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Report from the Study Visit on Corporations Law for the Legislative Affairs Commission of the National People's Congress and Provincial People's Congresses

Canada-China Legislative Cooperation Project

September 6-13

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From September 6-13, 2005, the Parliamentary Centre facilitated a study mission to Canada for the **Legislative Affairs Commission of the National and Provincial People's Congress**. As part of the First Annual Workplan of the Project, this visit was requested by the Legislative Affairs Commission to assist with the **overhaul of the existing Corporations Law of China**, which was adopted 12 years ago, in order to reflect the changing business environment in the wake of China's WTO accession. It was planned as a special pilot activity, which, according to the description of the Project Implementation Plan, aimed to assist "the Congresses with particular pieces of legislation that may not fit within the thematic focus of the project".

Led by Mr. An Jian, the Vice Chair of the Legislative Affairs Commission of the NPC, the mission involved key members of the national taskforce responsible for reviewing the substance of the legislative amendments as well as representatives from two provincial legislatures responsible for developing regulations that defined mechanisms and procedures to implement the national law in the local context.

The central purpose of the current mission was **to provide an opportunity for the group of legal researchers and drafters involved in the legislative review to access the Canadian expertise in drafting and administering the Business Corporations Act**. The program included meetings with experts from various government agencies at the federal and provincial levels, i.e. Corporations Canada and Ontario Ministry of Government Services respectively, to provide an overview of the trends and priorities in the drafting and administration of the corporate law in Canada. Site visits to a number of institutions responsible for administering the Act, including the Toronto Stock Exchange, were arranged to demonstrate procedures and mechanisms used to enforce the Corporations Act in practice. Meetings with corporate managers and legal professionals were also

arranged to present “end-user” perspectives on the impact of the current corporate law regime and the participation of the industry in the law-making process.

By sharing thoughts and exchanging experiences with their Canadian, **the Chinese participants acquired useful knowledge and skills on a wide range of legal issues** that can be applied in the reform of the corporate law regime of China. They indicated that the study visit particularly helped to address the following issues of priority on the agenda of the current legislative review:

1. Remove various entrance barriers for incorporation such as restrictive capitalization requirements to boost the incentives of potential investors;
2. Improve norms and standards for corporate governance and strengthen the accountability of directors and officers
3. Create mechanisms to protect the rights of small shareholders
4. Protect the interests of creditors and other stakeholders from wrongful actions of the corporation
5. Adopt regulations to strengthen transparency and oversight of corporations with public offerings

Findings from the Study Visit

While the study visit opened up a wide range of topics associated with the corporate law for discussions, focused attention to the following issues repeated in most of the discussions, which yielded substantive findings. Feedback from the delegation indicated that findings on these issues would become reference resources for the review on the legislative amendments as part of China's initiative to modernize its corporate law regime.

The Fundamentals of the Corporate Law

It was a common understanding that, compared to partnership and sole proprietorship, a corporation provided the distinguishing feature of **limited liability for its owners and managers because it is considered a separate legal person**. Also it was recognized that corporations as a form of business made it possible to separate the owners, directors and employees, whereas a sole proprietor as the owner and manager of the business could not be his or her own employee. The separate legal personality was believed to offer corporations a number of advantages that encouraged investors to take risks and enhanced the reliability of modern economy. For example, it was noted that corporations could have perpetual existence which means that shareholders, officers and directors could come and go without affecting the distinct legal personality of the corporation.

Under the Chinese context, however, the separate legal personality brought some challenges and risks to the market operation. Limited liabilities created difficulty for

the creditors to deal with default on loan repayments, while separate legal status of the corporation caused trouble for the investors to put an effective oversight on the directors and managers of the corporations, to whom their investment was entrusted. **The perception of these risks and search for effective responses underlay all discussions** of the delegation on various legal aspects of the corporate law.

Shared Jurisdiction on Corporate Affairs

Speakers from Corporations Canada noted that the regulation of corporations, like other policy areas such as agriculture and immigration, fell under **the shared jurisdiction of the federal and provincial governments** under the Constitution. It was mentioned that the federal government and all provinces have separate legislation dealing with corporations which is administered by separate government bodies. However, policy and legislative decisions were usually coordinated within the framework of the **“cooperative federalism”**, often facilitated through regular meetings of officials from the federal and provincial authorities, in response to the expansion and integration of commerce and trade across provincial borders and growing demand for coherent procedures and requirements. As a result, the corporate laws at the federal and provincial level saw an increasing tendency to converge.

It was demonstrated that shared jurisdiction on corporations was also reflected on active **information-sharing in the implementation of law**. Generally, corporations involved in inter-provincial business were required to be incorporated at the federal level as well as in all provinces in which they did business. Therefore, sharing of resources and information would be crucial to the development of ability for governments across Canada to provide comparable services to citizens. Much of the work done was shown particularly in the administration of the incorporation process. For example, NUANCES, a powerful name-searching engine used by Corporations Canada to ensure the uniqueness of the names of corporations in Canada, was also made available to a few provinces to assist them in processing incorporation requests.

