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CORPORATE GROUPS AND STRATEGIC ALLIANCES:

NEW REFORM INSTRUMENTS TO THE CHINESE

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INTRODUCTION

The advent of corporate groups is the result of corporate development.[1] A corporation can become a shareholder of other corporations by purchasing their shares.[2] By the holding and cross-holding of shares,[3] a number of companies connected together may form a corporate group.[4] The controllers of the group "may plan, instigate and co-ordinate its managerial, operational and financial activities on a group basis, while implementing [these activities] through individual group companies."[5] In doing so, the corporation can enjoy the advantages of maximizing financial returns, limiting commercial risks and expanding markets. However, the practice adds new complexities to the already complicated corporate system, which stems from the fact that the fundamental norms and legal framework of the corporation had been built up prior to the emergence of corporate groups in the early-industrialized countries. As a result, the use of corporate groups inevitably brings certain contradictions and challenges to the well-established corporate notions and practice.[6]

Today, most companies of the corporate world belong to different corporate groups in one way or another.[7] Efforts have been made by different legal systems in favor of developing an effective legal framework to deal with the problems presented by corporate groups. Basically, two strategies have been predominant. The first is to create or build a separate legal regime to regulate the operation of corporate groups.[8] German corporate law falls into this class.[9] The second

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1. *See* ROBERT I. TRICKER, INTERNATIONAL CORPORATE GOVERNANCE: TEXT, READINGS AND CASES 326 (1994).

2. *Id.*

3. *Id.* at 327.

4. *Id.* at 326.

5. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), CORPORATE GROUPS DISCUSSION PAPER 1.3 (1998).

6. *See* Cashel, *Groups of Companies – Some US Aspects*, *in* GROUPS OF COMPANIES 20-23 (Clive M Schmitthoff & Frank Wooldridge ed. 1991).

7. *See* Tunc, *The Fiduciary Duties of a Dominant Shareholder*, *in* GROUPS OF COMPANIES 1 (Clive M Schmitthoff & Frank Wooldridge ed. 1991).

8. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), *supra* note 5, at 1.43-1.48. *See generally* D.D. Prentice, *Groups of Companies: The English Experience*, *in* GROUPS OF COMPANIES IN EUROPEAN LAWS 36 (Klaus J. Hopt ed. 1982).

involves conditionally abandoning traditional principles of corporate law and applying specially designed legal structures for corporate groups, upon the occurrence of certain events. This principle is generally applied by Anglo-American systems.[10]

Since the 1970s, the People's Republic of China has undertaken a great deal of effort to establish a network for enterprise cooperation for the purpose of enhancing the competitive ability of its enterprises.[11] Various trials were carried out, including setting up various enterprise alliances (*lian ying*), enterprise groups (*qi yie ji tuan*) and corporate groups (*ji tuan gong si*).[12] China's 1994 *Company Law*[13] only addresses the terminology of parent companies and subsidiaries, but has no further provisions specific to corporate groups.[14] The 1986 *Civil Code*[15] does not contain a definition of corporate group, but only defines an enterprise alliance as 'a joint operation between enterprises or an enterprise and an institution.'[16] Such a joint operation may result in the establishment of a new legal entity or a partnership, or may be simply based on a cooperative contract.[17] With the development of corporate practice, the patchy provisions relating to enterprise alliances in the 1986 *Civil Code* become less and less relevant. China urgently needs to develop an effective legal framework to guide the practice of corporate groups, because more and more state-owned enterprises are being "corporatized" and most newly established firms take the form of a company.

This article will first examine the theoretical challenges and difficulties brought by corporate groups. Part II of this article will introduce the development of corporate groups and other forms of business alliances in China. Finally, Part III will discuss how the problem of corporate groups has been tackled by other jurisdictions so as to provide some wisdom and inspirations for the Chinese government's legislative and practical efforts in this arena.

I. THE THEORETICAL ISSUES CONCERNING CORPORATE GROUPS

A. The Abuse of Separate Personality and Limited Liability

Separate personality and limited liability form the basis for the modern corporation.[18] The vitality and attraction of the corporate structure rest on its predictability to investors.[19] It makes it possible for investors to evaluate their

9. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), *supra* note 5, at 1.49.

10. *See id.* at 1.27-1.31.

11. *See* YIPENG LIU ET AL., COMPLETE WORKS ON THE COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA FOR PRACTICE 18 (1994) [hereinafter "COMPETE WORKS"].

12. *See id.*

13. *See* Company Law of the People's Republic of China (1994) [hereinafter "Company Law"].

14. *See id.* at arts. 12 & 13 (1994).

15. *See* General Principles of Civil Law (1986).

16. *See id.* at arts. 51, 52 & 53 (1986).

17. *Id.*

18. *See* L.B.C. GOWER, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 88 (1992).

