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RESEARCH ARTICLE

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On directors' accountability in China: Good faith path

Abstract The mode of deferential review on directors' management decisions coincides with the requirements of adaptive efficiency, being conducive to encouraging directors' tentative experiments. However, under the rule of business judgment, directors' accountability requires for onerous burden of proof on the plaintiff, and the formal review of directors' decisions and the uncertainty of the standard of care have rendered the duty of care almost an empty shell, and consequently the unfaithful conducts of directors between gross negligence and malice are always at large. The good faith path is not only a mechanism to fill the gap of accountability but an important mechanism to overcome the information asymmetry between shareholders and directors. The judicial practice of directors' accountability in the 1990s produced a good faith path, and the good faith concept has been rejuvenated with creative changes, the standards of conducts become clear with the increasing operability of judicial reviews. In China, the standards on fiduciary conducts can be defined by the judicial interpretation of the Company Law, so as to incorporate such misconducts as intentionally causing the violation of law by company, failure to disclose candidly, abuse of power and gross disregard of responsibilities, hence inducing the good faith path to accountability.

Keywords directors' accountability, corporate senior managers, good faith, grave misfeasance

摘要 董事经营决策的尊重审查模式契合了适应性效率的要求，有利于鼓励董事进行尝试性试验。但是，在商事判断规则下，董事问责需原告负担严苛的举重责任，董事决策审查形式化及注意标准的不确定性，使得注意义务几乎被掏空，介于重大

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过失与恶意之间的董事失信往往逃脱法律责任。诚信路径不仅是问责空隙的填补机制，也是克服股东与董事之间信息不对称的重要机制。二十世纪九十年代以来，董事问责的司法实践催生了诚信路径，诚信概念亦因创造性转化而获得新生，其行为标准日益明晰，司法审查可操作性增强。 中国可通过公司法的司法解释界定诚信的行为标准，将故意让公司违法、不坦诚告知、滥用职权和严重失职纳入其涵摄范围，从而引入诚信问责路径。

关键词 董事问责，公司高管，诚信，重大过失

With waves and changes in the field of business, directors are the leaders of enterprises that navigate those uncertainties. Thus, the decisions of directors are closely related to the rise and fall of the company. Eight central enterprises checked by State Audit Office of the People's Republic of China suffered loss or potential loss of RMB5.487 billion and erosion of state-owned assets at RMB1.375 billion due to mistakes in decision-making, breach of decision-making procedures and poor management. (Li, 2007) At the end of November 2004, Chen Jiulin, who set his mind to be a "super CEO", made a gigantic loss of USD550 million from trading of oil futures, involving nearly 16,000 investors and more than 100 creditors, (Han, 2006) which clearly indicated the hazard of omission or wrong acts of directors. With implementation of scientific outlook of development, directors' accountability has become a new eye-catching phenomenon in Chinese economic and social life. In February 2007, Chen Jiulin, former executive director and president of China Aviation Oil (Singapore) Ltd., was punished by dismissal from office and deprival of the CPC membership by the State-owned Assets Supervision and Administration Commission of the State Council, and Jia Changbin was ordered to resign. (Zhong, 2007) It can be said that such way won good social responses.

Where there is directors' accountability, there shall be law on accountability. In 2004, the State Council promulgated the Several Opinions on Promoting the Reform, Opening up to the Outside World and Stable Growth of Capital Market, which specifically provides for the establishment of the accountability mechanism for breach of duties by officers of delisted companies and practical maintenance of the lawful rights and interests of investors. At present, the provisions on directors' accountability are concentrated on state-owned enterprises and state-owned shareholding companies only. In 2003 the State Council issued the Regulations on the Supervision and Management of State-Owned Assets of Enterprises, Articles 40 and 41 of which provides for the compensation liabilities, disciplinary punishments (administrative punishment) and criminal liabilities of the responsible persons of state-owned and state-holding enterprises for abuse of authority and malpractice with losses caused to the state-owned assets of enterprises, hence declaring the end of the mode of "operation without liability". State-owned asset supervision and administration commissions of provinces and cities responded in succession and released a number of provisions on prosecution of the liabilities of the leaders causing material losses to state-owned assets, such as the Interim Measures for Prosecution of Liability for Material Mistakes in Operating Decisions of Beijing (2005), the Measure for Prosecution of Leaders' Liabilities for Material Losses of State-owned Assets of Shanghai (2005), and the Interim Measures for Prosecution of Leaders' Liability for Losses of Assets due to Decision Mistakes of Province-Owned Enterprises of Guangdong (2006). In 2006, China Insurance Regulatory Commission promulgated the Trial Measures for Prosecution of Leaders' Liabilities in Major Cases of State-Owned Institutions. Moreover, part of the directors may also be imposed with accountability in accordance with CPC disciplines and administrative disciplinary rules.[1]

Penalties may not be imposed wantonly while awards may not be granted arbitrarily. Whether shall directors take the responsibility for decision mistakes? The titles of the accountability measures of Beijing and Hebei province clearly state their purpose and aim of prosecuting the liabilities for material business "decision mistakes" and the liabilities for the "decisions in violation of rules and regulations" to be prosecuted by the accountability measures of Guangdong obviously include "decision mistakes".[2] As we know, any business decision is

[1] This reflects the features of the governance structure of Chinese state-owned enterprises. Firstly, many directors are CPC members and subject to party disciplines. The revised CPC Disciplinary Regulations of 2004 specifically provides for the prosecution of liabilities of the responsible persons of enterprises as principal and key leaders for dereliction of duty and malpractice. Secondly, based on the principle of the CPC Party in charge of cadres, the responsible persons of enterprises including the board chairman, vice board chairman, directors, general managers, deputy general managers of solely state-owned companies and the board chairman, vice board chairman, directors, general managers and deputy general managers to be acted on behalf of the state-owned equities of state-holding companies shall be appointed by the government in accordance with the related authority of cadre administration, who are usually of the status of carders in the charge of the central government, provinces or cities and naturally subject to the relevant administrative disciplinary rules. For instance, the Interim Provisions on Administrative Punishment for Unlawful Act and Disciplinary Offence in the Field of Production Safety jointly promulgated in 2006 by the Ministry of Supervision and the State Administration of Work Safety is also applicable to the responsible persons of enterprises appointed by the state administrative authorities.

[2] In terms of lexical meaning, mistakes refer to the errors of work due to negligence or poor level of capabilities. Obviously, state-owned asset supervision and administration commissions of the country use the concept of "decision mistakes" in a broad sense, covering the circumstances of violation of decision-making procedures, abuse of authority and errors of work while the narrow-sense mistake is only one of them. See Paragraph 1 of Article 3 of the Interim Measures for Prosecution of Liability for Material Mistakes in Operating Decisions of Beijing. As discussed below, the narrow-sense mistake is generally protected by business judgment rules without accountability.

made under specific situations and conditions, and with complexity of operation environment and directors' limited information and rationality, decision-making risk exists at any time. Even if the decisions are scientific, once the conditions change, they may turn to mistakes. This involves the core issue of liability standard, and if the liability standard is inappropriate, the accountability system may not only constrain and hinder the brave exploration and innovation of directors who want to make achievements (Wang, 2007) but also invite the reckless judicial intervention after getting rid of the discretion of directors, with obviously adverse effects. Then, how to seek a balance between the accountability and discretion of directors?

Directors are not only responsible for strategic decision-making but also have the functions of control and supervisions, and the larger the company, the heavier the liabilities for control and supervisions by the directors are. For those matters without need of their decisions, in case of material cases or losses due to incomplete corporate control system and poor supervision, directors may not pass the buck to others due to mistakes of operators and direct managers or natural disasters but bear the leadership liability. (Zhou, 2007) For example, in frequent mining accidents, when dozens or even a hundred of people may usually be killed and injured and the company may also suffer huge losses, how to prosecute the leadership liability of directors besides prosecution of the liabilities of operators and direct managers? How to judge such indirect liabilities of directors?

All those are the issues to be faced by directors' accountability. To sum up, they unveil a more basic topic: Which path of accountability can effectively cover various misconducts of directors? And how to concurrently balance the discretion and accountability of directors?

1 Care path in difficulty

The two traditional duties of loyalty and care[3] of directors aim at the moral character and capability of directors. The duty of loyalty covers the issue of pursuit of private interests by directors, and the prosecution of operation liability apparently belongs to the issue of capability, which always falls in the field of the duty of care. Nevertheless, it is hard for judges. As we know, to do business is like playing chess, and judges are no wiser than directors in making management

[3] The academic circle has always used the concept of duty of care. Article 148 of the revised Company Law of 2005 adopted the concept of "due diligence" as a preference of legislative organs. Generally, due diligence here refers to the duty of care. At present, major textbooks on commercial law and company law still use the concept of duty of care. Hence, this paper makes no difference between care and due diligence.

decisions. Hence, it is always very difficult for judges to make comments on directors' capability or whether they have made full efforts. Thus, business judgment rules are universally adopted while the duty of care is increasingly inane, and even some experts in company law have aggressively questioned "whether the duty of care exists". (Lubben, Darnell, 2006) Simultaneously, a big gap of accountability occurs.

