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The Analysis of the Legal Issues Concerning Directors' Liability to Third Parties Under China New Company Law

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Whether to introduce a general liability system for directors to third parties has always been a focal point of controversy in the revision of the "Company Law". From a global perspective, only a few countries such as Japan and South Korea have established this system, and China's attitude towards it has also gone through multiple transformations from rejection to tolerance, acceptance, and recognition. In fact, starting from the overall social interest, the introduction of this system has important theoretical and practical significance. It can be seen that China has made bold attempts to establish general rules for directors' liability to third parties, but the relevant debates have not stopped. At present, it is necessary to clarify the nature, scope, and form of this liability, and to design a compatible system with other rules to fundamentally achieve the original intention of the system.

Keywords: director, liability to third parties, China's new "Company Law"

Introduction

On December 29, 2023, the new "Company Law" was deliberated and passed, and will come into effect on July 1, 2024. After thorough discussion from the first draft to the third-round moderation draft of the "Company Law (Revised Draft)", the general liability of directors to third parties was formally established in Article 191. Although the new law has been promulgated, the debates have not stopped. Despite the legalization of directors' third-party liability in the new law, there are still strong opponents and supporters in the academic community regarding the legal theory and reality of this clause. Some scholars clearly oppose Article 191 of the new "Company Law", believing that it is acceptable to establish a director's third-party liability system in specific areas or for special directors (such as independent directors) (Huang, 2023), but it should not be extended to a general principle. The current expression of Article 191 is too broad and will cause many problems, such as when directors make decisions on the distribution of interests between various stakeholders for the overall interests of the company, it is inevitable to damage the personal interests of some people. If directors are generally given liability to third parties, they may be overly cautious when performing their duties, and may even adopt

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conservative strategies, thereby affecting the company's decision-making efficiency and competitiveness. Giving third parties the right to directly hold directors accountable will lead to an imbalance in the company's governance structure (People's Judicial Journal Official Account, 2024). Most scholars support this clause, believing that the law serves the reality of society. With more and more cases of creditors suing companies and directors for joint and several liabilities, the call for holding directors legally responsible is getting stronger and stronger, and it has become a general trend to formulate general regulations on directors' liability to third parties (Sato, 2013; L. Ye & D. Ye, 2022). Although the "Securities Law" has taken a more aggressive attitude towards director liability in specific areas and has designed joint liabilities of directors, supervisors, and the company for third parties, the wheel of history is rolling forward, and it is necessary to establish a general clause on directors' general third-party liability in the higher-level law "Company Law" (Liu, 2023). In response to the opponents' concern about the arbitrary "third party" being damaged by the director's decision and suing, which leads to litigation, and increases the director's liability, the supporters believe that, first, the director synthesizes the conflicts of interests of all parties, complies with the articles of association and regulations to make business decisions, which belongs to the unfavorable commercial significance to "third parties", and the purely economic losses caused are not within the director's compensation liability; secondly, the provisions on the issue of directors' third-party liability in Article 191 are very restrained, and it is not easy for the "third party" to prove, which will not cause the chaotic situation of everyone suing as the opponents say, and the director will not easily bear compensation liability (Li, 2024; People's Judicial Journal Official Account, 2024).

In addition, even among the supporters, there are different opinions on whether the director's third-party liability is tort liability or special statutory liability; whether indirect damage is within the scope of the director's compensation; whether the form of liability is joint liability or supplementary liability, and whether the "third party" includes shareholders in addition to creditors, and whether directors have a fiduciary duty to shareholders, and there is no unified conclusion yet. Whether the establishment of the general clause on directors' third-party liability in the new "Company Law" is the final settlement after the debate or a violent increase in the director's liability, this article will deeply analyze the necessity of the existence of this system and the subsequent supporting mechanism construction from four dimensions: the origin of the debate, the focus of the debate, the reality of contradictions, and the correct choice.

The Origin of the Controversy: Should the Director Bear Responsibility to Third Parties?

The Rise of the Legal Person Organ External Liability Theory

The company law has always adhered to a core view that the director is the foundation of the company's organ, that is, the "legal person organ theory". This theory believes that the director is to the company what the hands and feet are to the human body. The company, as a legal person, is composed of multiple organs, and the director is only one of the components of the company and does not have the ability to independently bear responsibility. The actions of the director are naturally undertaken by the company as a whole (Wang, 2017). According to this theory, there is an internal employment relationship between the company and the director, which does not have external effect. The actions performed by the director on behalf of the company are identified as the company’s actions, and the faults committed by the director in performing his duties are deemed to be the company’s faults. There is no direct legal relationship between the director and the third party, and there is no legal basis for the director to bear a fiduciary duty or responsibility to the third party. Influenced by this view, the early Chinese legislative authorities, even though they noticed that some foreign countries had established the director’s third-party liability, still completely rejected the introduction of this system.

