

Analysis of the Connotation of Good Faith of Directors in China: Comparison with Delaware Corporate Law

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Abstract: Due to the accountability gap between the duty of loyalty and the duty of care, some countries have begun to restructure the fiduciary duty system of directors in corporate law, with the most important call to introduce an independent duty of good faith to directors. Typical is the discussion of the concept of "good faith" in Delaware, USA, for nearly 20 years. In China, such a controversy has also arisen. To clarify whether it is necessary to introduce the question of the duty of good faith, this article clarifies the concept of the duty of good faith by collating a series of precedents from the Supreme Court of Delaware and the Court of Chancery that laid the foundation for the duty of good faith. A comparative study of the legislation about good faith in US company law and its limitations concludes that there is no need to introduce an independent duty of good faith under a fiduciary duty in China and then proposes that the judgment on "good faith" can be introduced into the fiduciary duty of directors by expanding the scope of the existing duty of loyalty to include the connotation of "good faith", or by introducing the principle of good faith in the field of company law.

1. Introduction

As an important concept in corporate governance, the fiduciary duty of directors is one of the core rules in the legal relationship of the company, which balances the interests of directors and the company and its shareholders and determines the boundary of judicial intervention in the management of the company. In China's company law, directors' fiduciary duty includes the duty of care and the duty of loyalty. The legal basis is Article 147 and Article 148 of the Company Law of the People's Republic of China. The former refers to the attention standard that directors should pay attention to, like dealing with their affairs, emphasizing efforts and extent, which has a specific relationship with personal ability. The latter emphasizes the director's loyalty to the company, which means that the director should not damage the company's interests and benefit himself from the obligation of omission [1]. However, Article 147 of current Chinese Company Law is limited to a general provision on the duty of care. Article 148 lists the specific acts of breach of the duty of loyalty but lacks general provisions, which has caused the application problems of the fiduciary duty in Chinese judicial proceedings. The root cause of these problems is that China's legislation on the fiduciary duty of directors needs to be revised and detailed.

In contrast, American corporate law has a richer connotation of directors' obligations. The United States is the pioneer and explorer of commercial trust practice. After the *Smith v. Van Gorkom* case, the American academic and judicial circles began exploring Good Faith for many years. After that, some Chinese scholars conducted research on it. However, before the law introduces good faith, it is necessary to analyze the interpretation of good faith and find its position in the directors' fiduciary duty.

2. Good Faith in China's Existing Legislation

The concept of good faith has emerged in Chinese legislation. The Guidelines for Articles of Association of Listed Companies (2022) stipulates that directors and supervisors should have a duty of loyalty and duty of care to the company. In addition, Article 40 stipulates that the controlling

shareholder and the company's actual controller have a good faith obligation to the company and the public shareholders.

There have been cases in judicial practice that the controlling shareholder has violated good faith in the company. Although it is not a direct provision for directors' fiduciary duty, directors and controlling shareholders are both core elements of corporate governance. At the same time, the Securities Investment Fund Law of the People's Republic of China based on the legal trust relationship does not adopt the concept of "duty of loyalty." Article 9 of the law requires fund managers to perform their duties and fulfill their obligations of good faith, care, and diligence [2].

Since China's current Company Law does not provide for good faith, courts usually judge the performance of directors' fiduciary duty according to Articles 147 and 148 of the Company Law.

The concept of good faith, which has been actively discussed in American corporate law, is closely related to the practice of American corporate law and has been debated for many years. Therefore, in China's company law, whether it is necessary to provide an independent fiduciary duty for directors must be carefully considered. We will discuss this in detail to provide a theoretical basis for China's application.

3. Good Faith in American Company Law

The United States is regarded as the birthplace of corporate governance and the pioneer and explorer of commercial trust practice. Studying the governance structure of American companies and drawing on its trends will help solve the dilemma of China's good faith. Delaware has attracted more than half of the large public companies to register in the United States. It has become the center of the legislation and revision of American corporate law [4]. Some scholars posted the label Delaware's "company law myth" to explain why the company law of the state has been "leading the company laws for hundreds of years" in the United States and even the world [5]. Therefore, in this paper, the author discusses the company law of Delaware.

