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The Comparative Law Yearbook of International Business

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Editor's Note

Volume 17 of the *Comparative Law Yearbook of International Business* contains a wide variety of articles which are of interest to the international commercial practitioner. The topics covered range from the ethical issues for lawyers involved in cross-border transactions to insider trading.

In several of the chapters, reference is made to the growing European Union (EU), with one chapter particularly focusing upon the free movement of goods throughout the EU's Member States. Competition within the EU is also dealt with, the provisions of Articles 85 and 86 of the Treaty of Rome being of particular relevance due to the large amount of recent case law in this area.

There is a large section dealing with company law matters, including the emergence and development of new types of corporation, privatization and the westernization of companies in countries such as China. The recovery of monies and the enforcement of judgments in this respect are always issues of high priority in business; thus, this volume discusses these matters in a separate section entitled "Debt Recovery". The remainder of the book is divided into parts dealing with finance and mergers and acquisitions, together with a general commercial law section.

The contributions to the *Comparative Law Yearbook of International Business* have been prepared by specialist practitioners from all corners of the world for the use of international business lawyers and their clients.

Susan Cotter, Editor
Center for International Legal Studies
Salzburg, Austria

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The Adoption of the Open-Door Policy

After decades of political turmoil and the subsequent arrest of the "Gang of Four" soon after Chairman Mao's death in 1976, the political climate of China finally began to stabilize in the late 1970s. As the country became stabilized politically, the Chinese government realized that economic reform was needed urgently in order to offer China the opportunity to become modernized and to keep pace with the rest of the fast changing and developing world. China has lost a few decades already due to political uncertainty and instability, and certainly cannot afford to lose any further time waiting for its modernization. Moreover, China cannot remain isolated from the rest of the world community if the goal of modernization were to be materialized. Therefore, the real awakening came in 1978, in the third plenary session of the 11th Central Committee meeting of the Communist Party of China held in December of that year. The party decided that China would require economic reforms and would, therefore, be opened to the outside world for the first time in decades.[1]

Since early 1979, various forms of economic reform have been seen all over the country. To name a few of them, the government has set up many special economic zones and economic development and technology zones in China, and has attracted different kinds of foreign investment. Some commentators have even suggested that the current opening up of China to the outside world is at least comparable to, if not more dramatic than, the opening up of Japan to western trade

1 "China — The Titan Stirs", *China Survey*, *Economist*, 28 November 1992, p. 3.

more than 110 years ago, during the period of the Meiji reformation. This observation is perhaps quite true because both countries came to understand that if modernization was to be achieved then they could not afford to be islands on their own, isolating themselves; they must open up their countries to the outside world.

During the past seventeen years of economic reforms in China, one of the most interesting and important reforms which requires detailed discussion is that of the dismantling of the state-owned companies and their transformation into western-style joint stock shareholding companies. As this phenomenon gains momentum, we will see more and more joint stock shareholding companies in China in the future. This in turn will gradually transform the country's planned economy back into a market one.

The Rise and Fall of State-Owned Companies

Shortly after the communist party took over the China mainland in 1949, they began the process of land and economic reforms. They turned many formerly privately owned companies into state-owned companies. The reason for this was because of the Marxist theory that production capital belonged to the people of China. Therefore, privately owned shareholding companies, which are based on the concept of individuals holding shares of companies and living on the dividends generated by the shares they hold, was totally incompatible with communist ideals, as this economic structure would create a class of people who lived on interest earnings. They would also exploit the working class people as they earned their living out of the capital which belonged to the people of China as a whole in the first place.[2]

This process of transforming privately owned companies into state-owned enterprises went on into the 1950s. This gradually turned the Chinese economy into a planned economy from a market one, as all state enterprises are required to produce in accordance with pre-drawn state economic plans, rather than to produce with reference to market demands. However, with approximately four decades of experimentation, it is generally accepted that state-owned

2 *See* generally, Jiang Yirwei, "Several Questions Concerning the Shareholding System", *Journal on Problems of Stock, Share System*, HK 160620 Beijing Jingji Guanli, Chinese Number 1, 1988, pp. 4-10 and 48.

companies have proved to be coming close to economic disaster. This is because, generally speaking, most state-owned companies are not profitable entities on their own and the state is always required to support them financially.

There are several reasons to explain the economic failure of such state-owned entities. Firstly, in state-owned companies, there is no clear separation between ownership and management.[3] Because of this, it is common to find excessive government interference at management level, which often affects the entities' performance. Also, all managers in state-owned companies have "iron rice bowls" as their jobs are guaranteed no matter how their companies have performed. Therefore, this system offers the managers no incentive to perform well.[4] Secondly, until very recently, there was no bankruptcy law concept in China.[5] Therefore, poorly performing state-owned companies would never go bankrupt. In turn, the government would pay for their losses. This is because the idea of state-owned companies going bankrupt was totally inconceivable, even up until the 1980s.[6] However, in a laissez faire economy, these enterprises would have gone out of business if they were unprofitable. This practice of the government subsidizing unprofitable state-owned entities has lead to the inefficient distribution of production capital.[7] As a result, it halts the growth of the economy.

Thirdly, all the state-owned companies have traditionally relied on debt financing alone, as equity financing does not exist anymore.[8] Therefore, there is a fixed interest rate cost no matter how the companies performed. This would be very harsh on the state-owned companies if they were not profitable entities in the first place. The situation of Chinese state-owned companies is best summed up by Janos Kornai, a Hungarian-born economist at Harvard:

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3 Henry R. Zheng, "Securities Regulations in China: Development and Conflicts", *East Asian Executive Reports*, May 1987, pp. 7-12.