The doctrine is only a means of interpreting social phenomena, and the advantages and disadvantages of the theory should be judged by the actual effectiveness of solving problems (Li, 2024). With the widespread occurrence of cases where creditors require directors and companies to bear joint and several liabilities in judicial practice, the legal person organ theory can no longer meet the practical needs of directors bearing responsibility to third parties. A breakthrough in the traditional theory that recognizes the director should also bear personal responsibility when he is at fault is gradually emerging and has become the mainstream doctrine in today’s world. This doctrine believes that as a legal fiction of a “person”, the legal person does not have a real brain and limbs, and its behavior and expression of intent completely depend on the meaning and actions of the internal organs. This makes the director, as an organ, bear the dual roles of both the legal person and the individual when performing his duties, and therefore should bear personal responsibility to the third party under certain conditions (Wang, 2022). The “certain conditions” here refer to: the director should bear compensation liability if he causes damage to the third party intentionally or with gross negligence while performing his duties. In practice, the “Japanese Company Law” Article 429 (old “Japanese Commercial Code” Article 266-3), Article 430 stipulates the director’s third-party liability from different aspects and adopts special rules for dealing with director liability (Sato, 2013). The “Korean Commercial Code” Article 401, while stipulating the director’s third-party liability, also emphasizes that the director and the company should bear joint and several compensation liabilities (Choi, 2020, p. 464), and France and Switzerland have made the same provisions. The legal person organ external liability theory emphasizes that when the illegal acts of the director overflow to the third party, in order to balance the rights and obligations between the company, the legal person, and the third party, the director’s liability to the third party should be exceptionally recognized.

The Balance of Directors’ Rights and Obligations and the Expansion of the Fiduciary Duty Theory

The balance of directors’ rights and obligations. In the modern corporate governance structure, the expansion of directors’ rights has become more and more obvious. Unlike the past when shareholders directly participated in the company’s business management, today, as the market environment becomes more complex and changeable, with the expansion and diversification of the company’s business, the internal governance structure of the company has also gradually changed. The directors need to master more information, resources, and means, and also need to obtain more rights to make timely and effective decisions. Directors, through resolutions, elevate their own thoughts to the company’s thoughts, replacing shareholders as the actual person responsible for the company’s business management, making their control over the company gradually stronger. In addition, under the current company law framework, the role of the capital system in protecting the interests of small and medium-sized contract creditors and tort victims has been weakened. At the same time, creditors have begun to rely more on the good exercise of directors’ control over the company. Their decisions and actions directly affect the company’s financial situation and the protection of creditors’ interests. Creditors expect directors to properly manage the inflow and outflow of the company's capital (Zhu, 2021). Therefore, in the absence of strict capital system protection, the directors' integrity and professional ability have become key factors in protecting the interests of creditors. However, excessive rights expansion and abuse are inseparable. In the traditional corporate governance structure, directors are mainly responsible to the company and shareholders. However, with the expansion and complexity of the company's business, the directors' actions often have a direct or indirect impact on third parties. According to the principle of balance, in order to ensure the relative balance of directors' rights and obligations, it is necessary to establish a corresponding balance mechanism to ensure their proper exercise.

Expansion of the fiduciary duty theory. The fiduciary duty theory originated in the common law countries of the United States and the United Kingdom. Before the widespread recognition of the corporate personality principle, the traditional view was inclined to recognize a fiduciary relationship between directors and shareholders; with the general establishment of the corporate law personality, the view changed, believing that the main duty of directors is to be loyal to the company and work diligently, and no longer to regard the personal fiduciary relationship as its core responsibility. Under the influence of this principle, directors only owe fiduciary duties to the company and do not owe such duties to individual internal members of the company, nor do they have a reason to bear obligations to third parties outside the company. From a legal perspective, the premise for forming a fiduciary relationship is: there is an unequal rights and obligations relationship between specific parties. In other words,

> one party has the ability to affect and change the legal status of the other party through its own actions, and the affected party must accept the legal consequences arising therefrom. In order to protect the interests of the beneficiary and prevent the fiduciary from abusing its power, thus protecting the trust relationship between the two parties, the law requires the fiduciary to bear fiduciary duties to the beneficiary. (Zhang, 1998, pp. 151-152)

This premise is applicable to the current context of directors abusing their rights and harming stakeholders, which makes directors owe fiduciary duties to stakeholders in special circumstances. Directors have extensive rights to manage the company, and under normal circumstances, they only owe fiduciary duties to the company. However, when directors abuse their rights and cause substantial harm to stakeholders, an unequal legal relationship exists between the two parties, and at this time, the subject of the director's fiduciary duties should be extended to third parties. Of course, the fiduciary duties between directors and third parties do not exist independently, but are generated through the company as an intermediary. When the company has sufficient payment capacity and creditors have the guarantee of compensation, it is not appropriate to extend the director's duties to third parties.

The Absence, Introduction, and Changes of the Director's Third-Party Liability Mechanism

Regarding whether the director needs to bear compensation liability to third parties, scholars have been discussing this issue as early as 30 years ago, and the theoretical community has also gone through different stages from complete rejection to acceptance. Influenced by the traditional legal person organ theory, the academic community generally believed that as an organ of the company, the director does not need to bear compensation liability to creditors, and the damage caused to others by his performance of duties is borne by the legal person (Tong, 1990, p. 165; Ma, 1994, p. 155). Based on this, the 1993 "Company Law of the People's Republic of China" (hereinafter referred to as the "Company Law") completely denied the director's third-party liability system and did not have relevant legal provisions. In 2004, when the Standing Committee of the National People's Congress promulgated the decision to amend the "Company Law", some scholars had already paid attention to this issue and supported the director's compensation liability, even suggesting that the "Company Law" directly add provisions on the director's civil liability to third parties (Wang, 2004, p. 147). During the revision of the "Company Law" in 2005, the Standing Committee of the National People's Congress conducted in-depth studies on the legislative practices of major countries and regions. They noticed that most foreign laws do not explicitly stipulate the director's compensation liability to third parties. Therefore, with a cautious attitude, the Standing Committee of the National People's Congress did not mention the director's compensation liability to creditors in the 2005 "Company Law" (Zhang, 2005, pp. 59-67). In recent years, with the frequent occurrence of cases where directors' misconduct damages the interests of third parties and creditors sue the company and directors for joint and several compensations, the call for holding directors legally responsible has become increasingly strong, and the views of the theoretical and practical communities have also changed quietly. In response to the call of practice, the "Company Law Judicial Interpretation (II)" Articles 18-20 exceptionally recognize the director's compensation liability when hindering liquidation; the "Company Law Judicial Interpretation (III)" Articles 13 and 14 stipulate the director's responsibility when the director assists shareholders in withdrawing capital when the shareholders fail to fulfill their capital contribution obligations or fully contribute capital. The "Securities Law" has also taken the lead in designing joint and several liabilities of directors and the company for third parties in securities issuance and information disclosure. In the sixth revision of the "Company Law" in 2021, whether to introduce a general liability of directors to third parties quickly became a hot issue of this revision. The "Company Law (Amendment Draft)" (first draft) Article 190 created a general clause on the liability of directors to third parties; the second draft deleted the excessive "joint and several liability", and the third draft is consistent with the second draft, only changing the article number from 190 to 191. On December 29, 2023, the new "Company Law" was reviewed and passed, consistent with the third draft, which means that China has officially introduced a general system of directors' liability to third parties.