1.1 Mode of deferential review and inanition of duty of care

Facing constantly changing field of business, directors may make management decisions among possible choices on the basis of limited information only, relying partly on science and partly on experience, common sense or intuition. Such decisions are not absolutely safe but often go wrong, which is self evident. Even with respect to the decisions that are deemed as the wisest by decision-makers, we shall also make good psychological preparations, and once an unexpected situation occurs, timely adjustment and responses shall be made without sticking to old methods. Management decisions are so complicated that judges admit their lack of experience, and it is hard for judges to make any business decisions. To avoid being trapped in complex business judgments, courts have always been cautious to review directors' management decisions, very constraint and lenient, and generally holding a deferential attitude towards the discretion of directors.

Consequently, business judgment rules originated from the United States are widely followed.[4] We can clearly perceive from the long-term painstaking efforts of courts to seek for a balance between the discretion of the board of directors and its accountability. At the beginning of the 20th century, a US judge questioned: "How to establish a fair liability for the company or its directors, neither harming the utility of the company as a business instrument nor impairing the enthusiasm of people who adopt it." (Lubben, Darnell, 2006) Many judges frankly admit the difficulty in written judgments, i.e., the expertise involved when reviewing the management decisions and the background of decision-making may not be reorganized after the event. In the shareholders action of In re J. P. Stevens & Co. and Solash v. Telex Corp.,[5] the US court candidly stated that "Because businessmen and women are correctly perceived as possessing such skills, information and judgment not possessed by courts and

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[4] Japan had precedents to accept such rule since the middle of the 1970s. German courts have taken a self-retaining attitude and have the philosophy not to discourage the tentative trials of entrepreneurs and there appeared a German-style business judgment rule long ago, and in 2003, the rule was also introduced as one of the ten programs to improve company law and capital market regulations.

[5] 542 A. 2d 770, Fed. Sec. L. Rep. p.93.

because there is great courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith." And the Seventh Circuit of the US also held that managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism "selects out" judges who try to make management decisions. In the long run firms are better off when management decisions are made by business specialists, even granting inevitable errors.[6] What's more, any decision is made under special circumstances and conditions, and once external constraining conditions change, correct decisions may turn into mistakes. It is no wonder that the Second Circuit of the US clearly pointed out: "The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later. After-the-fact litigation is a most imperfect device to evaluate corporate management decisions."[7]

Directors' management decisions shall be deferred. However, business judgment rule almost excavates the duty of care, which constrains directors' accountability and the search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. (Bishop, Ducks, 1968) It is indicated in three aspects as below.

1.1.1 Plaintiffs bear strict burden of proof

Business judgment rule is a rebuttable presumption in favor of directors. It assumes that business judgment made by corporate directors is based on sufficient information, and it is reasonably believed such judgment conforms to the best interest of corporations. Such assumption has three elements: (1) Directors are independent and free of stakes, (2) good faith, and (3) exercise of due care.[8] If accountability is to be imposed on directors, the plaintiff shall overthrow such assumption first, that is, preponderance of proofs is needed to prove any of the three elements does not hold water. For example, directors have conflicts of interest with such decisions or directors lack good faith. Otherwise, directors are under the protection of the rule and the court need not conduct

[6] Kamen v. Kemper Financial Services, Inc. 908 F.2d 1338, 59 USLW 2076, Fed. Sec. L. Rep. p.95.

[7] Joy v. North, 692 F.2d 880, 35 Fed. R. Serv.2d 223, Fed. Sec. L, Rep. p.98, 860.

[8] Understandings by the US states of business judgment rule are not completely consistent, and the doctrine of the three elements here is based on Article 8.31 (a) in the US Model Business Corporation Act and Article 4.01 (c) and (d) of ALL Governance Principles.

substantive review on directors' decisions. The rule has the plaintiff to bear the strict burden of proof but it is hard for the plaintiff to obtain internal corporate evidences, and thus directors' accountability often meets a lot of troubles.

1.1.2 Formalization of review on directors' decisions

Due care requires that directors shall have due reasons to believe that their judgment is made on the basis of collecting all the information as possible and seeking and considering other reasonable choices possible with due diligence and skills. Facing the world of uncertainties, the more information directors as corporate leaders have, the more possible correct decisions will be made, and it may be said that information determines the quality of management decisions. If directors have not taken initiatives to collect the relevant information at all or the information collected is insufficient, the court has no reason to respect their decisions. Of course, directors shall also take the best interest of their company as the starting point based on collecting sufficient information and carefully study all sorts of possible choices before selection and decision. Without investigation and analyses and for a rash to conclusion, the requirement for due care may not be satisfied and no protection of business judgment rule will be received. Therefore, judicial review on the duty of care evolves into a business decision process or procedure review, decision-making process separated from the content of decisions. The court will not evaluate the content of decisions or make a judgment on the rationality of the content. Directors are not required to undertake legal liabilities unless decisions are extremely ridiculous or fallacious.

This means that if doing things according to routines and considering the relevant information conventionally, directors will be safe and sound without worrying about accountability. The globally sensational case of the action by the representatives of the shareholders of Disney is a typical example.[9] In October 1995, Michael Eisner, president and CEO of Walt Disney made great efforts to get his good friend Michael Ovitz, a Hollywood superstar broker, to be director and president of the company. Ovitz only worked 14 months and then resigned, and the company paid a high price for discharge of the service contract with nearly USD140m paid as severance pay. Shareholders were full of anger and filed a lawsuit with the court against directors. After 37 days of trial, Delaware Chancery Court ruled on dismissing the claims on August 2005 and in August 2006 Delaware Supreme Court affirmed the original ruling. The judges stated that though Eisner controlled the company and acted arbitrarily, which was not in line with the requirements of the best corporate governance, he employed Ovitz to join the company purely for the best interests of the company. As to how to

[9] 907 A.2d 693, Del. Ch.2005; 906 A.2d, 2006 WL 1562466.

invite Ovitz to join, how to arrange the service contract and how to terminate the contract ultimately, sufficient information was collected and analysis and selection had been made among all possible solutions. Thus, he had exercised due care with no need to bear the liability for compensation. Other directors had also exercised due care similarly, and they were not required to bear the liabilities of compensation for the huge loss suffered by the company, either.

1.1.3 Uncertainty of the standard of care

Whether directors shall bear compensation liability depends on whether the duty of care is violated or not. The standard of care, a mixture of agency, trust and tort law, has been highly vague. For judging whether directors' management decisions are based on sufficient information and whether fully knowing all the important information that should have been acquired in reasonable circumstances, there exist two different views in doctrine and in the field of legal practice, namely, ordinary negligence and gross negligence, and the mainstream position holds the standard of gross negligence.[10] Nonetheless, the positions of courts vary, and even the same court may have different standpoints in different cases. Such uncertainty adds to many obstacles for directors' accountability. Thus, with increase of the discretion of judges, the complexity of management decisions leaves judges hard to determine whether the element of gross negligence is met, which may trigger the results of driving away the "wolf" of director discretion and inviting the "tiger" of judicial arbitrariness.

Such uncertainty may be clearly seen partly from the evolution of the duty of care. In early periods, corporations were mostly engaged in such public areas as railway, canals and banking, and acting as director was usually for the purposes of prestige and honors. The courts followed the standard of care on the agents without compensation in the UK to regard directors as agents without compensation and their lack of care would be imposed with legal liabilities only when it reached the degree of fraud. Obviously, that is the mode of high deference of director decisions, which had not changed until the end of the 19th century, and at the beginning of the 20th century the idea that directors were agents without compensation was discarded and replaced by fiduciaries, whereby the fiduciary relationship replaced the agency relationship, and gross negligence became the standard of care, requiring the fiduciaries to fulfill the duty of care and diligence as managing their own affairs, and hence increasing the standard of care. The US Supreme Court held such standpoint. In the 1930s, the corporation

[10] Many written judgments have discussions on the standard of care. Such as Aroson v. Lewis, 473 A.2d 813, Del. 1984 and In re Disney Company Derivative litigation 907 A.2d 693, Del. Ch.2005.

laws of many states including New Jersey and Delaware adopted the standard of negligence, whereby directors shall be prosecuted for accountability if failing to exercise due care. The swing of the standard of care lasted to the middle of the 1980s. The short-lived Smith v. Van Gorkon case was typical. The uncertainty of the standard of care and judicial arbitrariness may trigger chains of social, economic and even political responses.

