FLEXIBLE SYSTEM APPROACH FOR DETERMINING DEEMED DIRECTORS UNDER CHINA'S COMPANY LAW

Mo Zhi

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To strengthen the regulation of controlling shareholders and actual controllers (dual controllers), China's Company Law of 2024 introduces deemed director provisions (DDPs) in articles 180 and 192. Through legal fiction, fiduciary duty and joint liability can be imposed directly on dual controllers without legal directorship, thereby addressing the accountability gaps caused by traditional status-based imputation. However, the DDPs face the implementation challenge due to the openness of key terms like 'actually executing company affairs' and 'instructing', coupled with the need for a precise review standard by judges when making determinations. It is essential to adopt a flexible system approach in judicial interpretation by the Supreme People's Court. The system comprises three elements: formality, diligence, and reliance, which correspond to the principles of separate legal personality, parity of power and accountability, and equitable protection of interests. Through segmented evaluation and complementary interaction of the elements, this approach will provide judges with a relatively clear framework to avoid arbitrary adjudication and preserve the adaptability of the DDPs to complex business realities.

I. INTRODUCTION

In China's private companies, there is a prevalent existence of controlling shareholders and actual controllers (hereinafter referred to as dual controllers). From the financial fraud of Kangmei Pharmaceutical to the asset transfer of Sinobioway Biomedicine,[1] governance issues are largely attributed to them. Therefore, how to regulate their misconduct has been a crucial issue. Dual controllers may engage in operations as directors or managers. However, they are more inclined to manipulate legally appointed directors (*de jure* directors) by appointing proxies and allocating board seats. It has been noted that, due to the absence of directorship, dual controllers can easily circumvent their

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1 *See* Li Shuguang, *A Summary for the Kangmei Pharmaceutical Case*, 2 Journal of Law Application 118 (2022). FORMER ACTUAL CONTROLLER OF SINOBIOWAY BIOMEDICINE PAN AIHUA, WHO WAS CONVICTED OF EMBEZZLEMENT OF DUTIES AND MISAPPROPRIATION OF FUNDS, CLAIMS TO APPEAL, at https://www.stcn.com/article/detail/1123648.html (Last visited on August 2, 2025).

liability.[2]

In this context, the *Company Law of the People's Republic of China of 2024* (hereinafter referred to as the Company Law) has adopted a straightforward way to further strengthen the regulation on dual controllers.[3] It introduces the doctrines of *de facto* director and shadow director (collectively referred to as deemed director) in the third paragraph of article 180 as well as article 192 (collectively referred to as the deemed director provisions, or the DDPs). The former states that if dual controllers without directorship actually execute company affairs, the duties of loyalty and diligence shall apply. The latter states that if dual controllers instruct directors or managers to harm the interests of the company or shareholders, they shall bear joint and several liability.

The DDPs establish a legal basis for the fiduciary duties and liabilities of dual controllers, thereby enhancing their accountability for corporate failures. It has a positive impact in deterring misconduct and fostering effective governance. However, the extent to which the DDPs will be effective in the future is uncertain. This depends on the approach judges adopt to implement the DDPs. As the terms of 'actually executing company affairs' and 'instructing' are open-ended, and the provisions do not list specific situations where dual controllers may be held accountable, judges must reconcile abstract texts with complex cases through reasoning and identify deemed directors accurately in accordance with certain review standards to ensure consistent application of the DDPs. In response, an approach based on *Wilburg*'s flexible system theory will be proposed for the judicial interpretations of the Supreme People's Court in this article.

II. THE DEEMED DIRECTOR PROVISIONS IN CHINA'S COMPANY LAW: FEATURES AND CHALLENGES

A. The Drawbacks of Traditional Imputation and the Features of the Solution

Companies are an aggregation of statuses, which constitute the basis for individual imputation.[4] This structure is efficient for identifying liable parties

2 *See* Zhao Xudong, *The Dilemma and Outlet of China's Corporate Governance System*, 2 Modern Law Science 89, 96 (2021).

3 NATIONAL PEOPLE'S CONGRESS, THIRD REVIEW OF THE DRAFT AMENDMENT TO THE COMPANY LAW: FURTHER STRENGTHENING THE REGULATION ON CONTROLLING SHAREHOLDERS AND ACTUAL CONTROLLERS, at http://www.npc.gov.cn/c2/c30834/202308/t20230828_431188.html (Last visited on August 2, 2025).

4 *See* Liang Kaiyin, *On the Establishment of the Principle of Status Imputation in Company Law*, 4 Law and Social Development 87 (2021).

and conforms to the Rechtsschein theory. However, statuses in companies lack intrinsic exclusivity, so the conventional imputation raises the issue of nominalism: if someone is considered not to have exercised corporate power due to the absence of status, they can operate secretly outside the governance structure and evade their liabilities. It will encourage dual controllers to interfere with operations while no longer serving as directors and/or managers. The phenomenon of 'those with authority bearing no liability, and those with liability holding no authority' arises.[5] For this, the Company Law confirms substance over form by introducing a more direct and convincing solution.[6] If dual controllers are directors or managers, judges may impose liability directly based on the first and second paragraphs of article 180.[7] However, if not, the solutions outlined in the DDPs serve as a legal fiction and a standard of conduct.