Specific Controversial Issues Concerning Directors' Liability to Third Parties

Despite the general system of directors' liability to third parties established by Article 191 of the new "Company Law", which significantly fills the gaps in the current legal system for holding directors accountable and the lack of protection measures for third parties, it has important theoretical value and practical significance. However, there are still three key controversies about the rules of directors' liability to third parties that need to be further clarified and resolved.

Nature of Liability: Tort Liability or Special Statutory Liability

Tort liability theory. Determining the nature of directors' liability to third parties is the premise and foundation for discussing this system. In the Japanese academic community, the tort liability theory is a minority opinion. This theory believes that the nature of directors' liability to third parties is the same as tort liability. However, given the large number of complex affairs that directors need to handle daily, to ensure efficiency, directors should only be responsible when they are grossly negligent, and should not be responsible for ordinary negligence. That is to say, the liability of directors to third parties is lower than the general tort liability in the "Civil Code" (Zuo Teng, 2013; Chen, 2013). Chinese scholars believe that the "Company Law" does not make specific provisions on directors' liability to third parties, and when there is no specific provision in the special law, the general law, that is, the provisions of the "Civil Code" on tort liability, should be applied. However, based on the particularity of the company's operating risks, special constitutive elements should be adopted (Wang, 2016). When the company and the director intentionally or grossly negligently infringe on the rights of the relative person, the relative person has the right to demand them to bear joint and several liabilities (Xing, 2021). It can be seen that before the "Company Law" lacked textual basis, most scholars agreed to attribute the liability of directors to third parties to the tort liability theory.

Special statutory liability theory. The statutory liability theory believes that the liability of directors to third parties is a special liability specially stipulated by law, which is different from general tort liability, and this is also the common view of the Japanese academic community. This theory believes that the liability of directors to third parties is higher than the general tort liability stipulated by the "Civil Code"—when directors make business decisions based on malice or gross negligence while performing their duties, even if the malice or gross negligence is not directed at the third party or does not have foreseeability of the damage to the third party, the director still needs to bear liability to the third party. If the tort liability theory is used for interpretation, the indirect losses suffered by the third party cannot be included. Those who hold this view believe that in the modern corporate governance structure, the rights of directors are gradually expanding, and the risk of their actions causing harm to third parties is also increasing. Therefore, in order to maintain market order and the principle of fairness, it is necessary to increase the liability of directors to ensure that the rights and interests of third parties are effectively protected. The author also believes that it is more appropriate to identify the nature of directors' liability to third parties as a special statutory liability. Article 191 of the new "Company Law" has clear provisions on the subject of the act, the subjective attitude of the person performing the act, and the form of liability, which is sufficient to show that the liability of directors to third parties is not a general tort liability in the general sense, and the establishment of the legislation also shows that the official value orientation of China supports the special statutory liability theory.

Scope of Liability: Direct Damage or Both Direct and Indirect Damage

Direct damage refers to the damage directly caused to a third party by a director's personal act of malice or gross negligence while performing his duties. This kind of damage is direct and obvious, and does not need to be triggered through other media or factors. For example, if a director of a company approves an illegal pollution discharge project, and the company profits from it but causes damage to the health of nearby residents, this damage is considered direct damage. Indirect damage refers to the damage caused to a third party's interests due to the company's inability to fulfill its external responsibilities because the company has suffered damage. This kind of damage is indirect and needs to be influenced through the company as a medium. For example, if a director embezzles the company's funds, causing the company to be insolvent and bankrupt, and the company is unable to pay its debts, the creditors suffer losses as a result.

Direct damage under the tort liability theory. Under the tort liability theory, the prerequisite for directors to bear responsibility to third parties is that there is a direct legal relationship between the subject of the act and the third party. Therefore, the scope of the director's compensation should be limited to direct damage, which is caused by the director's harmful act, and there is a direct legal relationship between the two. However, there is no basis for compensation for indirect damage. In indirect damage, there is an employment relationship between the director and the company, a creditor-debtor relationship between the company and the third party, but there is a lack of a direct relationship between the director and the third party. Moreover, the loss suffered by the third party is purely economic, which is far from the director's harmful act and is not foreseeable, so there is no basis for pursuing indirect damage. For such losses, shareholders' derivative lawsuits and the exercise of creditors' subrogation rights can be used to compensate.

