic reports. Independent directors must scrutinize the authenticity of these reports through various means to minimize the negative impact of information asymmetry; they must also fulfill a reasonable duty of care in cases of irregularities in the company's operations, continuously monitoring the company's operational status[13].

#### **4.3 Amendments to judicial accountability**

The first section discussed the flaws and deficiencies in the independent directors' liability system; this part responds to the aspects of responsibility assumption (or determination) of independent directors, mainly focusing on revisions and improvements to the burden of proof and exculpatory reasons[14].

##### **4.3.1 Introduction of the business judgment rule**

The feasibility of adopting the business judgment rule, as practiced in German law, has been discussed earlier, but it still requires localization adjustments considering China's national conditions. Firstly, concerning the standards of proof, a combination of objective and subjective standards should be used. Objectively, the negligence of an independent director should meet the "ordinary negligence" standard; subjectively, the director's decision-making, combined with their professional capabilities and skills, should be deemed reasonable and potentially exculpable[15]. If such decisions lead to losses for the company, they should not be pursued further, as determined by the requirements under board centrism that encourage diligent performance by independent directors. Secondly, regarding judicial restraint, it is generally believed that after applying the business judgment rule, courts typically do not conduct substantive reviews of decisions made by independent directors, only examining whether there is any illegality in these decisions. This reflects judicial respect for internal corporate governance and the business judgments of independent directors. However, merely conducting a formal review in some cases can have the opposite effect, particularly in assessing the conduct under the duty of diligence: independent directors should exercise sufficient caution and thorough review to ensure they are fully informed.

### 4.3.2 Exemption

Currently, the explicit exculpation provisions for independent directors in China are found only in Article 85 of the Securities Law, which stipulates joint and several liability for directors, supervisors, and other directly responsible personnel in cases of false statements, except when they can prove their innocence. However, in judicial practice, the approach is often "penalty upon signature," where independent directors effectively have no grounds for defense. Even if independent directors present a reasonable defense, it does not serve as a tool for exoneration or defense but at most as a factor for courts to consider mitigating their liability. Considering the "Kangmei Pharmaceutical case" discussed earlier, where independent directors faced exorbitant compensations, one might wonder whether it is necessary to introduce relevant exculpatory reasons under the current harsh scrutiny of independent directors in a board-centric governance model[16]. What type of exculpatory reasons could better balance the responsibilities and risks faced by independent directors? The provisions of Article 16, Section 1 of the "Regulations on Handling Civil Compensation Cases of False Statements in the Securities Market," issued by the Supreme Court on January 21, 2022, bear a striking resemblance to the defenses granted to independent directors in foreign laws for relying on the opinions of professionals, serving as a good summary of judicial experience in terms of exculpatory reasons[17].

## 5. Conclusion

The draft amendment still overlooks several core issues in the field of independent directors' liability system: the contradiction between stringent standards for diligent performance by independent directors and the need for them to fully perform their duties; should the business judgment rule be introduced for accountability standards when independent directors fail to perform their duties diligently? Also, how should the sparse incentive systems for independent directors, details of director insurance, and independent director compensation be considered? These issues require not only that corporate entities provide reasonable guarantees for independent directors to perform their duties but also that judicial authorities make case-specific judgments and summarize judicial experiences. Furthermore, legislators need to make appropriate legislative responses based on a full understanding of the imbalances in China's corporate "power-duty" operational structure[18]. Only by addressing these issues can the operation of independent director responsibilities align with the governance model of board centrism and ensure the vibrant functioning of China's economic market.

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