Thus, directors' accountability is greatly constrained. A director who makes a business decision as a matter of routine by considering the relevant information will be safe and sound, and in such case it may be said that the traditional duty of care has no longer existed. (Lubben, Darnell, 2006)

1.2 Gap of accountability: Directors in breach of good faith

With inanition of the duty of care, directors' accountability is only limited to the circumstance of extreme incompetence in business (Lubben, Darnell, 2006), which simply renders directors not to do the most unfavorable things as possible so that the existence of the duty of care has been scarcely known to people (Coffer, 1984), only to leave a huge gap of directors' accountability. With misconducts not covered by the duties of care and loyalty, many directors have been at large since the duty of care only aims at the circumstance of extreme incompetence and the duty of loyalty only at the conflicts of interest. The conflicts of interest here are generally understood as economic interest. In Beam v. Stewart of 2004, directors determined not to file a lawsuit against Martha Stewart even though Stewart and the other directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as friends, even when coupled with Stewart's 94% voting power", Delaware Supreme Court still deemed that directors had not conflicts of interest with the company,[11] not to mention the violation of the duty of loyalty. In China, if directors have not benefited themselves, a case like that will often end up with nothing conclusive by excuse of "paying tuition" or "doing wrong things out of good heart", which is similar.

Thus, as long as directors have neither sought for private purposes nor fallen in the circumstance of extreme incompetence, the path of care can not help here. Whether to let other misconducts of directors be without prosecution of liability? For example, for a company to have more profits, its directors may knowingly have the company to violate laws, in which case the directors are too often good at thinking, and naturally there is no such issue that it is reasonably believed directors do not act in the best interest of the company. Once a violation is investigated and prosecuted, the company will be severely fined and even closed,

[11] Beam v. Stewart, 845 A.2d 1040, Del. 2004.

and consequently, whether should the directors be prosecuted for liabilities? If no accountability is imposed, what expectation do shareholders have of their selected directors? Devotion to duty and operation according to law are the basic expectations by shareholders to directors. So intentionally having the company to violate laws lose trust to shareholders and breach of the reasonable expectation of shareholders, not to mention malpractice and abuse of power of directors. Shareholders are fear of incompetence of directors, and more of the mistrust and unfaith of them. With mistrust of directors, a company usually goes from rise to fall and even disappears. For example, Sichuan Changhong, a famous Chinese home appliance enterprise, had been a dragonhead in Shanghai A-share market with net business margins, interest rate of assets and gains per share taking the lead of the industry. As of 2001, the company decided to explore overseas market with US APEX as cooperative partner, and though in a short time over two years, Changhong had accounts receivable of USD467.5m, APEX had revenues of USD1b in 2002 and 2003 and had fund to pay the purchase price. Why had APEX not paid the purchase price and why was Changhong not worried about it? The financial statements of the two years of Changhong did not change too much, without provision of depreciation reserves for huge accounts receivable, and in 2003 the company had profits of RMB200m. Not until July 2004 when Changhong changed the president, with Zhao Yong acting as president and general manager, depreciation reserves was withdrawn. In 2004, the situation worsened sharply with deficit of the company reaching RMB3.7b, and its share price dropped accordingly, with investors astonished. (Lang, 2006) Since the decision on cooperation with APEX had gone through the decision-making procedure as a matter of routine, it is obviously hard to impose directors' accountability based on the duty of care. However, considering MBO dream of corporate directors of years, there was obviously a suspicion that directors had not recovered the accounts receivable purposefully to store energy for MBO. If so, directors had neglected their duties and abused authorities. In this case, if accountability was not prosecuted, it would lead to the loss of trust of investors and endanger the economic development of the whole society, and there would be unimaginable consequences. Upon auditing on the economic responsibilities of the leaders of 8 central enterprises, the State Audit Office found out that some calculation is more profits of RMB4.372b and some calculation is less profits of RMB3.335b. (Li, 2007) Such loss of trust is surprising and thus, it seems that accountability shall be imposed on directors for their loss of trust.

1.3 Reasonableness of the mode of deferential review mode: Interpretation of adaptive efficiency

How to fill in the gap of directors' accountability gap? The rationality of the mode of deferential review is involved here. If such mode is not rational, the simplest way is to remove the business judgment rule. However, is the business judgment rule rational? Is the mode of deferential review rational? The answers are undoubtedly affirmative, to which we could apply the adaptive efficiency theory. Such theory was put forward by Douglass C. North, a Nobel Prize winner. He believed that adaptive efficiency is the key to economic growth. For a country or a micro-organization, though we are not clear what rules are needed to have such efficiency, apparently an institutional structure to have such efficiency will play a critical role in promoting exploration, experiment and innovation. (North, 1990) Guidance shall be given to the institutional progress of learning and working, and knowledge development shall be acquiesced so as to guide individual decision process to an evolving system different from the original status. Institutions shall also be allowed to decentralize decision-making and make experiments, encourage development and utilization of special knowledge, and proactively explore various ways to solve economic problems. Mistakes of organizations shall be eliminated with sharing of innovation risks of organizations. As a saying goes, "no risk, no reward". Whether to tolerate or encourage tentative experiments is the key factor of corporate competitiveness. The mode of deferential review based on the business judgment rule is such institutional structure, which conforms to the institutional demands and goal of companies for encouraging directors to be brave in exploration, innovation and risk taking. No wonder, most countries have accepted such rule.

The ultimate goal of law is social welfare (Cardozo, 1998), and the mode of deferential review with adaptive efficiency has its own rationality of existence. Thus, another way shall be found to prosecute the accountability of directors in breach of good faith.

2 Rise of good faith path: Creative transformation

How to prosecute the accountability of the directors in breach of good faith? The mission is granted to good faith obligations. As we know, good faith obligation has long existed, and even in the Anglo-American law where the concept of good faith has developed relatively slowly there are plenty of fiduciary norms. At least 13 sections in the UK Companies Act 2006 directly prescribed the rule of good faith. Subsection 1 of Section 172 thereof provides that a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to the following factors. Though there is no corporation law at the federal level in the US, there are 13 sections in ABA Model Business Corporation Act providing for the rule of good faith and there are two places covering the good faith rule only in Section 4.01 of ALI Principles of Corporate Governance: Analysis and Recommendations (hereinafter referred to as ALI Governance Principles). Section 8.30(a)(1) of the Model Corporation Act provides that each member of the board of directors, when discharging the duties of a director, shall act in good faith and Section 8.31(a)(2) further provides that a director who fails to perform functions in good faith shall be liable to the corporation or the shareholders. According to Section 8.51(a)(1)(i), a corporation may indemnify an individual who is a party to a proceeding because he is a director against liability incurred in the proceeding if he conducted himself in good faith. Corporate legislations of most states have such provisions.[12] Nevertheless, good faith has long been understood as subjective good faith, which is established as empty shell due to weak litigation. Thus, for initiation of the good faith path, its creative transformation is required.

2.1 Subjective good faith leaves the rules of good faith an empty shell

Though the rules of good faith have been established, they have been an empty shell for a long time basically with no application, for which there are two reasons: Ambiguity of good faith and misleading of subjective good faith. Undoubtedly, good faith, as transparent white-paper rules, is very abstract, general and ambiguous in nature. Since good faith is of no positive meaning, judges usually can not make it clear what good faith is, but point out what good faith excludes, and they use the term “good faith” in the sense of exclusion. If judges have other way out, they will not use such an ambiguous instrument. What’s more, the term “good faith” in statutes is partially understood as subjective fiduciary, or good faith. In many domestic translations of Anglo-American corporation law documents or works, “good faith” is also translated as “kindness”. In the practice of exploring director liability by use of

[12] For example, Section 717 (a) in New York Corporation Act provides that every director shall discharge his duty as director in good faith. Section 102 (b) (7) (ii) of Delaware General Corporation Act authorizes the articles of association to reduce or exempt the compensation liabilities of a director in violation of the duty of care who acts in good faith. Section 145 (a) and (b) provides that corporations may indemnify a director for compensation or charges undertaken by the director in the proceedings if the director acts in good faith. Section 309 (a) and Section 204 (a) (10) (ii) of Californian Corporation Act has the same provisions. The same is true for other countries of the Anglo-American law system. Section 122 (1) and Section 124 (1) (a) of Canadian Business Corporation Act provides that every corporate director and officer shall (a) act in good faith and in the best interest of the company when discharging power, duties and functions. Section 124 (1) (a) permits a corporation to indemnify a director or officer for the compensation liabilities undertaken by the director or officer who has acted in honesty and good faith and in the best interest of the company.

"acting wrongly out of good heart", the so-called "good heart" is another version of "kindness", which has severely restricted the role of good faith and hinders the judicial operation, and thus there is no choice but to place it idle.