4 Henry R. Zheng, "Securities Regulations in China: Development and Conflicts", *East Asian Executive Reports*, May 1987, pp. 7-12.

5 For the development of Chinese bankruptcy law, *see* Xiao Zhu Yue, "Corporate Bankruptcy Law in China", *International Business Lawyer*, June 1989, pp. 269-275.

6 Xiao Zhu Yue, "Corporate Bankruptcy Law in China", *International Business Lawyer*, June 1989, p. 270.

7 For a discussion of how production capital is used efficiently, *see* generally, Li Xinyan and Meng Huan, "How the System of Joint-Stock Ownership can be Introduced into Large and Medium State Enterprises", Joint-Stock Systems Advocated for State Enterprises 40060090 Beijing Liaowang, Chinese Number 41, 10 October 1988, pp. 17-18.

8 For a full discussion of how Chinese companies obtain financing traditionally, *see* generally, Hu Yebi "China's Capital Market", Hong Kong: The Chinese University Press, 1993.

> "Communist firms are geared toward the bureaucrats who give them orders rather than customers who buy from them, toward output rather than profit, toward the social welfare of their employees rather than efficiency. Market signals become even more muffled because the 'soft budget constraint' given to a firm by the state banking system ensures that loss-makers, no matter how hopeless, continue to be financed so that jobs are not jeopardized. Lacking profitability as a guide to the right level of capital and output, firms feel an insatiable 'investment hunger'."[9]

Due to the failure of the state-owned companies system, an alternative system must be adopted in order to expand the growth of the economy. Many scholars argue that the joint stock shareholding companies system is the key to overcoming the difficulties arising from state-owned companies.[10] In the joint stock shareholding system, there is a clear line drawn between ownership and management. The owners of the companies are the shareholders. They are totally separate from the managers who run the companies on a daily basis. Moreover, the managers have a much greater incentive to work well because their jobs would be jeopardized if they failed to earn profits for the companies. The shareholders would not allow the management team to stay on if that were to happen. Also, managers' remuneration is often tied to the economic performance of the companies which, therefore, gives an additional incentive to the managers to work hard and perform well.

Moreover, unlike with state-owned companies, under the joint stock shareholding system, the companies must assume their own profits and losses. This would drive inefficient companies, or companies which fail to meet consumers' demand, out of business. In turn, this would lead to an efficient distribution of production capital and thus, enhance the growth of the economy.[11] The practice of distributing production capital to badly managed or money losing entities in a state-owned companies system is a waste of production capital and greatly accounts for the slow

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9 "China — The Titan Stirs", *China Survey*, *Economist*, 28 November 1992, p. 10.

10 For a full discussion of how the joint stock shareholding companies system would overcome the problems found in the state-owned companies system, *see* Li Xinyan and Meng Huan, "How the System of Joint-Stock Ownership Can Be Introduced into Large and Medium State Enterprises", *Joint-Stock Systems Advocated for State Enterprises*, 40060090 Beijing Liaowang, Chinese Number 41, 10 October 1988.

11 Li Xinyan and Meng Huan, "How the System of Joint-Stock Ownership Can Be Introduced into Large and Medium State Enterprises", *Joint-Stock Systems Advocated for State Enterprises*, 40060090 Beijing Liaowang, Chinese Number 41, 10 October 1988.

growth of the economy. Also, in the joint stock shareholding system, ownership of shares would be diversified. This would reduce the business risk of the government because it would not hold all of the shares. This would solve the problem of the government having to subsidize money losing state-owned entities.[12]

Furthermore, Chinese people have one of the highest income saving rates in the world. However, without the method of direct equity investment under the joint stock shareholding system, the only methods of investment available to them were to keep their savings in banks or to purchase government bonds.[13] However, with the establishment of the joint stock shareholding system, people can invest their savings by buying companies' shares. This phenomenon would turn idle bank savings into production capital and stir up the growth of the economy.[14] Because of all these reasons, academics argue that the joint stock shareholding system is the logical alternative to the state-owned companies system.

Justification of the Joint Stock Shareholding System

It has been stated above that after the Chinese communist party took over in 1949, they were very hostile toward the joint stock shareholding system as it was incompatible with Marxist communist theory. Therefore, one may wonder how the Chinese government could allow the adoption of the joint stock shareholding system on a theoretical basis. Again, there are many theoretical justifications for adopting the joint stock shareholding system. To begin with, the government takes the view that a perfect socialist country would evolve in four consecutive stages.[15] The first stage is capitalism, the second stage is the primary stage of socialism, the third stage is the advanced stage of socialism, and the last stage is the stage of reaching the communist utopia. Chinese officials argue that China is currently at the second stage of the process. They suggest that during this stage of political development, it is essential for China to utilize some capitalist tools in order to allow the

12 Henry R. Zheng, "Business Organizations and Securities Laws of the People's Republic of China", *Business Lawyer* 43, February 1988, pp. 549-619.

13 Hu Yebi, *China's Capital Market*, Hong Kong, The Chinese University Press, 1993.

14 Hu Yebi, *China's Capital Market*, Hong Kong, The Chinese University Press, 1993.

15 Hu Yebi, *China's Capital Market*, Hong Kong, The Chinese University Press, 1993, pp. 67-68.