19. *See generally* C.A. COOKE, CORPORATION TRUST AND COMPANY 39-50 (1950).

business risks and liabilities.[20] These qualities were foreseen by those founding fathers of modern corporate law. In designing corporate laws, they had the clear view of designing a business form that would protect individual investors through preventing their investment from triggering unlimited personal liability. As the holding of shares of other companies was generally forbidden by laws at that time, the doctrines of separate personality and limited liability were, for a time, thought to be sufficient.[21] However, problems arose when limited liability was needed to extend to holding companies.[22] This then introduced limited liability within limited liabilities.[23]

Portfolio investment by corporations was generally permitted by the end of nineteenth century, as a means of pooling resources and sharing profits.[24] The conventional concepts of separate personality and limited liability began to apply to holding companies and started to experience crises.[25] Since the purpose of the existence of groups of companies is to achieve an optimal performance of the group as a whole,[26] this goal sometimes necessitates the sacrifice of an individual company's benefits in order to maximize the gains of the whole group.

For example, to implement a strategy that is good for the group, a parent company may instruct a particular subsidiary to sell raw materials to another subsidiary at a low price and to buy the products manufactured by the first company at a high price. In doing so, the group makes gains at the expense of the interests of outside shareholders and creditors of that particular subsidiary. In such cases, business is fragmented among the component companies of the group, and limited liability and separate personality are used to "protect each fragment of the business from liability for the obligations of all the other fragments".[27] Hence, it becomes evident that the traditional doctrines of corporate separate personality and limited liability are no longer adequate in dealing with corporate groups.

In relation to corporate governance, corporate groups pose the question of how the directors of the companies of the same group direct their loyalties. How do they comprehend and judge the concept of "for the best interests of the company" when they make their business decisions, especially in a situation where there is a conflict of interest between the group as a whole and the individual companies to which they owe their duty of loyalty? With the increasing

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20. *See* Cashel, *supra* 6, at 24.

21. The power to purchase other companies' shares, without specific authorization to do so, was firmly forbidden by the common law at the early stage of corporate history. *See* PHILLIP I BLUMBERG, THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 56, 61 (1987). *See also* Great Eastern Ry. v. Turner, 8 L.R. Ch. App. 149, 151-152 (1872); In re William Thomas & Co. v. Sully, 1 Ch. 325, 329-330 (1915).

22. *See* Cashel, *supra* note 6, at 24.

23. *See* PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW: THE SEARCH FOR A NEW CORPORATE PERSONALITY 58-59 (1993).

24. *See* BLUMBERG, *supra* note 23, at xl.

25. *See generally id*, at 3-61.

26. *See* GOWER, *supra* 18, at 334.

27. *See* BLUMBERG, *supra* note 23, at 59.

domination of corporate groups in the world and the national economies, every corporate system has to give adequate attention to the issues posed by corporate groups, such as remedial mechanisms for outside shareholders (e.g., non-group members) and duties of controlling companies.

B. The Strategies of Regulating Corporate Groups

In the conventional sense, corporate groups disturb the balance of power between management and the companies concerned. As a result, the fate of the subsidiary companies is decided by someone other than their direct management and board of directors. This is a problem that every corporate system has to face. Different strategies have developed. While some systems regulate a corporate group as a single entity, others adopt the approach of conditionally disregarding the separate personality of individual companies of the group. While some systems allow greater freedom to the controlling companies, others may have stricter rules relating to the exercise of power by parent companies.[28] The best example of this could be the divergence between German law and the common law.

Germany was the first country to have a separate legal regime, here in the form of the *Aktiengesetz*, as a way of regulating groups of companies.[29] The law stipulates strict rules of disclosure.[30] It defines the situations of contractual group relations, *de facto* group relations and integrated group relations.[31] Once a company falls into the category of group companies, it is regulated by a different and self-inclusive set of rules in terms of liabilities and corporate governance.[32] The rules clarify the responsibility of holding company managers to the subsidiaries, and the liability of a holding company to the debts of the subsidiaries.[33] While a parent company enjoys the freedom of directing its subsidiaries, it has to fully indemnify the subsidiaries' losses caused by its decisions within the next accounting period.[34] In other words, the German law treats a corporate group as a single entity. Hence, it is a logical conclusion that this entity exists to pursue the interests of the group as a whole. Later, German courts also developed a body of leading cases, which has further enhanced the potential of the German law in relation to the regulation of corporate groups.[35]

In common law jurisdictions, groups of companies are gradually brought under effective control by extensively introducing statutory rules concerning

28. *See* Eddy Wymeersch, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 1066-1067 (Klaus J. Hopt et al. eds. 1998).

29. The separate legal regime, Aktiengesetz, was produced in 1965.

30. *See* Aktiengesetz at §§ 20-21, *available at* http://www.aktiengesetz.de.

31. *See* BLUMBERG, *supra* note 23, at 161.

32. *See id.*

33. *See* Aktiengesetz, *supra* note 29, at sec. 309, 317 & 322.