Good faith is originally a unity of subjective good faith and objective good faith. Objective good faith refers to the rules of conduct, expressed as external behaviors, while subjective good faith is an internal state, expressed as internal belief. Individual subjective belief does not necessarily constitute good faith but are necessarily subject to social evaluation, that is to say, subjective good faith is of objective color. (Xu, 2001) In other words, objective good faith is absolute while subjective good faith is relative. What's interesting is that good faith in Anglo-American contract laws is mostly limited to objective good faith, which means to keep one's words, no fraud and fair conduct and undertaking of implied obligations. (Xu, 2004) Nevertheless, corporation law has not taken the same path but understood it as subjective good faith, and treated lack of good faith the same as malice and bad faith, whereby lack of good faith is the same as malice without a middle zone. Malice is understood as a mental bad intention or evil idea, without any faithful intention to promote corporate interests.[13] Thus, the system of directors' accountability is severely constrained. Firstly, the plaintiff undertakes the strict burden of proof. If the plaintiff wants to overthrow the assumption of directors' act in good faith, the preponderance of proofs shall usually be given to prove that the director has the intention near to fraud or claim that the directors' management decisions are obviously unconscionable, without other interpretation than malice.[14] Such onus of burden of proof often makes the plaintiff terrified at sight, and furthermore, naked malice is rare to see in modern corporations. Secondly, judicial error exists. Since judges are also ordinary people, it is rather difficult for them to review the subjective intention of directors because it shall be judged whether the directors act in the best interests of the company and there are various ways to realize the best interests of the company that are very ambiguous by themselves. For example, when a company has many suppliers of factors, is the interest of its shareholders the most important or shall considerations be concurrently given to the stakeholders? Seeing that the interest of its shareholders is the most important, how to pay attention to the interest of majority shareholders and minority shareholders concurrently? How to coordinate the instant interest and the long-term interest of its shareholders? If its stakeholders are considered, is the priority given to its staff, creditors, communities or social accountability?

[13] Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A2d 1199, 1208 n.16 (Del. 1993).

[14] In re J.P. Stevens & Co., Inc. Shareholders Litigation, 542 A.2d 770, Fed. Sec. L. Rep. pp. 780–781.

Is the instant interest or the long-term interest more important? Supposing the goal is determined, how to evaluate the true intention of a director in choosing tools from “the toolbox”? What’s more, a director may pack its private interest in the stakeholders in disguise. It may be that a director will never speak out his or her intention, and except for a very special and lucky case where a director makes confession, generally, for a judge to explore the subjective intention of a director is just like a guess, which is easy to cause judicial errors.

2.2 Driver of creative transformation

Why did courts start exploring new functions of good faith till the 1920s? (1) There exists the need for filling the gap of accountability. As mentioned above, since Smith v. Van Gorkon sparked a sensation, Section 102(b)(7) was universally adopted. Corporations may reduce or exempt the compensation liabilities of a director in violation of the duty of care by articles of association, which was adopted by the most majority of corporations in fact. For those directors who have committed gross negligence, even though accountability is imposed on them by path of duty of care, the compensation liability will be ultimately reduced or exempted. Thus, directors are favored between the discretion and the accountability of directors. Nonetheless, courts shall not be constrained in case of loss of good faith of directors and new paths to accountability shall be found. Consequently, it is natural to focus eyes on the long-term idle rule of good faith. Since the events of Enron and WorldCom at the beginning of the century, the confidence of investors has suffered great attacks, criticisms on director incompetence, greed, malpractice and mistrust have poured in, and calls for strengthening directors’ accountability have been on increase, which has accelerated the progress of such creative transformation. (2) The concept of good faith in corporation law is in bad need to keep pace with times. Great changes happened in tort law in the 20th century with the doctrine of objective fault replacing the doctrine of subjective fault in the mainstream position. Faults were evolved into accusatory acts from accusatory mental state, and the evaluation of the acts replaced that on the mental state of the actors to meet the demands of modern society for strengthening the provision of remedies to innocent victims. (Wang, 2003; Xiong, 2007) Apparently, the subjective good faith of corporation law has been out of date. To strengthen the protection and remedy for investors, the concept of good faith also needs to realize modern transformation, through which the concept of good faith will rejuvenate by acquiring a new meaning and some of the problems will also be settled by new and effective solutions. (Lin, 1995)

2.3 Creative transformation driven by judicial judgment: Evolution of objective good faith

The "legislation during tackling of events" mechanism in case law is of use again. Whether to try the triad of the fiduciary duties of directors for the purpose of establishing the independent status of good faith or to inject the standard of conduct in the concept of good faith, once established, the dereliction of duty on purpose and failure to perform functions is equivalent to the lack of good faith. During such process of transformation, the advantage of the "legislation during tackling of events" is fully demonstrated.

2.3.1 Exploration on the triad of fiduciary duties

To endow good faith with new meanings, Delaware Supreme Court has made painstaking efforts. Firstly, it tried to make "ternary" division of the fiduciary duties of directors so as to endow good faith the same status as the duties of loyalty and care. Cede II of 1993 has taken the lead and there have presently been more than 10 precedents adopting triad, mainly including Cede III, Malone v. Brincat and Emerald Partners v. Berlin. In 1993, Delaware Supreme Court initially put forward the view of "ternary" fiduciary duties in the judicial opinion of Cede II, and if "the directors are charged of breach of any of the triads of their fiduciary duty — good faith, loyalty or due care, the plaintiff shall bear the burden of proof."[15] The same court stated in Cede III in 1995: "To rebut the [Business Judgment Rule], a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duties — good faith, loyalty or due care."[16] In Malone v. Brincat of 1998, the court clearly stated: "This Court has endeavored to provide the directors with clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders. This Court has also endeavored to mark the safe harbors clearly."[17] In Emerald Partners V. Berlin of 2001, the court once more stated: "The directors of Delaware corporations have a triad of primary fiduciary duties: Due care, loyalty and good faith. Delaware corporations have the right to believe that their directors will perform the three fiduciary faith duties at any time."[18] Though those judicial opinions neither gave specific connotation to the fiduciary duties nor had concrete analysis on the cases,

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[15] Cede & Co. v. Technicolor, 634 A.2d 345, 361, Del. 1993.
[16] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, Del. 1995.
[17] Malone v. Brincat, 722 A.2d 5, 10, Del. 1998.
[18] Emerald Partners v. Berlin, 787 A. 2d 85, Del. 2001.

the standpoint of the court to grant independent status to good faith is very clear.

Indeed, the equal position of good faith with the duties of loyalty and care has not been settled. (1) The Court of Chancery has different opinions in this regard. In Jackson Nat'l Live Ins, Co. v. Kennedy of 1999, though the court cited the judgment of the Supreme Court that the stakeholders concerned were entitled to expect the directors to perform the fiduciary duties in due care, good faith and loyalty in Malone, the then Vice-Chancellor Steele significantly stated: "It leaves to the Supreme Court and the academic circle to make a difference between the loyalty and good faith in the fiduciary duties."[19] (2) The standpoints of Delaware Supreme Court were not consistent. In Stone v. Ritter of 2006, the court stated in the written judgment: "The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element', i.e., a condition, 'of the fundamental duty of loyalty'.… although good faith may be described colloquially as part of a triad of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[20] Though the controversy over whether good faith is independent may continue, such discussion has greatly driven retrospection and understanding of the meaning of good faith and promoted the progress of its creative transformation.

2.3.2 Intentional dereliction of duty or failure to perform duties fails to act in good faith

The key to drive the creative transformation of good faith was for the court not to cling to the subjective intention of directors any more but take dereliction of duty on purpose or failure to perform functions as failure to act in good faith so that the standard of conduct on devotion to duty or what should be done has been established, which originated from the 1996 shareholders' derivative action of the company of Caremark. Though the case ended up with settlement, it was of the milestone significance in establishing the standard of acts of objective good faith. (Sale, 2003) The issue of this case was whether the directors had performed their supervision duty for corporate violation of law or not when various fines and compensations as much as USD250 million were borne by the company due to violation of rules and regulations. The legality of the contracts of the company were checked and examined by senior lawyers employed by the board of directors, the guide of contract relationship and the ethics manuals of employees had been revised and the measures including examination and approval of the

[19] Jackson Nat'l Live Ins. Co. v. Kennedy, 741 A.2d 377, 388, Del. Ch. 1999.
[20] Stone v. Ritter, No. 93, 2006 WL 3169168, Del. 2006.

contracts by regional managers have also been adopted to prevent unlawful corporate acts. Since directors were responsible for strategic decisions and control only, what was the boundary of the duties of the board of directors in supervising the ordinary decisions of the employees and managers by the basic departments of the company? Chancellor Allen stated the duties of directors should include ensuring good faith that the company "has established appropriate information and reporting systems. It may be a mistake to conclude that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance…. A director's obligation includes a duty to attempt in good faith to assure that corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, be a failure to act in good faith." Of course, only continuous and systematic failure to supervise is regarded as lack of good faith, with liability required to be borne. Such view is of great significance, which means the objectivization of the standard of good faith and that good faith is devotion to duty while failure to perform the functions of supervision is lack of good faith. Such view is repeatedly cited in many cases below, which seems to become a self-fulfilling prophecy.