Both direct and indirect damage under the special statutory liability theory. Firstly, the special statutory liability can directly stipulate that directors owe fiduciary duties to third parties without the need for some kind of inference. Therefore, under the theoretical framework of special statutory liability, directors are not only responsible for the direct damage caused to third parties due to their own negligence, but also need to bear the indirect losses brought to third parties due to the company's decreased ability to pay (Mitsurou, 2015, p. 211). Secondly, in indirect compensation, the amount that the company and the director compensate to the third party is different. The compensation to the company should be equivalent to the loss of the company's assets caused by the director's dereliction of duty; while the compensation to the third party should be based on the total amount of the third party's uncollected debts. Therefore, the compensatory significance of this indirect damage should be recognized (Yō, 2006, pp. 439-442). In addition, creditors are different from shareholders. Under general circumstances other than bankruptcy, creditors can get priority in the company's assets, and directors do not generally bear all the indirect losses of the third party. Their compensation is limited. Finally, based on the principle of balance, the special statutory liability breaks through the traditional compensation rules, which can solve the current company law's indirect liability investigation mechanism problems, prevent the embarrassing situation where the company cannot pay its debts and the third party is damaged, but the director who is at fault can escape responsibility; it also helps to strengthen the director's sense of responsibility, force them to act cautiously, and protect the legal rights of the third party. It can be seen that compared with the tort liability theory that does not recognize indirect compensation, the understanding of the scope of responsibility under the special statutory liability theory is more in line with today's practical needs.

Form of Liability: Joint Liability or Supplementary Liability

The evolution of China's liability form orientation. Looking for legislative examples about director liability worldwide, most countries adopt the "no liability" principle, and directors do not need to bear compensation liability for losses caused to creditors due to their duties. For example, countries like the United States and Germany believe that creditors can get enough compensation from the company, and even if the company goes bankrupt, they can get compensation through bankruptcy liquidation procedures. "Only in very few exceptional cases of violating transaction obligations or organizational obligations does the director need to bear personal liability" (Raiser & Veil, 2019, p. 223), and in principle, they are not liable. Different from the United States and Germany, Japan and South Korea are one of the few countries that stipulate directors' compensation or joint liability. Article 429 of the "Japanese Company Law" stipulates the director's compensation system for third parties, and Article 430 stipulates the joint compensation system between directors. Japanese law does not explicitly stipulate joint liability between directors and the company, but some Japanese scholars believe that the Company Law can be interpreted as directors being jointly liable with the company if they cause damage to third parties due to intentional or gross negligence while performing their duties (Mitsuo, 2016, p. 308). Article 401, Paragraph 1 of the "Korean Commercial Code" directly stipulates the director's joint compensation liability.

China's 2018 "Company Law" did not involve the director's joint liability and limited the civil liability form of the director to individual liability. In the context of the "Company Law" lacking a director's third-party liability, Article 85 of the "Securities Law" took the lead in designing the joint and several liabilities of the listed company's directors, supervisors, and senior management for damages caused to third parties due to information disclosure. The first draft of the "Company Law (Amendment Draft)" took the "Securities Law" as a blueprint, extending the director's liability to third parties to other extensive scenarios beyond the capital market, breaking through the traditional liability form, and innovatively adding provisions that directors need to bear joint liability with the company for damages caused to others due to intentional or gross negligence while performing their duties. After the first draft was published, it caused a heated debate in the academic community, and there was endless debate on whether to stipulate "joint liability". Some scholars pointed out that although the establishment of joint liability can play a good deterrent role, joint liability also has serious side effects, increasing the risk and responsibility costs faced by entrepreneurs and merchants, inducing the chilling effect of the director and supervisor market, and it is necessary to maintain the modesty of legislation (Liu, 2023). Therefore, the second draft denied the "joint liability" in Article 190 of the first draft and deleted it, only stipulating in Article 52 that shareholders who violate the non-monetary capital contribution obligations and the directors responsibility bear joint compensation liability; Article 57 stipulates that directors who assist in capital withdrawal bear joint compensation liability with shareholders, greatly limiting the scope of "joint liability". The third draft is consistent with the new "Company Law", using the second draft's expression, only changing the article from 190 to 191.

The modest liability form of the company being mainly responsible, and the director's joint liability being auxiliary. The expression of the form of liability in Article 191 of the new "Company Law" is "The company shall bear the responsibility, and if there is intentional or gross negligence, it shall also bear the compensation liability". It can be seen that the legislative purpose of the legal provision is that the company bears the responsibility as a principle, and the director bears the responsibility as an exception. In view of the dual nature of the advantages and disadvantages of the statutory joint liability, it is necessary to ensure the cautious and moderate application of joint liability when proposing strategies to promote benefits and eliminate drawbacks. "The statutory joint liability must be based on the core values of public order and good customs and risk spillover, and strictly control it within a very few special circumstances" (Liu, 2023, p. 103). The author believes that the cautious form of liability should be established, with the company bearing the responsibility as the main body and the director's joint liability as the auxiliary, and the types of losses be strictly distinguished, caused by the director to the third party, applying different liabilities to direct and indirect losses. If the company and the director are required to bear joint liability without distinguishing the type of loss, although it can make the third party receive compensation to the greatest extent, it will also cause a psychological rebound of the director and suppress the director's enthusiasm and innovation.