The Enabling Nature of the Canada Business Corporations Act

It was noted that the **CBCA was created as the legal basis for the government to facilitate rather than restricting the incorporation demands of citizens**. The assumption behind the Act was that citizens have the right to pursue their economic objectives through the venue of corporations. It was based on this rationale that the incorporation procedures and documentation requirements were usually set to be quite straightforward and simple to follow. It was also based on this rationale that applications for incorporation were usually processed fairly quickly and with few restrictions. This would be especially the case with the launch of the new website to guide applicants step by step through the incorporation

process, which normally took ten to fifteen minutes to complete. Online tools, resources and call centres were also made accessible to any citizens who had needs for assistance in filing incorporation.

The enabling model of the Canadian corporate law was in contrast with the existing regulatory framework in China which still featured high entrance thresholds for individuals who wish to incorporate, particularly in terms of restrictive capital and credit requirements. The Chinese delegates clarified that the astringent nature of the law had been intended to prevent against business frauds but emerging business opportunities in China began to **warrant the development of a more relaxed legal regime to help citizens fulfill their growing motives to invest.** Findings from the discussion indicated that the dilemma should be overcome through enhancing the oversight function of non-governmental institutions in the market. But the Chinese delegates mentioned that some important market institutions were still lacking or premature in China, which would make it practically difficult to lift the statutory requirements.

Use of Electronic Technology

The experience of Corporations Canada, as the government agency responsible for handling all incorporation requests, highlighted **the value of electronic technology as a tool to improve the efficiency of the incorporation process.** It was noted that the incorporation forms are now available online to be filed electronically, which saved both the applicants and government offices substantial time and costs in comparison to the traditional paper-based filing procedure. The evidence raised was the ever-larger capacity of the government to process incorporation applications, which increased threefold a year after the acceptance of electronic filing. The delegation was shown all behind-the-scene facilities to support the electronic incorporation and obtained a visual understanding of the practical tools and methods which would make the electronic system operational.

Limited Coverage of the Canadian Corporate Law

Through the discussions, the Chinese delegation observed that the Canadian corporate law covered a more narrow range of issues than intended to address by the Chinese legislation on corporations. It was realized that the **CBCA was formulated primarily to address issues related to the incorporation of corporations.** Very few aspects of the daily operations of the corporation were regulated and most decisions regarding the design of governance structure and oversight mechanisms were left to the directors and shareholder meetings to make.

When asked how to deter against misconducts without concrete enforcement measures being written into the Corporations Act, the Canadian speakers underscored **the importance to foster linkages between the corporate law**

and other laws with general implications for businesses. Demonstrated as an example, the Tax Law discouraged the company owners to transfer assets from the corporate account to their personal accounts by setting lower personal rates than those on the corporate income. Likewise, criminal law prohibited corporations from undertaking criminal activities and provided standards for enforcement in the event of criminal offence. The Chinese legislative staff were encouraged to investigate how to harmonize the Corporations Act with all other related laws and regulations in order to make more meaningful impacts.

Spontaneous Surveillance of the Market

It was explained that limited intervention of the government on corporate governance structure were possible due to the existence of strong oversight functions already performed by a variety of private sector institutions such as banks, credit bureaus and stock exchange market. A corporation was not expected to provide information regarding its initial capital at the time of incorporation but bank would check spontaneously with credit rating organizations whenever corporations applied for loans. By the same token, the corporation would be unlikely to attract or retain investment unless it had a sound and reliable governance structure and reporting mechanism.

The delegates concluded that this could be an important lesson learned to be applied to the reform of China's corporate reform. **They realized that the key cornerstones of a functioning regulatory system on corporations would rest upon the development of strong and capacitated market institutions.** They were also convinced that the industry associations should be informed and engaged in the legislative drafting and analysis in order to maximize the mutual reinforcement of the statutory requirements and industry self-regulation.

Accountability of Directors and Officers

Both the delegation and the host institutions underscored the duty of directors and officers to act honestly and in good faith with the best interests of the corporation in mind when exercising powers and discharging duties. A recurring theme throughout the visit was about how to **design an enforcement mechanism that can hold directors and officers effectively accountable.** It was noted that, besides the shareholder meeting held annually, the current corporate laws at both the federal and provincial levels also held directors personally liable for their actions/decisions or decisions authorized by them that were contrary to the Act or other law or that brought losses to the business.

Advocacy and expansion of best practice proved to be an important contributor to the overall accountability in corporations. Lessons learned shared by one speaker, for example, indicated that individuals who served as directors and officers should be separated as much as possible to minimize the probability of conflicts of interest.

It was also recommended that a certain number of independent directors be required to sit on the board in order to place effective check on directors with management roles.