Abbott Laboratories in 2002 at the US 7th Circuit had followed suit.[21] In the shareholders' representative action against Disney in 2005, Chancellor Chandler defined good faith more specifically. He stated: "Through long-term careful consideration, I believe that dereliction of duty on purpose or intentional failure to perform duties are the appropriate (if not sole) standard on judging whether the fiduciaries are in good faith or not. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, acts with intent to violate applicable positive law or intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient."[22] In this regard, Delaware Supreme Court strongly affirmed in a final judgment in August 2006. On the contrary, in Stone v. Ritter in November 2006, the same court, as a matter of fact, did not admit the equal status of good faith duty with the duties of loyalty and care, but expanded the duty of loyalty

[21] In re Abbot Laboratories Derivative Shareholder Litig., 325 F.3d 795, 811, 7th Cir. 2003.
[22] 907 A.2d 693, Del. Ch.2005, pp.123－125.

without requirement of the conflicts of interest so as to incorporate good faith in the scope of loyalty. However, the court cited the standard established in Caremark as usual and stated: "A necessary condition for director liability of good faith is to assure a reasonable information and reporting system exists but not have a second-guess evaluation on the occurrence of absolutely opposite consequences,"[23] and further dismissed the claims of the plaintiff. It seems that it has become an unpreventable trend to judge whether directors have acted in good faith on the basis of the standard of conducts.

Consequently, good faith is clarified. The concept of good faith as a unity of subjectivity and objectivity is of two important significances. One is to expand the coverage of good faith and liabilities may be prosecuted for an act in breach of good faith. Nonetheless, the business judgment rule still plays a role and the directors' accountability system may still satisfy the requirements of adaptive efficiency. The second is to strengthen the maneuverability of the standard of judicial review over good faith. Thus, the court may avoid the exploration on the troubling subjective intention so as to reduce judicial errors.

3 Accountability functions of good faith obligations

Judicial explorations on the accountability functions of good faith spread like raging fire. There are fierce arguments on the accountability functions of good faith between the judicial circle and the circle of corporation law. Due to the length of this paper and the theme thereof, various doctrines will not be analyzed in details here.[24] (Zhu, Peng, 2007) What deserves discussion is still whether Chinese directors' accountability system also needs the good faith path. If so, how to define the boundary between good faith path and care path? What accountability functions can be utilized by introduction of the good faith path?

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[23] Stone v. Ritter, No. 93, 2006 WL 3169168, Del. 2006.

[24] Mainly five views are covered here, namely, the doctrine of contractual obligations, the doctrine of alternative good faith obligation, the doctrine of no positive meaning, the doctrine of accessory obligation and the doctrine of independent obligation. The doctrine of contractual obligation is of great influence on the interpretation of the occurrence of good faith obligations but fail to unveil the specific value and functions of the good faith obligation of directors. The doctrine of alternative good faith obligation, the doctrine of no positive meaning and the doctrine of accessory obligation reflect the features of the good faith obligation of directors including the complexity, twists, instrument and policy natures to some extent but fail to reflect its increasingly clear and independent space and value. The doctrine of independent obligation not only interprets the space of the independent role of good faith obligation and clarifies the boundary of its duties of loyalty and care but also provides codes of conducts of directors as well as the judgment mode of maneuverability for judicial review, and hence it is of forward-looking characteristics.

3.1 China is also in need of good faith path

Indeed, the good faith path of the state of Delaware is highly efficient but we may not necessarily follow its suit. Though case law has its own advantages and adaptive attributes as "legislation during tackling of problems", its sporadic and piecemeal measures are also clear from the evolution of the good faith path with constant trial and correction of errors. When Section 102(b)(7) is adopted to calm down the director liability panic caused by Smith v. Van Gorkom, the good faith path is applied to cope with the wave of reduction and exemption of the director compensation liabilities provided for in Section 102(b)(7) so as to fill the gap of the accountability with the directors who have acted in gross negligence. However, since China falls in the statute regime with late-starting advantage, she can settle a problem all at once and avoid the process of trials and errors. It can be found upon calm thinking that care path to directors' accountability is sufficient and there is no need to adopt both the care path and the good faith path together provided we permit corporation to reduce and exempt director compensation liabilities in violation of the duty of care through the articles of association. Then, can corporations be prohibited from reducing or exempting the compensation liability of their directors who have violated the duty of due diligence?

According to Article 150 of the Company Law of China, where any director violates the duty of care with loss caused to the company, he shall undertake the compensation liability. The term "shall" used here is compulsory. However, the shareholder derivative action in Article 152 provides that shareholders have the right to file a lawsuit in their own names with the court in the interest of the company. The term "have the right" used here is permissive. As for shareholder's direct action in Article 153, it is also provided that shareholders may file a lawsuit with the court. Here a term "may" is used. Now that shareholders may decide at their discretions whether to exercise shareholders' derivative action rights and direct action rights, whether can they reduce or exempt the compensation liability of the directors through articles of association? Does it belong to the scope of corporate self-governance? Obviously, law does not prohibit shareholders from doing so. Whether shall law prohibit shareholders from doing so? The classic political theory told us that the fundamental source of legal authority is the consent of free people. (Luo, 2004) Such choice made by shareholders at free will to reduce or exempt the compensation liabilities of the directors due to violation of the duty of care should be permitted by law. In practice, there have been some corporations which reduce or exempt the liabilities of the directors through articles of association to encourage them to make exploration and innovation. (Luo, 2007) Company law is no more than a kind of standard contracts, and such kind of choice should belong to the free space of company law. (Zhang, 2005) However, no choice may go against the implicit clause that directors may not act in breach of good faith. Otherwise, it is against the reasonable expectation of shareholders. That is to say, the necessary condition of reduction or exemption of the liabilities of director is to assure that he shall act in good faith. Thus, it still seems necessary to treat differentially the circumstances of breach of good faith between gross negligence and malice, hence adopting care path to prosecute the liabilities due to gross negligence and the good faith path to prosecute the liabilities of the directors in breach of good faith.

The good faith path is of two major functions, namely, the gap-filling mechanism of accountability, the overcoming mechanism of information asymmetry between shareholders and directors.

3.2 Function 1: Gap-filling mechanism of accountability

Though good faith has long existed, the good faith path to accountability is originated from filling the gap of directors' accountability. With the good faith path, the business liabilities of directors may be prosecuted "concurrently" by three ways: To prevent directors from making private benefits by applying the duty of loyalty, to prevent directors from incompetence by applying the duty of care and to prevent directors from breach of faith by applying the duty of good faith. The three paths are of their own use and functions respectively, which may both impose effective accountability on the directors who act for private purposes, in negligence and in breach of faith and maintain the mode of deferential review on directors' duties of care, hence helping encourage directors to be brave in making exploration and innovation and adapting to the goal of adaptive efficiency.

How to clarify the boundary of the good faith path and the care path? As we know, the acts of directors with projection may be divided into three levels:[25] (1) Subjective bad faith. If a director acts with the intention to imposing damages, such act is of the most blatant and classical malice, which is the easiest to be identified and prosecuted for liabilities, and such liability may obviously not be reduced or exempted by the articles of association. (2) Breach of the duty of care. If a directors acts without bad faith but in gross negligence, his liability falls in the category of reduction and exemption in the articles of association. (3) The situation between intentional negligence and intentional failure to perform duties. Such situation does not involve the conflicts of interest but more impeachable than gross negligence. If there is no separate tool to regulate such situation, legal liabilities may be easily evaded. In such situation, the malice and impeachability

[25] Chancellor Steele carried out trenchant analysis on such division of three levels in the final judgment of shareholders' representative action of Disney. See 907 A.2d 693, Del. Ch.2005.

are lower than bad faith and no bad faith has been formed, and accordingly the protection of the business judgment rule is available. Even if accountability is prosecuted by the path of gross negligence, the ultimate liability may also be exempted through the articles of association. Since naked bad faith is rare to see in modern corporations and the liability of gross negligence may also be exempted through the provisions of the articles of association, directors' accountability is mostly likely to be established as an empty shell. Thus, it is not only necessary to adopt lack of good faith as a separate tool for prosecution of accountability but also feasible to distinguish it from bad faith and gross negligence. Consequently, the breach of good faith duties consists of the two circumstances of bad faith and breach of good faith. Bad faith is opposite to good faith while breach of good faith is not equal to bad faith. With breach of good faith as the tool for prosecution of accountability, the failure by directors to perform duties purposefully may not end up inconclusively any more by excuse of doing wrong out of "good heart".

In fact, such a middle state has long been perceived and treated differentially by legislators. For example, Section 102(b)(7) of Delaware General Corporation Act allows for the articles of association to exempt the compensation liability of directors in violation of fiduciary duties with four exceptions, namely, (i) violation of the duty of loyalty to the corporation or shareholders; (ii) acts or omission in breach of good faith, or intentional misconducts, or knowingly violation of law. If good faith is to be incorporated in the duty of loyalty, there is no need to list the breach of good faith in Item (ii) after the breach of the duty of loyalty has been listed in Item (i). Otherwise, the effect will be ruined by adding something superfluous. When separately listed in legislation, it is different from the duty of loyalty, both of which are irreplaceable and of own use. If the duty of care is said to absorb good faith duty, it will undoubtedly repeal the protection of directors under Section 120(b)(7). In addition, according to Section 145(a) and (b), if legal proceedings are lodged against directors or officers who are in breach of the duty of care, the charges, amount of judgment, fines and settlement money may be indemnified by the company except for breach of good faith duties, which aims at protecting directors and officers. If good faith duty is equivalent to the duty of care, the breach of the duty of care will automatically breach the good faith duty, which equals to the deprivation of such protection, obviously opposite to the purpose of legislation. This indicates that the duty of loyalty and the duty of care can neither absorb nor cover good faith duty, and the good faith path is irreplaceable.