To elaborate, first, the director should bear a non-truly joint liability with the company for the direct losses caused to the third party. The reason for the direct loss is that the director's behavior has a strong externality. The director bears the compensation liability based on the special statutory liability, and the company bears the compensation liability based on the legal person theory for the losses caused to the third party by the legal person organ, both of which are based on independent reasons to bear responsibility to the third party, but the scope of compensation borne by the company and the director is the same, that is, all the direct losses suffered by the third party. The fulfillment of either the company or the director can lead to the extinguishment of the debt. The third party can request compensation from the intermediate responsible party, the company, and the company can compensate and then recover from the director, or it can directly request compensation from the final responsible party, the director (Yang, 2012). Because the cause of direct damage is complex, it usually does not occur directly to cause damage to the third party. Based on the exceptional nature of its application scenario, more convenience should be given to the third party when recovering, so there is no need to distinguish the order when the company and the director bear joint liability. Second, the director should bear a supplementary liability for the indirect losses caused to the third party. Supplementary liability refers to the civil liability that the supplementary liable person bears for the supplementary payment when the main liable person who should bear the payment responsibility is insufficient in property. In terms of theory, the indirect losses caused by the director to the third party meet the constitutive requirements of supplementary liability: first of all, in terms of the order of responsibility, there is a clear order between the company and the director, and the director cannot bear all the responsibilities before the third party claims against the company. This is because the root of the third party's loss lies in the company's failure to perform or fully perform its obligations, and the director's dereliction of duty only exists as an indirect factor. The law expands the scope of the compensation subject in order to protect the rights and interests of the third party and prevent the director from escaping, allowing the director to bear direct responsibility, but the company is still the primary bearer of responsibility, and the director should play a supplementary role. Secondly, in terms of the scope of responsibility, the third party should also have a clear limit when claiming against the director. This limit should not exceed the scope of responsibility that the director bears to the company due to their dereliction of duty, and this scope will not expand due to the third party's pursuit. Lastly, once the director has made full compensation to the company, the third party no longer has the right to demand compensation from the director to avoid the director from making duplicate compensations.

Arguments Against Directors' Liability to Third Parties

Resistance Within the Corporate Governance Model

First, highly concentrated equity structure. Compared to Western developed countries, China's equity structure and governance structure are fundamentally different. Most Chinese companies are actually under the actual control of controlling shareholders or state-owned companies with insiders in actual power. Therefore, the so-called board centrism is often just an idealistic romantic concept in reality. A highly concentrated equity structure does not support the establishment of a general clause on directors' liability to third parties. Under this structure, directors are appointed by controlling shareholders or major shareholders and are essentially spokespersons for the appointing shareholders. It can be said that when directors perform their duties, they only have the interests of the appointing shareholders in mind and may even be controlled by the controlling shareholders and become vassals of the actual controllers, lacking the ability to independently decide on the company's operations. Based on this reality, if third parties are given the right to directly pursue directors' liability, this not only violates the principle of consistency between rights and obligations, allowing the real responsible parties to escape punishment, but may also encourage controlling shareholders or actual controllers to continue to harm the interests of third parties behind the scenes, leading to more serious consequences.

Second, directors do not enjoy executive rights, and their income and responsibilities are not proportional. The rights allocation model of Chinese company legislation has been deeply imprinted with the shareholder meeting centrism since its inception. This model determines the core position of the shareholder meeting in the company's daily operations and major decision-making, while the board of directors plays more of an executive role. Even though the new "Company Law" has shifted towards board centrism, it still cannot change the tone of shareholder meeting centrism. In actual operations, sometimes decisions made by the company's shareholders may harm the interests of third parties, and directors inevitably cause harm to the interests of third parties when executing these decisions. Therefore, if the responsibility is attributed solely to the directors, it is not only unfair to the directors but also leads to an imbalance in the company's governance structure. In addition, the board of directors enjoys executive rights as a whole, and individual directors do not enjoy executive rights separately. This means that in daily operations, it is highly unlikely for individual directors to directly cause damage to third parties, and high compensation far exceeds the remuneration received by directors, causing directors to often face an embarrassing situation of being unable to bear the responsibility.

Third, increased operating costs. "Setting up a general rule on directors' liability to third parties will lead to increased operating and compliance costs for companies".[1] Firstly, it will greatly increase the risk and responsibility costs faced by directors. The mismatch between income and responsibility will cause eligible directors to shy away. In order to attract talent, companies have to raise salaries or even promise to provide financial compensation or purchase insurance for the losses that directors may incur due to liability to third parties, thereby increasing the company's operating costs. Secondly, in addition to bearing civil liability to the company, if directors cause losses to third parties due to fault, they also need to bear personal compensation liability. The heavy civil liability makes directors cautious when performing their duties, losing their innovation and adventurous spirit. In the long run, this conservative attitude will have a negative impact on the company's operations and development, and may even harm the interests of the company and its stakeholders.

The Lack of a Mature Professional Manager Market

The cornerstone of the modern company system is the separation of ownership and management rights. However, in the current context of relatively concentrated equity and an immature professional manager market, the board of directors, as a key institution of corporate governance, often finds it difficult to fully exert its role. Under the "separation of two rights" framework, directors are elected based on the will of all shareholders, but in China, the positions of the board of directors are basically appointed by shareholders according to their shareholding ratio and agreement. Therefore, although directors are theoretically responsible to all shareholders, not just to the shareholders who appointed them, in practice, directors inevitably bear the main responsibility to the shareholders who appointed them. There is a serious deviation between the theoretical and actual states, which urgently needs to be corrected and adjusted. China lacks a mature and independent team of managers, and there

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[1] See *The Improvement of Directors' Fiduciary Duties: Do Directors Have Responsibilities to Third Parties?* Conference Bulletin of the 2022 Annual Meeting of the Commercial Law Research Association of the China Law Society, Third Sub-Forum, Pages 16-17.

is no independent professional ethics and traditional culture. Against the backdrop of immature corporate governance structures and manager markets, establishing a general system of directors' liability to third parties may inappropriately increase the directors' responsibilities.