3.1 The Connotation of Good Faith from the Evolution Process

According to the traditional Delaware corporate law, directors' fiduciary duties usually include duty of care and duty of loyalty. *Smith v. Van Gorkom* in 1985 was the starting point for the Delaware court to discuss the rules of directors' good faith. The good faith is not included in the judgment of loyalty concerns or due care but appears in the form of juxtaposition with loyalty concerns and due care [6].

Therefore, many people think the regulation separates 'good faith' as an independent fiduciary duty from the duty of loyalty [7]. In 1996, in the case of *Gagliardi v. TriFoods Int'l, Inc.*, the judge made it clear that if some decisions were terrible, there was a risk of liability for damages caused by them, even in the absence of evidence of a conflict of interest or improper motive [8]. Therefore, if a director makes a non-conflict of interest transaction for the company's benefit, whether the decision is wise or foolish, low-risk or high-risk, it is beyond the court's review of the duty of loyalty [9]. In cases, the court often examines whether the directors have complied with the duty of loyalty by examining whether there is a conflict of interest [10]. In 2005, in *In re Walt Disney Co. Derivative Litig*, the court define good faith as a general requirement of directors' conduct.

Therefore, the connotation of good faith is presented: (1) there is a legitimate purpose, which is a requirement for inner goodwill; (2) for the company and shareholders, directors should assume the responsibility.

3.2 Situation of Breach of Dishonesty

It can be seen from the above cases that good faith tends to separate from the duty of care and the duty of loyalty [11].

However, the motive of dishonesty is not the only way to prove the violation of good faith. For example, in the *Caremark* case, the Delaware's Chancery Court made it clear that although there is no malicious motive, the continuous and systematic failure of directors to perform their supervisory duties is also one of the manifestations of their lack of good faith. For example, they have not

established a credible information reporting mechanism.

3.3 The Boundary between Good Faith, Duty of Loyalty, and Duty of Care

An issue has been debated in American corporate law for many years [12], namely the famous dispute whether the fiduciary duty "triad" existed, including care, loyalty, and good faith.

As mentioned above, the Delaware Supreme Court has argued in a series of cases that good faith should be independent of the duty of loyalty and duty of care. The debate concerns how to judge the director's breach of statutory obligations, which affects the director's liability system.

However, it is difficult to distinguish "good faith" as an independent duty from a duty of loyalty or duty of care because the duty of good faith overlaps with them to some extent. Professor Bishop of the Delaware's Chancery Court also criticized: the duty of good faith is not an independently actionable fiduciary duty; the "triad" is a forced separation of company law norms [13], which may lead to many concepts that are difficult to integrate, confusing the academic research of company law [14].

4. The Enlightenment of Good Faith in China

By reviewing the evolution of the "duty of good faith" in Delaware corporate law, we can conclude: In the cases mentioned above, the "duty of good faith" seems to have been gradually separated from the duty of care and duty of loyalty, and the connotation has been clarified to some extent. However, in the court's cases, the judges have not reached a consensus on how to use the "duty of good faith". They reflect that good faith, which has the almost same meaning as honesty or honest in Chinese, is highly abstract, and its content needs to be comprehensively judged through the relationship between the parties and the background and specific circumstances of the performance of specific obligations.

Therefore, referring to the United States, China doesn't have to introduce the "duty of good faith" as the connotation is difficult to interpret.

4.1 Difficulties in Application Caused by Unclear Connotation of Honesty

From the perspective of traditional Chinese semantics, the word honesty is logically related to loyalty. So, it is unnecessary to separate the "duty of good faith" from the duty of loyalty, and it is challenging to clarify the boundary between the two. Regarding the existing content, the duty of loyalty in the company law refers to the duty of the trustee to work hard in good faith to promote the company's and shareholders' best interests [15].