3.3 Function 2: Overcoming mechanism of information asymmetry

Besides filling the gap of accountability, good faith is also an important mechanism to overcome the information asymmetry between shareholders and directors. As well known, information asymmetry is the bottleneck to constrain the trust and cooperation between shareholders and directors. Such information as directors' capability and characters are all confidential private information of the directors, hard for shareholders to understand, which is called ex ante information asymmetry. As for what directors have done, what they are doing, what they will do, what they have done in the interest of the company and what they have done to the detrimental of the company, directors usually have monopoly information that is not hard to know by shareholders, which is called ex post information asymmetry. For example, in the case of China Aviation Oil, as of October 2004, its book loss up to USD180 million and overseas payment of additional margin at USD80 million were unknown to investors since they had not been disclosed. On October 20, China Aviation Oil Group placed 15% shares of China Aviation Oil privately to an institutional investor at the proceed of USD108 million, and then the institutional investor distributed by placement such shares to more than 50 investors at the price of NZD1.35 per share. Such investors did not know that China Aviation Oil had suffered a huge loss of USD 550 million until one month later, but such loss existed early on October 20 when the shares were placed. The proceeds from such placement were used to make up for the loss from the option dealing by China Aviation Oil. (Xu, 2005) With respect to Changhong corporation, if there were not the event of president change on July 2004, investors could not have known that the corporation had suffered a huge loss of RMB3.7 billion, not to mention knowing its board chairman was making preparations for MBO, since its annual report was normal as usual and took on a good look. The introduction of the good faith path is conducive to overcoming the problem, which may become the shareholders' screening mechanism and the directors' signaling mechanism.

3.3.1 Separating equilibrium: Shareholders' screening mechanism

As disadvantaged party of information, shareholders can do something, and the separating equilibrium mechanism put forward by the economist Joseph Stiglitz is the tool with which shareholders may take initiatives to prosecute the liabilities. (Wang, 2007) The so-called separating equilibrium means different options for different people as opposite to pooling equilibrium that people are willing to accept. For example, an airline divides travel places into first class, business class and economical class with different services and prices to meet the demands of different clients so as to identify the types of clients with different payment capabilities. Though no one will say he is of higher payment capability, the choices indicate to the airline their real types. Shareholders may also adopt such mechanism to induce directors not to conceal information, but tell the truth and be willing to tell the truth so as to indicate their real preference.

The good faith path may well be shareholders' separating equilibrium mechanism that enables the directors' accountability system to play a better screening function, since by the good faith path shareholders may more effectively tell whether directors have really made efforts and treat differently the directors who have made different efforts so that virtue will be rewarded and penalties will be imposed at discretion. That is to say, the following three situations may be distinguished with different treatments: (1) Acts both in gross negligence and breach of good faith; (2) acts in gross negligence but in good faith; and (3) acts in breach of good faith. They stand for three different degrees of efforts, which is what shareholders wish to learn and know most. After introduction of the good faith path, the strength of accountability of the three situations is of clear differences, which is naturally to induce directors to tell the truth and convenient for shareholders to understand the degree of their true efforts, hence differentiating rewards from punishments. This can avoid judging a man just by his victory or defeat and go out of the dilemma of "die whether uprise or not", hence driving directors to better perform their duties of due diligence.

3.3.2 Reputation: Directors' signaling mechanism

As the advantaged party of information, signaling is the first choice of the directors to gain trust of shareholders. Trust is a kind of tacit consent and a kind of expectation for the acts of others, and only with such tacit consent and expectation cooperation can be possible, which is universally regarded as one of the principal social capitals to determine the economic growth and social progress of a nation besides material capital and manpower capital. (Zhang, Ke, 2002) Economic studies have indicated that the reduction of information asymmetry is conducive to the establishment of trust. Hence, if directors proactively transmit signals of their reputation, it will undoubtedly help establish the trust between shareholders and directors.

Reputation is originated from good faith. Honesty is accompanied by trust and trust leads to honesty; and full honesty eliminates suspicion. Such ancient maxims tell the same truth. If the directors act in good faith, a trustworthy signal will be transmitted, which naturally conforms to the wishes of directors. The realization of trust is, of course, related to culture and interpersonal feelings, and what's more, it is also the result of people's rational choices, which is in need of institutional support. The establishment of good faith obligations of directors is just a kind of such institutional safeguard. Hence, a director who acts in breach of good faith shall be prosecuted for accountability, which is also an important condition for establishing the trust relationship between directors and shareholders. Otherwise, it will be hard for the reputation mechanism to work, since the shareholders who shall be punished but fail to adopt punishment measures will naturally pay the price, and excessive forgiveness for the acts in breach of good faith is by itself a kind of immoral acts.

4 Standard of act in good faith and covered objects of good faith

The concept of good faith has been vague so that it is called white-paper norms. If there is no definition of ex ante obligations, the prosecution of ex post liabilities would be thought of as "cruelty" or "oppression". What is wanted in the above-mentioned accountability measures issued by state-owned asset supervision and administration commissions of the country is such ex ante obligations. Though they spare no pains to list the areas of decisions in breach of rules and regulations by responsible persons of enterprises, from individual decisions, project investment, external guarantee and external money lending to restructuring, reorganization and bankruptcy of enterprises,[26] what is "violation of rules and regulations" is not mentioned at all and it is no wonder that there are murmurs of discontent from entrepreneurs. (Wang, 2007) Then, whether can good faith act as the code of conducts? How to specify it as ex ante obligation?

4.1. Clarification of the standard of acts in good faith

4.1.1 Objective good faith and standard of acts

As mentioned above, dereliction of duties or failure to perform functions is generally accepted as breach of good faith as distinctive mark of creative transformation of good faith concept. The significance of such pioneering work lies in that it has injected the standard of acts into good faith concept and established the ex ante obligation of loyalty to one's duties. This move not only specifies the standard of acts of directors but also enhances the operability of prosecuting the legal liabilities of directors by the good faith path. The reason is that the prosecution of legal liabilities needs objective or external standards rather than subjective guess. Chancellor Cardozo had a trenchant exposition, he stated: "The standard adopted by courts must be an objective one. In such matters, the thing that counts is not what I believe to be right. It is what I may reasonably believe that some other man of normal intellect and conscience might reasonably look upon as right." (Cardozo, 1998) It applies to directors' accountability in

[26] For instance, Article 4 of the Interim Measures for Prosecution of Liabilities of the Leaders of Provincial-Owned Enterprises for Assets Loss Due to Decisions in Breach of Rule and Regulations of Guangdong has adopted such listing technique.

company law, which is reflected the US courts' consistent position on liability standards. As a matter of fact, in the practice of directors' accountability, courts also adopt social assessment and the standard of acts to measure whether directors have acted in good faith or not.

By this token, though good faith concept is ambiguous, it is not merely an excluder (Summers, 1968),[27] but of positive meaning. With injection of the standard of acts and further acceptance by people of objective good faith, it is feasible to clarify good faith as an ex ante obligation. To conclude, good faith concept has the following four requirements for directors: Honesty and truthful and reliable statements; observance of accepted business rules; observance of basic corporate rules; and loyalty to duties, which not only reflects the lexical meaning of good faith,[28] but also embodies corporate structure and shareholders' rational expectations. With such ex ante obligation and standard of acts, it is logical to prosecute the legal liability for acts in breach of good faith. In the above-mentioned shareholder representative action of Caremark, shareholder representative action of Abbott, shareholder representative action of Disney, McCall v. Scott and shareholder litigation in re Emerging Communications, the dereliction of duties on purpose or failure to perform functions established by courts is breach of good faith by itself, which goes against the positive duty that directors shall be loyal to their duties.

4.1.2 Considerations for China on clarifying good faith standard of acts

How does China clarify the standard of acts of directors in good faith? As in a statute law system, though Chinese courts have no advantages for judges to make laws, there are plenty of mechanisms for the formation of rules. Considering the reality that judges of the courts nationwide are of different qualities, the way to

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[27] This is the theory of US jurist Summers. He held that judges used the concept of "good faith" in the exclusive meaning. The acts in breach of good faith excluded in contract law include lack of care and failure to perform or intentionally incomplete performance, abuse of appointment rights of clauses and determination rights of the clauses of model contracts, interference with other parties in performance of contracts or non provision of cooperation.