Unclear Fiduciary Duty Object of Directors

The emergence of the system of directors' liability to third parties is the result of the expansion of fiduciary duty theory. Generally speaking, directors only owe fiduciary duties to the company. However, when there is a special case where directors abuse their power and cause substantial damage to stakeholders, the legal relationship between the two becomes unbalanced. At this time, the scope of directors' fiduciary duties should be extended to third parties. Article 191 of the new "Company Law" states "shall bear compensation liability for causing damage to others", and the scope of "others" is not clearly defined in the Company Law. Some scholars have pointed out that the director's compensation liability is limited to the compensation liability that directors owe to the company's creditors and does not include shareholders or investors (L. Ye & D. Ye, 2022). There are also scholars who believe that the "others" mentioned in Article 191 refers to people other than the company as a subject, including shareholders[2] (People's Judicial Journal Official Account, 2024). The essence of this debate lies in the unclear object of directors' fiduciary duties, that is, whether directors' owe fiduciary duties to shareholders. It is a consensus in theory and practice that directors owe fiduciary duties to the company, but whether directors are responsible to individual shareholders in all scenarios still has room for discussion in theory. In fact, the interests of the company and shareholders are not completely consistent, and sometimes there are conflicts between the interests of shareholders. Directors are loyal to the interests of the company rather than the interests of shareholders, which is an important value reflection of directors being "directors of the company" rather than "agents of shareholders". Some scholars have compared the fiduciary duties under American law and believe that Chinese directors should also bear fiduciary duties to shareholders. However, the concept of fiduciary duties under American law is quite different from China in terms of connotation and extension. The standard of fiduciary duties in China is relatively high, and there can be no conflict of interest between the obligor and the beneficiary. Unlike China, the concept of fiduciary duties under American law is very broad, almost to the point where any mutual trust can induce fiduciary duties, without a service relationship between the obligor and the beneficiary, and even in the United States, the main object of directors' duties is still the company (Huang, 2020, pp. 246-260). In my opinion, under the modern corporate governance structure, in addition to pursuing economic interests, companies also need to actively undertake responsibilities and obligations to society, the environment, employees, consumers, and other parties. If directors are generally responsible to shareholders, it will not be conducive to the realization of the company's diversified values. In other words, directors do not need to bear fiduciary duties to shareholders in all scenarios. In the expansion to directors' third-party liability, the "third party" should not include shareholders. For some scholars who worry about the board of directors infringing on the rights and interests of minority shareholders, it is possible to strengthen shareholder derivative lawsuits and introduce specific shareholder oppression relief, rather than a general third-party liability system.

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[2] The viewpoint of Professor Li Jianwei is detailed in the article Mobile Salon | Does a Director Owe a Fiduciary Duty to Shareholders?—Legal Principles and Reality of Articles 191 and 192 of the New Company Law, published on People's Judicial Journal official account on February 3, 2024, https://mp.weixin.qq.com/s/TNpXrqWV26OfvWn8VM3n1g.

The Regulatory Approach to Directors’ Liability to Third Parties Under Chinese Company Law

Adhere to the Value Orientation of Establishing General Liability of Directors to Third Parties

The legislation of any country is to solve its own unique problems. Society exists before the law, and the role of the law is to transform and build a better society. Therefore, when formulating and interpreting laws, it is necessary to consider from the perspective of the overall social interest. Starting from the current social situation in China, establishing a general liability of directors to third parties has profound legal basis and practical significance.

Firstly, as the executive organ of the company, directors should abide by laws, regulations, and the company’s articles of association when exercising their powers, and protect the rights and interests of the company and its stakeholders. However, in reality, there are many cases where directors abuse their power and harm the interests of third parties, which seriously violates the principles of fairness and justice of the law. Therefore, establishing a general liability of directors to third parties is an important measure to implement legal provisions and strengthen the legal responsibility of directors, and the cautious expression of the existing provisions will not make the directors’ responsibilities too harsh.

Secondly, from the perspective of the legal structure of corporate governance, as the core subject of corporate governance, the rights, obligations, and responsibilities of directors should be matched and mutually restrained. The existing legal provisions on directors’ responsibilities are not comprehensive enough, especially in terms of liability to third parties. Establishing a general liability of directors to third parties can fill this legal gap, improve the legal system of corporate governance, and promote the legalization and standardization of corporate governance.

Thirdly, from the perspective of legal remedies, the existing legal provisions for third-party remedies are relatively limited. This system can provide third parties with more comprehensive and effective legal remedies, ensuring that their rights and interests are fully protected.

Fourth, the aforementioned claim that directors are spokespersons for the appointing shareholders is generally correct, but it is too hasty. Although directors have interests related to the appointing shareholders, it does not mean that directors are completely subject to the appointing shareholders. Article 191 of the new “Company Law” provides directors with the courage to refuse the behind-the-scenes shareholders, which is also a kind of protection for the directors’ independent will and actions towards the shareholders.

Fifth, strengthening the liability of directors to third parties has become an important direction for the reform of corporate governance laws internationally. The establishment of general liability of directors to third parties in China can further align with international standards, enhance the international level of corporate governance in China, and enhance the legal competitiveness of Chinese enterprises in the global market. In general, establishing a general liability of directors to third parties is an inevitable choice under the current social situation in China.