34. *See* Wymeersch, *supra* note 28, at 1066.

35. *See* Hopt, *Legal Elements and Policy Decisions in Regulating Groups of Companies*, in GROUPS OF COMPANIES 84 (Clive M Schmitthoff & Frank Wooldridge ed. 1991

corporate groups.[36] In the early stages, traditional law, based on the doctrine of separate personality and limited liability, was unable to deal effectively with corporate groups.[37] As a result, equity jurisprudence developed the concept of "piercing the corporate veil". "Piercing the corporate veil" refers to the situation where courts disregard the principle of separate personality by treating companies within a group as a single entity.[38] However, the remedy was still inadequate, as it was only available in "rare" and "exceptional" situations.[39] The situation did not improve until a sophisticated doctrine of "control" was generally adopted by the common law jurisdictions.[40] The United States has taken the lead in this process. The concept of "control" typically refers to situations where a company has the power to direct or command the direction of management or policies of another company. It is used to determine the demarcation of selective abandonment of the traditional principle of corporate personality, and the demarcation of selective application of enterprise principles, a system of rules specially designed for regulating corporate groups. Once a company satisfies certain conditions, it is assumed to have control over another company.[41] Thus, the relationship between the companies should be regulated by the enterprise principles.[42] Enterprise principles impose "legal obligations upon [the] parent corporation or other affiliated corporations of the group for acts of a subsidiary participating in the collective conduct of a common integrated enterprise."[43] When enterprise principles apply, the corporate group is treated as a single entity.

The difference between the German approach and the Anglo-American approach lies in the fact that the Anglo-American model persists in the separate entity approach. In this system, "each company in a corporate group is a separate legal entity with its own rights and duties."[44] Therefore, parent companies do not

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36. *See generally* Prentice, *supra* note 8, at 99-129.

37. *See* Phillip I. Blumberg, *National Law and Transnational Groups and Transactions: Survey of the American Experience*, 5 AUSTL. J. CORP. L. 295, 297 (1995).

38. *See* Prentice, *supra* note 8, at 101.

39. *See* Blumberg, *supra* note 37, at 298.

40. *See* BLUMERG, *supra* note 233, at 153-61.

41. "Control" is universally used to determine group relationship. However, different systems have different interpretations regarding its content. For example, in the USA, "control" means "the power, directly or indirectly, to exercise a controlling influence over the management and policies of a company." It can be exerted either by the ownership of voting securities, or one or more intermediary persons, or by contract, etc. A person who, alone or jointly with others, owns or has the power to vote more than twenty-five percent of the outstanding voting securities of a company is presumed to have the control over that company. *See* 15 U.S.C. § 80a-2(a)(9)(2001). In the UK, a company is assumed to have control or influence over another company, if it is a member and controls the composition of the latter's cord of directors, or if it controls half the nominal value of the latter's voting share capital. *See* Prentice, *supra* note 8, at 99.

42. *See* PHILLIP I. BLUMERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 24-25 (1983).

43. *See* Blumberg, *supra* note 377, at 296. For a comprehensive overview of the areas of American law in which enterprise principles have superseded traditional entity concepts of corporate law, *see generally* Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295 (1996).

44. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), *supra* note 5, at 1.28.

automatically become parties to contracts entered into by subsidiaries with external parties, nor do they become automatically liable for the debts of the subsidiaries.[45] Directors owe their primary duties to their individual companies and they should make business decisions for the good of their own companies.[46] Directors can take the group's welfare into consideration only if there is no conflict of interest, and may be liable if they make a decision that benefits the group as a whole but detriments their own individual companies. This doctrine has been firmly accepted by the courts of Anglo-American jurisdictions. For instance, in the English case *Charterbridge Corp., Ltd. v. Lloyds Bank*,[47] Justice Pennycuick rejected the view that the directors in a subsidiary could have acted with a view to the benefit of the group as a whole, without giving separate consideration to the interests of their own company. His Lordship said, "[e]ach company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company. This becomes apparent when one considers the case where the particular company has separate creditors."[48] In the Australian case *Equiticorp Fin. Ltd. (in liq) v. Bank of New Zealand*,[49] Justices Clarke and Cripps took an even stricter view in relation to breach of directors' duties, stating that "[a] preferable view may be that where the directors have failed to consider the interests of the relevant company they should be found to have committed a breach of duty. If, however, the transaction was objectively viewed in the interests of the company, then no consequences would flow from the breach."[50]

Single enterprise principles apply where there is the possibility of victimizing creditors and minority shareholders. The general view is that single enterprise principles supersede separate entity principles upon the occurrence of certain events stipulated in a jurisdiction's corporate legal regime. Comparatively, the single entity model of Germany is generally perceived as advantageous in coping with the problems of corporate groups.[51] One certainty is that this approach is definitely closer to economic reality,[52] and the adoption of this model is beneficial in terms of reducing practical and theoretical complexities associated with providing an appropriate legal system to govern corporate groups.