We can see that "good faith" or "honesty" is highly abstract. Its specific content can only be judged on a case-by-case basis based on the relationship between the parties in a specific case, the director's behavior, and the performance of rights and obligations. The case law of the United States can be gradually enriched through precedents.

4.2 The Absence of a Business Judgment Rule Weakens the Value of Good Faith

Unlike China, the Delaware Corporate Law sets up the Business Judgment Rule to identify and exempt directors from their fiduciary duties. The business judgment rule requires the plaintiff to collect evidence to overturn the director's business judgment. The emergence of business judgment rules provides security for company directors and their behavior to avoid risks in business decisions so that the company's strategy can be respected and maintained [16]. Significantly since the 20th century, the rights of shareholders of American companies have been continuously weakened, while the rights of directors have been expanded daily. The frequent actions of serious dishonesty of company directors have significantly weakened the public's confidence in directors [17]. The US government initiated the reform of directors' fiduciary duties focusing on directors' duty of good faith to enhance investors' confidence. The rules of fiduciary duty established by American legislation and judicial development, especially the rule of business judgment, restrict the expansion of managers' responsibilities. In addition, it has become a breakthrough for it to go out of the shackles of its existing traditional laws [18].

However, China does not have the business judgment rule; that is, China does not provide directors

with protection from liability. There is no need to introduce a duty of good faith to expand the scope of directors' responsibilities and to prevent directors from using business judgment rules to evade responsibilities in China.

5. Possible Meanings of Honesty

5.1 Expanding the Scope of Directors' Duty of Loyalty

Since the duty of loyalty and duty of care can realize consumer protection, the "triad" fiduciary duty can be set aside to avoid adjustments to the legal system. An independent duty of good faith may differ from the duty of loyalty in that it does not need to consider conflicts of interest and it does not relate to gross negligence in the business judgment rule. Instead, it considers the directors' motives, which can also be assimilated into the connotation of the duty of loyalty.

Therefore, a feasible method is to take good faith as the review standard of the duty of loyalty and incorporate good faith and related requirements into the duty of loyalty.

5.2 Principle of Honesty and Credibility

The legal system needs sufficient legal principles as support, and legal principles can provide valuable guidance for legal rules. The duty of loyalty in the existing fiduciary duty of directors is based on the agency theory, and the duty of care is based on the theory of tort law [19]. Looking through the principles and systems in civil and commercial law in China, the closest concept to the obligation of good faith discussed in this paper is only the basic principle in civil law: the principle of honesty and credibility [20].

Specifically, as a fundamental principle in civil law, the principle of honesty and credibility represents the general moral standard of society to the actor. Fiduciary duty is the duty of strong people in an unequal fiduciary legal relationship [21]. The principle of honesty and credibility is the lower standard of civil and commercial activities, and fiduciary duty is the higher standard [22].

Due to the stability of the statutory legal system, the principle of honesty and credibility is the best choice under the existing legal framework. The author believes that civil law can be regarded as an essential requirement. That is, all people pursue personal interests without damaging the interests of others and social welfare.

6. Conclusion

The incentive and restraint mechanism of directors has always been one of the core issues of modern corporate governance. Due to the existence of directors, the company can grasp business opportunities and promote the efficient development of the company. Only by realizing the balance of rights and obligations, power and responsibility between directors and companies and shareholders as company operators can we promote the success of corporate governance.

Introducing the principle of credit into the company law to complete the director's fiduciary duty system is conducive to the directors' fiduciary duty norms, forming a systematic theory. Under the guidance of the theory, the behavior of company directors is supervised. At the same time, it strengthens the sense of responsibility of directors. It punishes the dishonesty of shareholders who do not comply with the fiduciary duty to unify directors' rights, responsibilities, and obligations. In this way, it can better play the backbone role of directors in operation, improve the corporate governance structure, and promote the healthy and orderly development of the market economy.

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