Strengthen the Interpretation of the Elements Constituting Directors’ Liability to Third Parties

To accurately grasp the understanding of directors’ liability to third parties, it is necessary to further strengthen the interpretation of its constitutive elements. From the wording of Article 191 of the new “Company Law”, the establishment of directors’ liability to third parties requires four elements: the director’s official actions, subjective intent or gross negligence, direct or indirect losses suffered by third parties, and a causal relationship between the director’s official actions and the actual damages suffered by third parties.

Firstly, the director’s official actions must be illegal. There are three understandings of the official actions here: First, the actor must have a real director status or a reasonable appearance of director status; second, it must be the execution of official duties, including the general powers of the board of directors stipulated in Article 67 of the “Company Law” and the specific responsibilities of directors scattered in other articles (deciding on the company’s external guarantees, acting as the legal representative of the company, verifying the capital contributions of shareholders, etc.) and the special powers of independent directors stipulated in Article 18 of the “Administrative Measures for Independent Directors of Listed Companies”; third, the non-external nature of the director’s actions. Article 191 only expresses “directors executing their duties and causing damage to others”, and does not distinguish between the internal and external nature of the director’s performance of duties, which means that even those directors who only participate in board decisions and are not directly involved in external affairs may also face the risk of bearing compensation liability due to the unlawful actions of other executive directors or directors acting as legal representatives. Of course, if the director can prove that they had clearly raised objections during the vote and it was recorded, they may be exempted from compensation.

Secondly, subjective intent or gross negligence. There are two situations to distinguish here: The first is the director’s intentional violation of laws and regulations or the company’s articles of association, causing damage to third parties; the second is the director’s actions that cause damage to third parties due to gross negligence. The “Company Law” strictly limits the liability of directors to third parties to the field of “intentional or gross negligence”, reflecting the restraint of the legislation. It can be said that only when the director has the above two subjective situations, the director owes a fiduciary duty to third parties. With the expansion and diversification of the company’s scale and business, directors need to have the ability to handle a large amount of information and make quick judgments. If the subjective standard is lowered to general negligence, it will lead to a large number of lawsuits and disputes, which is not conducive to the spirit of modern entrepreneurs taking risks; in addition, exempting minor negligence from punishment essentially conforms to the value orientation of the business judgment rule, that is, as long as the director makes decisions based on the maximization of the company’s interests after fully collecting information, even if the results damage the interests of the company or third parties, the court does not need to conduct ex-post reviews, and the subjective standard should adopt a light negligence standard in judgment (Chang & Zhang, 2013).

Thirdly, third parties suffer direct or indirect losses. As mentioned earlier, the understanding of the scope of responsibility under the special statutory liability theory is more in line with today’s practical needs, and the provisions of China’s new “Company Law” on third-party liability also reflect the value orientation of identifying the nature of responsibility as a special statutory liability. In the company’s operations, directors usually only have subjective faults against the company when performing their duties and do not have the intention to damage the interests of third parties. Therefore, when third parties pursue tort liability against directors, due to the lack of a direct legal relationship between the two, the third party’s path to compensation is often difficult. In order to provide more comprehensive protection for third parties, the special statutory liability expands the scope of the director’s compensation, and through direct legal provisions, both direct and indirect losses should be included in the director’s compensation scope.

The fourth, there is a causal relationship between the action and the damage. China adopts a considerable causal relationship standard for the causal relationship of directors' third-party liability, which is different from the general liability. The causal relationship of directors' third-party liability needs to pay attention to two special points. The first is the longer causal relationship chain. Under the special statutory liability theory, the scope of the director's compensation includes both direct and indirect losses. For indirect losses, directors often lack the intention to damage third parties, so when assessing the causal relationship, it is necessary to carefully identify whether the director's negligence is a reasonable condition for the occurrence of the damage, and to exclude those caused by external factors such as market risks and national policies that lead to the company's insolvency. The second is the particularity of the non-action causal relationship. Under normal circumstances, the direct cause of damage is often the positive actions of others, and pure inaction is difficult to constitute damage compensation liability (Yang, 2014). However, in the company's operations, there will also be situations where directors damage the interests of third parties due to inaction. If the director has an obligation to act and does not, and this inaction extends or strengthens the causal chain and leads to adverse damage results, then the director should bear the corresponding compensation liability.

Improve the Compatibility With Other Norms

Transition to the board-centric model. The shareholder meeting centrism has been deeply rooted in China's legislative rights configuration model, and the power configuration under this model will greatly compress the applicable space of directors' liability to third parties. The board centrism and the expansion of directors' powers are the prerequisite conditions for directors to bear responsibility to third parties (Xiang, 2003). Although the shareholder-centric model once held an important position in China's governance structure, with the development of the market economy and the renewal of corporate governance concepts, the board-centric model has become the optimal choice for the new era. The new "Company Law" also reflects the trend of the corporate governance model shifting towards "board centrism", which is specifically manifested in: First, the deletion of the statement "the board of directors is responsible to the shareholders' meeting" implies that the interests represented by the board of directors are not only those of shareholders but also include the interests of the company, employees, and other related entities, thus reducing its dependency on the shareholders' meeting; Second, adjustments have been made to the scope of powers of the shareholders' meeting and the board of directors. The phrase "deciding the company's business policy and investment plan" for the shareholders' meeting has been removed and reflected in the board's authority. Additionally, the statement "the shareholders' meeting may authorize the board of directors to make resolutions on issuing bonds" was added, indirectly reflecting that the center of the company's operational management is gradually shifting towards the board of directors; Third, the new "Company Law" stipulates that if the company does not establish a supervisor or a supervisory board, the board of directors may set up an "audit committee" to strengthen the board's internal supervision of the enterprise; Fourth, directors are granted the right to seek compensation from the company if they are dismissed without cause before the end of their term, giving directors the confidence to independently exercise corporate governance authority. Although the new "Company Law" ultimately abandoned the "residual power standard" from the first draft and did not make a clear provision on the ownership of residual power, it does not mean that it has stopped moving further towards board centrism. The bold reforms of the new "Company

Law" in the power allocation model also provide a theoretical and practical basis for the application of directors' third-party liability.