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45. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), *supra* note 5, at 1.28.

46. A clear example can be found in the UK company law and Australian company law. The UK has developed the principle in its case law that directors of each company should, in deciding what transactions their company should enter into, consider the interests of that company rather than the interests of the group as a whole. The leading case is *Charterbridge Corp., Ltd. v. Lloyds Bank* [1969] 2 All E.R. 1185. *Charterbridge Corp.* is applied by Australian courts. In their leading case, *Walker v. Wimborne* (1976) 137 CLR 1, Mason, J. insisted that in the group context, it is a fundamental principle that directors must consider the interests of the separate entity and further, they must consider its interest alone.

47. *See* Charterbridge Corp., Ltd. v. Lloyds Bank [1969] 2 All E.R. 1185.

48. *See* Charterbridge, *supra* note 477, at 1193.

49. *See* Equiticorp Fin. Ltd. (in liq) v. Bank of New Zealand (1993) 11 A.C.S.R. 642.

50. *See* Equiticorp Fin. Ltd., *supra* note 49, at 1019.

51. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), *supra* note 5, at 1.44 – 1.48. *See also* ALFRED F. CONARD, CORPORATIONS IN PERSPECTIVE 82-83 (1976).

52. *See* COMPANIES & SECURITIES ADVISORY COMMITTEE (AUSTRALIA), *supra* note 5, at 1.44.

II. THE ISSUES OF CORPORATE GROUPS IN THE CHINESE CONTEXT

A. The Historical Development of Corporate Groups in China

The Chinese leadership has long had the intention of establishing an efficient business network in China in order to foster economies of scale and to improve firm performance.[53] However, the aspiration of establishing enterprise groups was constantly frustrated by political and other reasons. As early as in 1948, Liu Shaoqi, the first vice-president of the PRC, made the suggestion of establishing a corporate system that nurtured enterprise alliances in China.[54] When Liu Shaoqi and Deng Xiaoping were in charge of economic development in the early 1960s, they frequently made a point of learning from the experience of establishing trusts and economic monopoly in developed countries so as to enhance the productive capacity of the state-owned enterprises.[55] In 1964, the first twelve trusts were put in trial use.[56] Some trusts were made up of enterprises making the same products for the purpose of unification of management. Some trusts comprised enterprises of main products and by-products for the purpose of comprehensive utilization of resources. As China strictly held the economic doctrines of the planned economy at that time, a trust was defined as an economic organization of socialist public ownership with a central management.[57] In other words, a trust was an economic unit with independent accounts that carried out business activities under state plans.[58] The historical situation determined that these trusts were established as a result of the state's administrative arrangement, rather than voluntary coalitions among enterprises.[59] Although the goal of establishing the trust system was to increase managerial efficiency, it was questionable whether it could significantly reduce administrative intervention at a time when state plans penetrated every aspect of economic activities.[60] Before the trial was completed, the Cultural Revolution began, which put the practice of trusts to an end.[61]

Since the economic reforms in 1970s, enterprises were given a certain degree of autonomy.[62] As the enterprises were allowed to retain part of the profits they generated, it became possible for the enterprises to freely form their business alliances. As a result, various forms of enterprise alliances appeared.[63] The Chinese government believed that the development of these enterprise alliances

53. *See* JIANMIN DOU, RESEARCH ON THE CORPORATE IDEOLOGY IN CHINA 96 (1999).

54. *See* LIU SHAOQI, THE SELECTIVE WORKS OF LIU SHAOQI 429 (1981).

55. *See* DOU, *supra* note 53, at 96-97.

56. *See id.* at 98.

57. *See* STATE ECONOMIC COUNCIL, *Report on Establishing Trusts in Industry and Transportation Sectors* 1964, *in* THE COLLECTION OF INDUSTRIAL AND ECONOMIC LAWS AND REGULATIONS OF THE P.R.C. 1949-1981 (1981).

58. *See id.*

59. *See* PING JIANG & XUDONG ZHAO, THE SYSTEM OF LEGAL PERSON 364-365.

60. *See* DOU, *supra* note 53, at 99.

61. *See id.* at 100.

62. *See* Jiang & Zhao, *supra* note 59, at 365.