[28] "Good Faith" has four stable meanings. The four meanings in the Webster's Dictionary: (1) A state of mind indicating honesty and lawfulness of purpose; (2) belief in one's legal title or right; (3) belief that one's conduct is not unconscionable or that known circumstance do not require further investigation; or (4) absence of fraud, deceit, collusion, or gross negligence. Black's Law Dictionary defines "good faith" as a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage. In Chinese, "good faith" consists of "honesty" and "trust". "Honesty" refers to truth without deceit. "Trust" means to believe; to honor what has been said; to keep promises; and to keep the covenants. Benevolence, honesty and credit are the three elements of the good faith principle in civil law.

let every court explore paths to make rules is obviously infeasible. In my opinion, the following three ways of thinking may be tried: Firstly, the Supreme Court gives replies to individual cases; secondly, the higher courts make specific provisions on good faith obligations in their guiding opinions on trial of corporate disputes;[29] thirdly, the Supreme Court makes specific provisions on application of good faith obligations in the judicial interpretation of company law. Comparatively, it is better to adopt the third scheme because the Supreme Court has been devoting itself to promulgating judicial interpretations of company law, and promulgated the Provisions of the Supreme Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (I) in March 2006, which has settled the connection of application of the new and old company laws. Now that the Company Law has been implemented for two years, and the relevant issues in its application are fully exposed, there are sufficient conditions for releasing a systematic judicial interpretations, which is an opportunity to define the standard of acts in good faith so as to further provide more operable review standards for courts of various levels to apply the good faith path, hence avoiding judicial arbitrariness and errors.

4.2 Coverage of good faith path

The violation of good faith obligations is of course impeachable. Then, what misconducts of directors are the covered objects of the good faith path? Or what misconducts are the causes of accountability for good faith? The accountability measures of state-owned asset supervision and administration commissions of the country are short of the provisions in this respect. Though the accountability measures of Guangdong Province have generally imposed accountability on the "decisions in violation of rules and regulations", with list of various areas of decisions in violation of rules and regulations, what is "violation of rules and regulations" is not mentioned at all, and thus there is no way to know the causes of accountability. Comparatively, Articles 40 and 41 of the Regulations on the Supervision and Administration of the State-Owned Assets of Enterprises specifically provides for two causes of accountability, namely, abuse of duty and malpractice. Though no accountability path has been specified, both of them may be incorporated in the good faith path. However, compared with the ex ante

[29] The higher courts of Beijing, Shanghai and Jiangsu have once promulgated such guiding opinions, which are prior to the revised Company Law of 2005, and have not touched the issue of good faith accountability. See the Guiding Opinions on Several Issues Concerning Hearing Corporate Dispute Cases (Trial) (2004) of Beijing higher court, the Opinions on Handling Several Issues on Hearing Corporate Action Cases (Trial) (2003) of Shanghai higher court and the Opinions on Several Issues Concerning Hearing Application of Company Law (Trial) (2003) of Jiangsu higher court.

obligation and standard of acts in good faith, abuse of duty and malpractice have not covered all the situations of the acts of directors in breach of good faith. Delaware experience offers useful lessons and frame of reference, and the good faith path should also cover the two situations where directors intentionally leave the corporation to break law and directors do not candidly give notification. That is to say, the good faith path should cover the following four misconducts: Intentionally get the corporation to break law; do not candidly give notification; malpractice, including manipulation of corporate decisions and superfluous considerations; and gross negligence. Consequently, the aforesaid judicial interpretations should make specific provisions in the application of good faith obligations.

4.2.1 Knowingly cause the company to disobey the law

Every one shall observe law and there is no exception for companies as corporate citizens. Article 5 of the Company Law of China requires that the company shall undertake in accordance with laws and administrative regulations and furthermore, Article 22 deems invalid the resolutions of the shareholders' meeting or general shareholders' meeting or the board of directors in violation of laws and administrative regulations, which is a self-evident proof. As head of the company, it is natural for directors to make the company to operate in compliance with law. It is right to say that the purpose of a company is the maximization of its interest, which, however, is not contradictory with the principle of legal compliance. The maximization of interest is the purpose of a company and the principle of legal compliance involves how to realize such purpose, where such purpose shall be reached through operation in compliance with law and such compliance of law has not revised that purpose. That is like participation in a contest for championship, where the rule of contest is not contradictory with the contest for championship. Though violation of rules may win more, to defend the violation of rules by the participant for the purpose of winning the contest as possible is tantamount to failure to understand the meaning of the contest. Similarly, the defense by the company that the violation is in the maximal interest of the company is tantamount to failure to understand the meaning of maximal interest. Section 2.01(a) of ALI Governance Principles provides for the principle of interest maximization, which, after requiring the company to adopt the objective of corporate profit and shareholder gain, provides for the principle of legal compliance in Subsection (b)(1), requiring that even if corporate profit and shareholder gain are not thereby enhanced, the corporation in the conduct of business is obliged, as a natural person, to act within the boundary set by law.

Why to incorporate it in the bona fide path? Firstly, it is the essence of good faith. To knowingly cause the company to disobey the law is dishonesty since there is a knowingly misconduct and a knowingly violation of the generally accepted commercial rules. To knowingly cause the company to disobey the law is also a representation of disloyalty to one's duties. Secondly, it is hard for the duty of loyalty or duty of care to cover such circumstance. On the one hand, intentional violation rarely involves self dealing, which is hard to incorporate it in the duty of loyalty. On the other hand, such act by a director is usually accompanied by careful thinking and reasonably believed as act in the best interest of the company, which is also hard to incorporate in the duty of care. The comments of Section 4.01(a) of ALI Governance Principles states that officers and directors should act consistently with Section 2.01 and a director or officer violates the duty to perform functions in good faith if he or she knowingly causes the company to disobey the law. There are many cases supporting such position in the US. In Roth v. Robertson,[30] the company was suspected of operating entertainment projects at weekends in violation of law, and its CEO decided to bribe over the petitioner. His act was undoubtedly in the maximal interest of the company and he might reasonably believe that the gains from weekend operation might far exceed the cost of penalties on the company, not to mention that it would be slightly possible to be prosecuted. Nonetheless, the court believed that he should indemnify the company for what it had paid. The ruling pointed out that liability for paying such an illegal bribe from corporate fund was upheld on ground of public policy, and accountability should be prosecuted for such director so that he should be ordered to indemnify the amount wasted thereof. In Abrams v. Allen,[31] the court of New York State made the same decision: (1) The director caused the plant to move, intentionally reducing the output; (2) such act caused large damages to the company; and (3) such decisions was based on illegal business grounds with the purpose of simply deterring and cracking the employees who participated in the action of labor disputes, which had violated the New York Labor Law and the US Federal Labor Relations Act. Consequently, the director was judged to pay the loss. In Metro Communications Corp. v. Advanced Mobilecomm Technologies Inc.,[32] the Delaware Court of Chancery held that a director might not manage the company by violation of law, even with interest to the company. In Guttman v. Jen-Hsuan Huang,[33] the Delaware Court of Chancery held that the director violated the fiduciary duty when causing the company to disobey the law.

If a director causes the company to disobey the law, he or she fails to act in

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[30] 118 N. Y. S. 351, N. Y. Supp. Ct. 1909.
[31] 74 N. E. 2d 305, N. Y. 1947.
[32] 854 A. 2d 121, Del. Ch. 2004.
[33] 823 A. 2d 492, Del. Ch. 2003.

good faith, and consequently, he or she shall indemnify the company with the loss suffered, such as pecuniary penalties. Such civil liability is established since it is hard to realize the lawful objectives solely by reliance on criminal law and administrative regulation, which is of real significance especially in China. The regulatory power of the government is limited after all, by which it is not possible to discover and prosecute all the illegal acts. To take it as an integral part of the company law may internalize legal compliance as corporate act, which is more conducive to realizing legitimate objectives. Furthermore, the company is usually punished in such circumstance, where directors may dodge punishment, and thus, it is necessary to prevent such act. At the same time, directors may not set off their liability for compensation with the gains to the company. Otherwise, the original intent of the imposition of such liability will be in vain. In this regard, Section 7.18(c) of ALI Governance Principles clearly states that the liability of managers for inappropriate dealing may not be set off with corporate gains from such dealing, and in case an offset is in breach of public policies, no offset may be made with the gains from the same dealing.

4.2.2 Failure of candid disclosure

In case of conflicts of interest, directors shall give candid notification to the board of directors, which is covered by the duty of loyalty of directors. With respect to the circumstance not relating to the conflicts of interest, directors shall also give candid notification since the board of directors is the hub of corporate governance and responsible for the decision and control of corporate strategies and all the corporate matters shall be decided by the Shareholders' Meeting. Directors shall naturally provide the board of directors and the shareholders' meeting with the information necessary for decision-making so as to render scientific decisions and directors are obliged to candid notification and candidly disclose to other directors and corporate authorities any known information bearing on the performance of functions or decision making by other directors or corporate authorities without misleading, intentionally or carelessly false or fraud mis-statements. Though the securities law provides for the duty of information disclosure of directors, the duty under company law may not be substituted for the following reasons: Firstly, the disclosure under the securities law does not include the important information known to a director but not known to other directors that is of impact on their performance of functions; secondly, most companies are not listed that are not subject to the securities law; and thirdly, the non-misleading rule under the securities law is only applicable to the investors that participate in securities transactions and those investors not participated in the transactions may not sue the directors on such basis, and hence, the scope of remedies for those non-participating investors. The court of Delaware has determined through cases that directors are obliged to notify the information on the matters subject to voting at the shareholders' meeting. With respect to this regard, in Turner v. Bernstein and Skeen v. Jo-Ann stores Inc.,[34] Vice Chancellor Jacobs took it as the duties of loyalty and care, while in Malone v. Brincat, the Supreme Court of Delaware clearly took it as fiduciary duty.