Improve the transparency of directors' information disclosure. One of the conditions for filing a lawsuit is the need for a clear defendant; the plaintiff must clearly identify the party that has infringed upon their rights so that the court can ascertain the identity and related information of the defendant. This implies that when a third party sues a director for compensation liability, they must have specific personal information about the director. However, in China, only the appointment information of directors, supervisors, and senior management of listed companies needs to be disclosed regularly, and the situation for non-listed companies is quite different. Although the new "Company Law" stipulates in Article 32 that the registration matters of a company need to be publicly disclosed through a unified enterprise information disclosure system, it is regrettable that the appointment information of directors is not part of the company's registration matters, which only includes the name of the legal representative. When a third party needs to hold a director accountable for infringement, they cannot obtain information about the director through public channels and have to pay for the corresponding investigation and confirmation costs, which undoubtedly increases the cost of accountability for the third party. The public disclosure of the appointment information of directors, supervisors, and senior management of non-listed companies is necessary to promote the spirit of autonomy and protect the credibility of information disclosure. Denying the transparency of director information will severely damage the rights of creditors to be informed, to choose, and to trade fairly (Liu, 2023). To better achieve the original intention of establishing the third-party liability system for directors, it is recommended that the appointment information of directors, supervisors, and senior executives be included in the scope of company registration matters and be publicly disclosed through a unified enterprise information disclosure system to enhance its transparency.

Improve the director's liability insurance system. To alleviate the economic burden and psychological pressure on directors due to bearing huge compensation liabilities, and to prevent them from being overly cautious and losing their spirit of innovation and adventure when exercising their duties, it is necessary to establish a corresponding relief system. The director's liability insurance system emerged for this purpose. Director's liability insurance was introduced to the Chinese insurance market in 2002. The "Corporate Governance Code for Listed Companies" Article 39 stipulates that "with the approval of the shareholders' meeting, listed companies can purchase commercial insurance for directors". The 18-year revised edition Article 24 further stipulates that "the scope of liability is subject to the contract, but directors who violate laws and regulations and the articles of association are excluded". The "Rules for Independent Directors of Listed Companies" Article 29 also encourages listed companies to establish an independent director insurance system. Unfortunately, these regulations all adopt an encouraging and authorizing attitude, lacking compulsion. Article 193 of the new "Company Law" is the first time in the history of the company law to stipulate the director's liability insurance system, emphasizing that the board of directors should report to the shareholders' meeting the amount of insurance, the scope of insurance, and the insurance premium rate, etc. However, the wording still uses advocating words like "can". In fact, after the Kangmei Pharmaceutical case, China has entered an era of high risk for independent directors. Against the backdrop of rising opportunities and risks in the capital market, independent director liability insurance should be a necessary protection for independent directors. In view of the particularity of the status of independent directors in the company and the necessity of insurance, the following suggestions are made for the improvement of the new "Company Law", other regulations, and related judicial interpretations: First, the "Company Law" should maintain its advocating attitude unchanged. For general directors of non-listed companies, the general law should fully respect the principle of corporate autonomy, and it should be up to the company to decide whether to insure directors; for directors of listed companies and independent directors of non-listed companies, compulsory provisions should be adopted in special laws such as the "Corporate Governance Code for Listed Companies" and "Rules for Independent Directors of Listed Companies" to provide special protection. Second, expand the scope of coverage and stipulate that as long as the director meets the "ordinary reasonable person" standard and acts in good faith to achieve the company's maximum benefit, insurance can be provided. Third, reasonable pricing. Relevant legal provisions can promote reasonable pricing by insurance companies to better ensure that director's liability insurance can be reasonably shared between companies and insurance companies. Fourth, increase the compensation limit. China should set a higher compensation limit standard to adapt to the increasingly complex and high-risk business environment. Fifth, clarify the insurance compensation rules. For compensation claims made by third parties against directors, insurance companies should compensate within the scope of the policy according to the liability limit, and the company should compensate for the excess part.

Conclusion

Although the general rules on directors' liability to third parties have been officially established through the "Company Law", it seems that the dust has settled, but in fact, there are still many disputes. This article always adheres to the theory of legal person organs bearing responsibility externally. In terms of the nature of liability, it adopts the special statutory liability theory. In order to promote the spirit of private law autonomy and entrepreneurial spirit, and to encourage innovation and adventure, the liability of directors to third parties should still adhere to the value orientation of cautious use of joint liability. With the deepening and complexity of corporate governance practices, in order to protect the legal rights and interests of external third parties, to make up for the shortcomings of the traditional legal person organ theory, to optimize the corporate governance structure, and to maintain transaction safety and economic order, it is necessary to introduce the civil liability of directors to third parties, urging directors to perform their duties more cautiously and responsibly. Of course, in order to avoid the concerns of the opposing parties that introducing a general liability of directors to third parties will blindly expand the directors' responsibilities, trigger a chilling effect in the director market, and ultimately lead to a stifling of corporate vitality, it is also necessary to strengthen the interpretation of the elements constituting the directors' third-party liability, improve the compatibility with other regulations, and better play its original intention of system design.

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