63. *See id.*

served the purpose of its economic reforms, and thus provided legal and policy support for the exercise.[64] At a time when the planned economy was still playing the dominant role and the market economy only played a supplementary role,[65] this type of free combination among enterprises was helpful in relation to improving the situation of self-isolation in different areas and different sectors caused by the planned economic structure. Because of a lack of legal definitions, all kinds of alliances were generally called horizontal economic alliance (*lian ying* or *heng xiang jing ji lian he*), in contrast with the vertical relationship between administrative departments and their controlled enterprises in traditional enterprise system.[66]

Later, the 1986 *Civil Code*[67] classified different types of economic alliances.[68] According to the *Civil Code*, there were three types of economic alliances: first, economic alliances that create a new legal entity (legal entity alliance); second, economic alliances that do not create a new legal entity (partnership alliance); and third, economic alliances based on a contract (contractual alliance).[69] Strictly speaking, the three economic alliances described were, in fact, not corporate groups, but special types of business cooperations that were a joint product of China's planned economy and the economic reforms being undertaken. Apart from some provisions in the *Civil Code*, there were also few legal documents regulating these economic alliances.[70] Since these provisions and regulations attempted to use uniformed rules to regulate different types of economic alliances, they were obviously inadequate and defective. If this were to happen in Western systems, these different economic alliances would had been regulated by different sets of laws. For example, while legal entity alliances should be regulated by corporate laws, partnership alliances and contractual alliances would be governed by partnership laws, contract laws and joint venture laws.

Furthermore, there are other defects in Chinese legislation concerning economic alliances. For instance, the economic alliance creating a new legal entity was bound by limited but rigid rules.[71] The binding tie of the alliance was not shareholding or interlocking directorship, but a cooperative contract.[72] The alliance ceased to exist once the contract was terminated.[73] The parties to the

64. *See* Jiang & Zhao, *supra* note 59, at 365.

65. This composed the macro-economic structure at the early stage of the economic reforms.

66. *See* Jiang & Zhao, *supra* note 59, at 365.

67. *See* General Principles of Civil Law, *supra* note 15.

68. *See id.* at arts. 51-53.

69. *Id.*

70. These legal documents include: STATE COUNCIL, Provisional Regulations Concerning Promoting Economic Alliances (1980); STATE COUNCIL, Regulations concerning Problems of Further Promoting Economic Alliances (1986); STATE ADMINISTRATIVE BUREAU OF INDUSTRY AND COMMERCE, Administrative Procedure of Registering Economic Alliances (1986); and MINISTRY OF FINANCE, Regulations Concerning Accounting Problems in Economic Alliances. *See* Jiang & Zhao, *supra* note 59, at 366.

71. *See* Jiang & Zhao, *supra* note 59, at 373.

72. *See id.*

73. *See* Supreme Court's Answers to the Questions Arisen from the Trials Involving Co-operative Contracts, art. 7 (1990).

alliance had no duty to disclose the contents of the contract to the third party, but had the right to freely withdraw their invested funds.[74] Moreover, there were no requirements on consolidated accounts and unified management of the group. As a result, the third party was left unprotected in the transactions with the economic alliance.[75] The arrangement also created uncertainties in the cooperation, as parties could terminate their contract at any time.[76]

The rules regulating China's partnership alliances brought even more confusion. *The Civil Code* distinguished between partnerships consisting of individuals and partnerships consisting of enterprises (partnership alliance).[77] While individual partners took unlimited liabilities, enterprise partners only did so if there were clear statements about their joint and unlimited liabilities in laws or in the cooperative contracts. This provided the opportunity for the parties to such alliances to avoid liability and to victimize the creditors and other third parties.[78]

With the deepening of China's economic reforms, the need to further advance the cooperation between enterprises increased. The existing economic alliances were not competent enough to accommodate the increasingly comprehensive enterprise cooperation and consequently, a new type of economic alliance, enterprise groups, emerged.[79] In China, the practice of enterprise groups started at the end of 1980s and the beginning of 1990s, and soon became dominant.[80] In the beginning, there was no clear definition of an enterprise group.[81] An enterprise group was generally perceived as a form of business alliance that could deliver larger scale cooperation among enterprises.[82] It was an aggregation of a large number of individual enterprises. The advantages of enterprise groups were several, and included accelerating the enterprise specialization, promoting technology development, and reducing informational asymmetries by facilitating the flow of information among enterprises.[83]

Although the enterprise groups have served important practical purposes in China and have been used as leverage by the Chinese government to assist enterprise reforms, little legal attention has been given to them. Up to now, there is no definition of enterprise groups contained in any Chinese legislative sources. However, academic discussions concerning enterprise groups have gradually produced a sophisticated understanding of the term. In the early stages, an enterprise group was defined as an "economic alliance consisting of a number of enterprises of different areas and different trades," or "an economic organization

74. *See* STATE COUNCIL, Regulations Concerning Problems of Further Promoting Economic Alliances, art. 5 (1986).

75. *See* Jiang & Zhao, *supra* note 59, at 374.

76. *See id.* at 375.

77. *See* General Principles of Civil Law, *supra* note 15, at arts. 30-35 & 52.

78. *See* Jiang & Zhao, *supra* note 59, at 378.

79. *See id.* at 383.