Why to incorporate such obligation in the bona fide path? Firstly, the duty of loyalty governs the circumstance where there are conflicts of interest with directors, while in such case there are no conflicts of interest with directors. Secondly, knowingly false statement is tantamount to dishonesty, which belongs to failure of loyalty to one's functions in violation of the standard of good faith rather than the duty of care. Certainly, only knowingly or recklessly breach of such duty constitutes failure of good faith. As far as remedies are concerned, besides liquidated damages, there are also disciplinary punishments including censure, adjustment of remuneration, delay of promotion, reduction of rank, discharge of title or revocation of director qualifications. In Smith v. Van Gorkom, as board chairman and CEO, Gorkom did not disclose to the board of directors the problematic methodology he used to arrive at the price of USD55 or the important fact that the CFO of the company believed that the leveraged purchase price of the share would be USD55–65. The court ordered him to bear the liability for compensation because he concealed the important information on the decision of merger in violation of the duty of candid disclosure.

4.2.3 Abuse of duty

As head, whether in exercising strategic decision-making power or in controlling and supervision, directors shall observe the generally accepted basic corporate rules, duly exercise authorities and independently make judgment in the best interest of the company without other considerations. Abuse of duty is prohibited by undue means even for due purposes, which falls short of good faith. Hereby two circumstances shall be identified: (1) Manipulation of decision-making procedures and (2) superfluous consideration. The act of directors in good faith is one of the elements for the effectiveness of the resolution or the transactions approved by the board of directors and the Shareholders' Meeting. Either the misconduct of directors by deceit or individual arbitrariness that causes the board of directors or the Shareholders' Meeting to pass resolutions, or superfluous consideration of irrelevant factors during the decision-making by directors, such as the act out of bad motivations including individual hatred, desire, jealousy, revenge, humiliation, glory is in violation of the elements for the effectiveness of

[34] With the case number at No. 16, 190, 1999 Del.Ch and 750 A. 2d 1170, Del. 2000 respectively.

the resolutions of corporate authorities, rendering those resolutions void or revocable. Recently, President Wolfowitz's World Bank scandal over his girlfriend is typical of the decisions based on superfluous consideration.[35] A special panel of the World Bank believed that President Paul Wolfowitz broke bank rules in arranging a pay package and promotion for his girlfriend, for which the World Bank was involved in the "crisis in the leadership" and he had also paid a high price and had to resign under the powerful social and public opinion pressure. In the turmoil of an independent director of Yili Shares, a listed company of China in 2004, the resolution of the board of directors on dismissal of the independent director was both the result of the manipulation by the board chairman Zheng Junhuai and also the conduct of revenge based on his personal hatred. (Shu, 2004) Upon knowing from media reports that Yili Shares invested a lot in treasury bonds and the composition of shareholders of Huashi Company, independent director Yu Bowei raised questions to the board of directors twice on April 27 and May 26, 2004, but the board of directors was ambiguous about such questions, lying down on the job. Upon solicitation of the consent of other two independent directors, Yu Bowei published a statement of independent directors on June 15, requiring for an auditing agency to audit the dealing of treasury bonds of the company. Board chairman Zheng Junhuai became very angry and boldly created a resolution at the interim board meeting on the afternoon of June 16 on dismissal of independent director Yu Bowei. Firstly, to lure the tiger out of his den, Zheng Junhuai caused Yu Bowei unable to attend such interim board meeting. Secondly, Zheng Junhuai manipulated the voting of the board of directors, where only 7 out of 11 directors attended the meeting and at the first round of voting on the proposed resolution, only one director was for the resolution with four directors abstaining rights. In order to reach the end, Board chairman Zheng Junhuai declared the meeting adjourned and interviewed initially with the relevant directors. When the second round of voting was held, five directors were for the proposed resolution, hence forming the resolution on dismissal of independent director Yu Bowei. On June 17, the company publicly disclosed such resolution of dismissal. The bona fide path to accountability shall be adopted for such wanton encroachment of the corporate governance mechanism.

Why to incorporate it in the bona fide path? With respect to the manipulation of corporate decisions, the duty of good faith obviously applies. In case of manipulation, directors acted rationally, and reasonably believed that they acted in the best interest of the company, where the duty of care did not apply. Such

[35] See World Bank held Wolfowitz in breach of rules, www.xinhuanet.com, 2007-5-16; Survey: Final stage of President Wolfowitz's World Bank scandal over his girlfriend, http://news.xinhuanet.com/world/2007-05/17/content_112777.htm, 2007-5-17.

measures as deceit and play of petty tricks belonged to the scope of good faith rather than the scope of loyalty. Furthermore, the duty of good faith may not only cover the acts that are inconducive to the company but also deal with the circumstance conducive to the company. Superfluous consideration is actually related to the self interest of directors, which may be covered by the duty of loyalty even when the duty of good faith is not adopted. The manipulation of corporate decisions is incorporated in the duty of good faith for the following reasons: (1) Does it refer to a kind of conflicts of interest under the duty of loyalty or merely an economic interest? Though it may be interpreted extensively, it is still not clearly incorporated in the duty of loyalty. (2) The duty of loyalty does not prohibit self dealing but requires for the fairness of such dealing while the duty of good faith absolutely self deals. Obviously, the treatment of the bona fide path is more powerful than that of the duty of loyalty. (3) The issue of application scope. The approval by the directors without interest of the dealing of the directors, or the decision by the judicial committee composed of the directors without interest on whether to give consent to the representative actions of shareholders may be subject to judicial review, where it is hard to apply the duty of loyalty since it does not involve any economic interest. Therefore, it is an effective treatment to incorporate it in the bona fide path. As pioneer of corporation law, Delaware has many cases where the decisions formed under the manipulation by directors of the corporate authorities have been declared invalid, such as Koch v. Steam, VGS v. Castiel and Adlerstein v. Wertheimer.[36]

4.2.4 Gross malpractice

Malpractice of directors is undoubtedly a breach of the duty of care. In case of gross malpractice, disloyalty to duties is constituted, hence violating the accepted basic corporate rule and consequently violating the duty of good faith, the impeachability of which is obviously higher than that of gross negligence covered by the care path. As far as legal consequences are concerned, if the bona fide path is adopted for prosecution of accountability, a company may not reduce or exempt the compensation liability of directors through articles of association and directors shall undertake their liabilities. Obviously, this has enhanced the strength in prosecution of gross malpractice. Since the middle and late 1990s, the courts of the US, especially the courts of Delaware, have generally recognized the following idea: Knowing or intentional malpractice of directors is failure of good faith. Besides the above-mentioned Caremark shareholder representative action, Abbott shareholder representative action, and Disney shareholder

[36] With the case number at No. 12, 515, 1992 Del. Ch, No. 17, 995, 2000 Del. Ch. and No. 19, 101, 2002 Del. Ch. respectively.

representative action, there were also the 6th Circuit Court McCall v. Scott and the Delaware shareholder action of In re Emerging Communications.[37] Those cases held that the knowing disregard by directors of the defects of corporate information and reporting systems was undoubtedly waiver of duties, and to have lassez faire of operators, to indulge operators and to cause errors, mistake or even violation of law in making decisions are all the acts in breach of good faith. For example, in Sichuan Changhong Co., directors were suspected of storing energy for MBO and intentionally failing to recover huge selling prices, leading to the huge loss of RMB3.7bn in 2004, where liability may be prosecuted against its directors by the bona fide path. Regretfully, due to lack of such accountability mechanism, no liability has been prosecuted against those directors.

5 Conclusion

It is both necessary and feasible to introduce the good faith path in the directors' accountability system. With the good faith path, the duties of loyalty, care and good faith respectively playing specific roles may be adopted to cover all kinds of the misconducts of directors effectively, fill the gap of accountability, and maintain the mode of deferential review on the management decisions of directors, which is conducive to encouraging directors to be brave in making exploration and innovation and consistent with the purpose of adaptive efficiency. Since the 1990s, the judicial practice of directors' accountability has given birth to the good faith path, and the good faith concept has rejuvenated through creative transformation, which drives the establishment of ex ante obligation and standard of acts of directors in good faith. The judicial interpretations of Chinese Company Law should define the standard of acts of directors in good faith and get intentionally the corporation to break law, failure to disclose candidly, abuse of duty and gross negligence in the coverage of the good faith path while the malpractice and self dealing are covered by the traditional duties of care and loyalty, hence resulting in constructing a "three-pronged" accountability mechanism of directors.

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[37] No. 15, 415, 2004 Del. Ch.

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