Protection of Minority Shareholders against Oppression

In a few meetings, the delegation expressed concerns about the threats to the interests of minority shareholders in the cases when biased decisions were made by controlling shareholders, which often wielded dominant influence through the board they elected. The delegation showed considerable interest in learning particular mechanisms designed to **ensure the immunity of minority shareholders from unfair corporate decisions effected by the controlling shareholders through constituent directors**. In response, a legal expert from the McMillan Binch demonstrated the following remedies that were available to small shareholders when a case of oppression occurred:

1. Requirements on unanimous agreement on any decisions to be made by the shareholder meetings
2. Protected right of any shareholders to appeal to the court for oppression remedy either through the buyback of their shares at a fair price or, if necessary, through the dissolution of a corporation
3. Protected right of any shareholders, regardless of the number of shares held, to take class actions against the director/officer for any misconducts against their fiduciary duty

Reliance on Judiciaries for Enforcement

The Chinese legislative drafters had the apprehension that the onerous administrative responsibilities to enforce the Corporations Act would dwarf the limited resources of the government. A major observation from the Canadian experience was that **the law enforcement, instead of being executed by government agencies, would fall under the domain of the judiciary**. It was mentioned that grievances against perceived wrongdoings of directors or officers were normally appealed to courts for settlements. Allegation, investigation, conviction and penalization against the misconducts of a corporation should also be the responsibility of judges and legal professionals instead of civil servants. Independent professional arbitrators, which provided a complementary mechanism for dispute settlement, were recognized as an additional safety valve to relieve the pressure on the courts while ensuring prompt and efficient justice.

Understanding of this model offered some inspiring lessons learned that could help the Chinese legislative staff determine how the new Corporations Act in China should address various enforcement issues. Despite the difference in the legal tradition and social context, the delegation concluded that the judiciaries have a decisive role to play, if the law is ever to make a meaningful impact.

Corporate Governance of State-owned Enterprises

The delegation explored the governance requirements for Crown Corporations from both the policy and industry perspectives. In their meeting with the Treasury Board of the federal government, they were informed that governance requirements for crown corporations were different from the private sector corporate law in the following aspects:

- Responsibilities were dispersed more widely among a number of players (e.g. Parliament, GiC, Treasury Board, Ministers);
- The flow of information was institutionalized through annual corporate plan and budgets, summaries of plan, etc.; and
- Unique measures such as special audits.

The visits with the Toronto Hydro revealed the **duality of the responsibility of directors in public corporations, i.e. balance of the public policy objectives with pure commercial targets**, which distinguished them from their counterparts in the private sector. The process for the Cabinet to appoint directors as well as major officers was also different from the normal practice typical to a private sector corporation - election of directors by shareholders. The measures and procedures in Canada lent to some discussions about the response of state-owned enterprises to strengthen the accountability of its management.

Lessons Learned from Programming

During the debrief session, the delegation indicated that the program successfully addressed all questions and issues pertaining to their legislative research. They appreciated the combination of diverse perspectives emanated from various meetings that were arranged with government policy-makers, legislative drafters, corporations, lawyers and stock exchanges. It was believed that **the multi-dimensional approach not only would enable the law to respond more effectively to various needs, but also would improve the overall awareness and skill of the Commission staff to engage the impacted communities in their legislative analysis and review.**

As is always the case, the achievement of the expected results is attributable to the active collaboration of the Chinese partners in the program design stage. **The delegation prepared and forwarded a detailed research outline** well in advance identifying all issues they would hope to address though the visit. This research outline was circulated to most Canadian participants in order to provide some context for their preparation. As a result, most discussions were able to maintain focus on and relevance to the topics of interest to the delegates. Certain speakers even took time to prepare comprehensive written notes in response to the

questions outlined by the delegation, which turned out to be useful reference materials for the purposes of preparation and follow up on the visit.

One of the challenges to work with the delegation was that their research interest was closely tied to technical substance of the Corporations Act rather than the process surrounding the legislative drafting and review. The CEA made effort to feed this into the general purpose of the project to improve the overall legislative capacity of the NPC staff. In order to avoid putting too much weight on substance, the CEA requested that speakers expose the delegation to the industry engagement and cross-departmental coordination around various issues as reflected in the legislative process. This enabled the delegation to **explore the dynamics among various stakeholders involved in the drafting and enforcement of law instead of seeing the Canadian corporate regime merely as a number of isolated provisions on technical substance.**

Due to the nature of the subject under discussion, it was difficult to build gender into discussions of each meeting. But the CEA and Canadian speakers did make effort to **demonstrate to the delegation that the Corporations Act applied equally to female or male directors and officers.** The delegation understood from meetings with lawyers and corporate managers that Canadian corporations have the growing awareness to increase the representation of women at high-level positions. It was also demonstrated that some specific mechanisms to protect minority shareholders actually opened up access for women in a family business to bring their grievance to public attention and assistance.

The evaluation of the delegation on logistical arrangements showed a high level of satisfaction. The costs of ground transportation and accommodation were slightly higher than planned but this was due to the fact that the visit took place at a busy travel season.