80. *See id.*

81. *See id.*

82. *See id.*

83. *See id.* at 384.

with multiple levels to answer the need of large scale of economy".[84] It is clear that the above descriptions do not capture the essence of the relationship. Later works provide clearer views on the nature of enterprise groups. Some point out that the essential characteristic of an enterprise group lies in its central management.[85] Therefore, an enterprise group has come to be defined as an economic alliance consisting of a number of legal entities and based on a central management.[86]

The lack of legal regulation relating to the practice of enterprise groups may soon end. The Chinese government is aware of the urgency of producing a legal framework to control the practice of enterprise groups. With the launching of the enterprise reform, the corporation becomes the focus of the country's economic activities.[87] It is predictable that China will head in the direction of standardizing the activities of its economic alliances by introducing the practice of corporate groups into its legal system.

B. The Perception of Corporate Groups

Both the Chinese government and the country's intellectuals are well aware of the importance of business groups to an economy.[88] Based on models from the United States, Germany, and Japan, the government and intellectuals have seen how business groups function to increase economic efficiency by internalizing market transactions within corporate groups. They are also aware of the fact that business groups have facilitated the rapid industrialization in some late-industrialized countries such as Japan and South Korea.[89] Hence, it is believed that developing China's large business groups with similar structural features of those in the above-above mentioned countries will speed up the process of economic modernization in China.[90]

The practice of business groups in China is still in a primitive stage. The country's existing enterprise groups, in fact, amount to joint ventures in a loose sense. They are small in size and lack stability. As discussed in the previous section, the tie binding individual enterprises to an enterprise group is a contractual agreement, rather than shareholdings.[91] In China, it is common for the individual enterprises of an enterprise group not to comply with the decisions of the central

84. *See* Guan Xiaofeng, *About the Nature and Legal Position of Enterprise Groups*, 3 Zheng Fa Lun Tan 51-55 (1988).

85. *See* Jiang & Zhao, *supra* note 59, at 390.

86. *See id.* at 391.

87. *See* XIANGYI XU, ORGANIZATION AND MANAGEMENT OF MODERN COMPANIES 242 (1999).

88. *See* DOU, *supra* note 533, at 148-50.

89. *See* Lisa A. Keister, *Engineering Growth: Business Group Structure and Firm Performance in China's Transition Economy*, 104 AM. J. SOC. 404, 404-06 (1998). *See generally* Eun Mee Kim, *The Industrial Organization and Growth of the Korean Chaebol: Integrating Development and Organizational Theories*, *in* BUSINESS NETWORKS AND ECONOMIC DEVELOPMENT IN EAST AND SOUTHEAST ASIA 272-99 (Gary Hamilton ed.) (1988), *available at* http://gsis.ewha.ac.kr/faculty/faculty6.htm (last visited January 19, 2002).

90. *See* Keister, *supra* note 89, at 404.

91. *See* Jiang & Zhao, *supra* note 59, at 392.

management of the group.[92] Some hold that the situation of lack of compliance will change, if the enterprises of a business group are brought together through the holding and cross-holding of shares among the enterprises of the group.[93] Hence, it is necessary to introduce a stockholding mechanism into China's enterprise groups.[94] This will become reality before long, as the current enterprise reform is a process of achieving general "corporatization."[95] Upon the completion of the reform, most Chinese enterprises will be transferred into companies.[96] The enterprise groups will certainly be replaced by corporate conglomerates.[97]

It is believed that the Chinese government should take the responsibility for designing an effective corporate group system for the country.[98] The experience of Japan and South Korea demonstrates that governmental guidance and support have been important in fostering the dynamic corporate group systems of those two countries, which, in return, have remarkably enhanced the competitive capacity of their corporations in the international market.[99] In China, most large and important enterprises are state-owned enterprises which, after the "corporatization," have remained and will remain as state-owned or controlled companies. The situation makes the government's role become even more significant in the process of establishing a corporate group system.[100] The enterprise reform may enable the government to kill two birds with one stone, by "corporatizing" state-owned enterprises on one hand, and assembling them into corporate groups on the other.

Companies should be bound to a group by the shareholding mechanism and by contracts. Shareholding is a crucial mechanism of sustaining control in the group structure.[101] It is recommended that the vertical and horizontal shareholding relationships should all be introduced into the Chinese enterprise system.[102] By establishing holding or parent companies, a corporate group forms a hierarchical chain of control among companies. This is the so-called vertical shareholding group. Meanwhile, it is suggested that the experience of cross-shareholding widely exercised by the Japanese *keiretsu* is also worth emulating.[103] The Chinese

92. *See* Jiang & Zhao, *supra* note 59,. at 393. *See also* Li Su, *Reforming the Enterprise Groups by Introducing Shareholding Mechanism Is Inevitable*, 4 LEGAL COMMENTS 51-57 (1987).

93. *See* Jiang & Zhao, *supra* note 59, at 393.

94. *See* XU, *supra* note 87, at 250.

95. The Fifteenth National Congress of the Communist Party of China (1997) pointed out that further economic reforms should focus on reforming large and medium-sized state-owned enterprises into normative corporations, so as to set up a modern enterprise system in China. This indicated the initiation of the "Big Bang" package of China's enterprise reform. Since then "corporatization" has carried out at an ever-larger scale in China.

96. *See* The Decision of the Central Committee of the Communist Party of China on Major Issues Concerning the Reform and Development of State-owned Enterprises, September 22, 1999, *available at* http://english.peopledaily.com.cn/other/archive.html (last visited Sept. 27, 1999).

97. *See id.*

98. *See* XU, *supra* note 87, at 228-229.

99. *See id.*

100. *See id.*

101. *See* XU, *supra* note 87, at 228-229.

102. *See id.*

103. *See id.*

call this type of shareholding structure a "horizontal shareholding structure" and intend to utilize the method to form the marriages between core companies, so as to achieve a "strong and strong combination" (*qiang qiang lian he*).[104]

The 1994 *Company Law*[105] is primarily drafted to regulate single companies.[106] There are nearly no provisions about corporate groups, except articles 12 and 13 which permit a company to establish subsidiaries.[107] Producing legal guidance for the practice of corporate groups should be the top priority of the government. At the moment, academic discussions have not yet reached an agreement on the legislative method for doing so. While some suggest having a separate law to regulate corporate groups, others recommend inserting special provisions for corporate groups.[108] An alternative view is to regulate corporate groups by the joint work of all relevant laws including company law, taxation law, and anti-trust law.[109]

Although it is not clear whether China will take the single entity approach or separate entity approach, the control test in Anglo-American systems is well-received in academic discussions.[110] Attention is also directed to the issue of protecting minority shareholders. On December 21, 1999, during the 13th Session of the National People's Congress (NPC) Standing Committee, China's top legislature examined and deliberated on the *Draft Amendments to the Corporate Law*.[111] It is expected that the forthcoming amended *Company Law* will provide indications about the direction of future development of the Chinese law on corporate groups.

III. THE EXTENSION OF CORPORATE GROUPS: COOPERATIVE STRATEGIES - STRATEGIC ALLIANCES AND NETWORKS

The corporate group is a device of resource allocation in a market economy. It is the third transaction mechanism after markets and the firm. Markets and the firm are alternative choices for transactions. Depending on their comparative efficiency or advantages, people can choose to execute their transactions either cross-markets or within a firm.[112] While firms have developed to reduce the transaction costs occurred in the market by internalizing transactions, they can also be costly due to scale diseconomies or control losses.[113] Thus, corporate groups are used to fill the

104. *See* XU, *supra* note 87, at 228-229.

105. *See* Company Law, *supra* note 13.

106. *See* PING JIANG & LIUFANG FANG, NEW CORPORATE LAW TEXTBOOK 221 (1998).

107. *See id.*

108. *See* Jiang & Zhao, *supra* note 11, at 405.

109. *See id.* at 409-411.

110. *See id.* at 392-411. *See also* XU, *supra* note 87, at 250-253.

111. Chinese lawmakers attending the ongoing 13th session of the National People's Congress (NPC) Standing Committee, China's top legislature, examined and deliberated the Draft Amendment to the Corporate Law on December 21. *See Chinese Lawmakers Deliberate Draft Amendment to Corporate Law*, PEOPLE'S DAILY ONLINE, December 23, 1999, at http://english.peopledaily.com.cn/special/soe/ 1999122300S101.html (last visited Nov. 11, 2001).

112. *See* Akira Goto, *Business Groups in a Market Economy*, 19 EUR. ECON. REV. 53, 60 (1982).

113. *See id.* at 61.

gap. Using corporate groups to execute transactions can avoid the transaction costs that would have been incurred by using markets and the costs caused by expansion of the firm.[114] Firms have strong incentives to form or join a group, when the benefit of forming or joining a group exceeds that of using the market and firm mechanisms.[115]

However, business groups are not the only alternative of markets and the firm. In fact, hierarchical relationships within firms and explicit market relations between firms are just "the extreme points of an organizational spectrum," and "hybrid forms of organization [which] occupy the intervening space."[116] These hybrid forms include not only business groups but also cooperative strategies comprising strategic alliances and business networks. In certain circumstances, for certain business purposes, strategic alliances and business networks have advantages over corporate groups.

A corporate group, in essence, is a formal cooperative arrangement. There have to be some kind of formal or binding links existing between the members of the corporate group, including common parent, cross shareholdings, and interchange of directorships. Costs are incurred in the process of establishing, maintaining and effectively using these binding links to achieve business purposes. Furthermore, forming or joining a corporate group is not the desirable solution for achieving certain business purposes in certain business environments. For example, to enter into an industry or regional sector by acquiring or establishing subsidiaries may be infeasible according to a country's law.[117] In this situation, it is desirable to do business through strategic alliances and networks.

Strategic alliances are defined as to include "joint ventures, collaborations, and consortia."[118] A joint venture is usually either a partnership or something closely allied to partnership, although it can take the form a joint venture company. Compared with a joint venture, other types of alliances are looser forms of cooperation such as product swaps, production licenses and technology alliances.[119] A network is also a loose form of business cooperation. To distinguish a network from other types of alliances, one needs to look at the purpose of using networks and alliances.

Firms go into a joint venture or an alliance for avoidance of the uncertainty inherent in market transactions and the costs of establishing hierarchies. The strength of joint ventures and alliances lies in their ability of promoting organizational learning.[120] By joining joint ventures and alliances, technological

114. *See* Goto, *supra* note 112 at 61.

115. *See id.*

116. *See* BUREAU OF INDUSTRY ECONOMICS (AUSTRALIA), NETWORKS: A THIRD FORM OF ORGANIZATION 7 (1991). *See also* the detailed discussions and analyses on this issue in OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 206-39 (1985).

117. *See* JOHN CHILD & DAVID FAULKNER, STRATEGIES OF COOPERATION: MANAGING ALLIANCES, NETWORKS AND JOINT VENTURES 2 (1998).

118. *See id.* at 6.

119. *See* CHILD, *supra* note 117, at 9.

120. *See id.* at 66.

and managerial know-how and knowledge are transferred and exchanged among partners, new product researche and development are jointly carried out, and employees are jointly trained. In addition, firms are motivated by the challenge of entering into international market to set up joint ventures and alliances.[121] This is because the choices of doing business in a target market are limited. In some situations, apart from direct exporting, a firm has to make a choice between licensing, counter-trade, product swap, or setting up a joint venture.[122]

Contrasting strategic alliances, the strength of networks lies in their specialization, adaptability and flexibility, not necessary in learning opportunities.[123] Networks exist for the reason that members of a network are complementary and synergistic in relation to functions and contribution.[124] A typical scenario is that a firm finds its customers, distributors or suppliers in its network. The bonds of the network are usually friendship, trust and interdependence.[125] Consequently, a network suggests close but non-exclusive relationships.

Recently, the function and advantage of cooperative strategies including strategic alliances and networks have been increasingly acknowledged.[126] This is because the economic globalization requires more effective business devices for global competition, and the technology development has provided opportunities for more flexible business arrangements by reducing the costs of communication.[127] It is interesting to see, with increasing exploitation of these strategies, what influence the practice may impose on corporate development.

Since opening up, China has effectively used many types of strategic alliances to assist its economic reforms.[128] These strategies have proven to be remarkably successful in attracting foreign investment to serve the purpose of the reforms.[129] Chinese-foreign joint ventures and other types of Chinese-foreign alliances play an important role in China's rapid economic development.[130] Internally, the Chinese government has also encouraged enterprise cooperation. Recently, discussions about enhancing enterprise strength by promoting enterprise cooperation have increased.[131] However, more attention has been paid to the formation of corporate groups and some close forms of cooperation. It seems the importance of informal cooperative arrangements, particularly business networks, has not been sufficiently addressed in China.

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121. *See* CHILD, *supra* note 117, at 67.

122. *See id.*

123. *See id.* at 7.

124. *See id.* at 113.

125. *See* BUREAU OF INDUSTRY ECONOMICS (AUSTRALIA), *supra* note 116, at 9.

126. *See id.* at 14.

127. *See id.* at 1 & 14-15.

128. *See generally* YUWA WEI, INVESTING IN CHINA: THE LAW AND PRACTICE OF JOINT VENTURES 73-81 (2000).

129. *See* WEI, *supra* note 128, at 10-13.

130. *See id.*

131. *See* XU, *supra* note 87, at 238.

CONCLUSIONS

The development of corporate groups is the choice of economic development. Firm production reduces the transaction costs of using the market mechanism. However, there is an organizational cost for using firms. Business groups offer an alternative transaction mechanism that, under certain circumstances, is more efficient than the market mechanism and internal organization.[132] Corporate groups have shown power in terms of facilitating economies of scale. To exist in groups makes corporations become fitter and more adapted to encountering the challenges brought about by increasing market competition and globalization.

The formation of corporate groups is one of the most significant components of China's enterprise reform. The Chinese government is planning a corporate system with strong corporate groups to ensure that the existing enterprises can survive the pressure from further opening up and to gain a share in international competition. The practice and the law making are still progressing. The experience of corporate groups in different systems provides rich resources for the Chinese to selectively take in suitable practice and make appropriate legal transplants. In today's China, apart from the focus on corporate groups, adequate attention should also be paid to the issue of how to foster informal cooperation among Chinese firms, such as strategic alliances and networks. In a fast changing environment fueled by economic globalization and rapid technologic innovation, it is important to be aware that "informal cooperative arrangements are fundamental to the success of decentralized economic organization".[133]

132. *See* Goto, *supra* note 112, at 61.

133. *See* BUREAU OF INDUSTRY ECONOMICS (AUSTRALIA), *supra* note 116, at 1.