Firstly, the legal fiction is a medium for adapting the law to social reality. The power exercised by dual controllers is not based on legal directorship but rather on their influence derived from ownership, agreements, or other relationships. That is to say, influencing the exercise of corporate powers and exercising corporate powers are two distinct facts, yet both lead to the same outcome for the company. Thus, when actual control of company affairs or instructing occurs, judges can treat dual controllers without directorship as *de jure* directors at the level of legal fact, thereby imposing fiduciary duties and liabilities. The legal fiction will not be obstructed by real facts such as appointment or registration, as it is a decisive fabrication created to achieve regulatory goals under specific conditions, unequivocally equating this fact with another.[8]

Secondly, actually executing company affairs and instructing constitute a negative and passive standard of conduct for dual controllers, as they are key to adverse consequences (fiduciary duties and/or joint liability) under the DDPs. This also creates an *ex ante* deterrence to prevent dual controllers from disconnecting status with power outside the framework of corporate law. Compared with a rule, a standard tends to be more abstract and concise, thereby promoting flexibility. Yet, the costs associated with understanding and implementing standards are high, which makes it difficult

5 *See* Zhao Xudong, *Controlling Shareholders and Legal Regulations on Them in Corporate Governance*, 4 Chinese Journal of Law 92, 97 (2020).

6 *See* Liu Bin, *Clarifying the Concept of Corporate Directors: Confirming Substance over Form*, 5 Journal of Comparative Law 82 (2021).

7 For fiduciary duties of directors in the Company Law, *see* Wu Yue, *Theoretical Interpretation and Practical Exploration of Directors' Duty of Oversight*, 5 China Legal Science 3, 6-13 (2024).

8 *See* Lu Peng, *Rectification of Legal Fiction*, 1 Journal of Comparative Law 138, 139-142 (2005).

to maintain certainty and consistency. Rules are more detailed, providing explicit guidance for conduct. However, the development cost is higher since all possible scenarios must be anticipated, which may lead to rigidity and loopholes.[9] In this context, the DDPs are the standard, because 'actually executing company affairs' and 'instructing' cannot intuitively convey the specific behavior they denote. Besides, positioning the DDPs as a standard rather than a rule will better correspond with the substantive trend and avoid loopholes for the circumvention of dual controllers.

B. The Challenge of the Deemed Director Provisions for Judges in Practice

Private enforcement of a standard relies on *ex post* judicial review. Consequently, the transition from legal text to practical application will involve a shift from a standard of conduct to a review standard.[10] The former refers to the requirements set by the law, whereas the latter is applied by judges to determine whether individuals have breached the law. Especially when laws are abstract, judges have more opportunities to introduce their interpretations, thereby intensifying the distinction between the two standards. In this regard, the DDPs are open-ended, thus generating multiple possible interpretations.

Firstly, 'executing' generally means carrying out tasks in accordance with superior orders, such as 'implementing the resolutions made at the shareholders' meetings' in article 67 of the Company Law (where the decision has been made previously), which involves less discretion. The question is whether the execution in the DDPs is the same or wider. Besides, since directors typically make decisions collectively, can attending board meetings and voting be considered 'executing' unless one of them is the legal representative?

Secondly, it further raises the question regarding whether 'affairs' are limited to the contents listed in article 67, thereby aligning with 'not serving as a company director' in article 180. Alternatively, can any affairs concerning appointments, finances, transactions, and even supervision related to operations be classified as affairs under article 180? How should these acts be interpreted, such as controlling the financial and contract seals, especially since they are not addressed in the Company Law? Moreover, would this

9 *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 3 Duke Law Journal 557 (1992).

10 *See* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 3 Fordham Law Review 437 (1993).

broaden the fiduciary duties that dual controllers should bear in the judicial process? [11]

Thirdly, we need to distinguish an 'instruction' from a proposal or advice. Since shadow directors lack formal status, instructions should be recognized as influence arising from a lasting legal or social relationship. It might not be an occasional adoption of advice and could limit the discretion of the instructed persons. Besides, is 'injuring' mentioned by article 192 an independent component, or is it integral to the definition of instruction? If it is the latter, judges should consider the purpose or content of the instruction, the consequences, and the causal link between the two.[12]

The openness of the DDPs is not unique in China. Although similar laws exist internationally, they are also quite abstract, resulting in extensive interpretive activities by courts. Take the UK as an example. On the one hand, the term '*de facto* directors' is not explicitly used in the *UK Companies Act*; instead, it is merely described in section 250, whereas various review standards have been developed through case law.[13] On the other hand, section 251 defines shadow directors as those in accordance with whose directions or instructions the directors of the company are accustomed to act. However, the courts have developed a richer, and even divergent, interpretation. The judge in *Re Unisoft* held that at least a majority of directors followed the instructions,[14] whereas the judge in *Re Deverell* indicated that neither obedience nor a compulsory relationship was necessary.[15] More importantly, shadow directors and *de facto* directors were previously regarded as distinct concepts, but their boundaries tend to blur recently due to their similar influence over the company.[16] Scholars also believe that the similarities between them surpass their differences, and the distinction is essentially meaningless.[17]

As can be seen in the examples of the UK, the review standard of shadow directors and *de facto* directors remains on a case-by-case basis and has not yet been unified. A primary reason is that the concept of deemed director is structured to address formalism, which makes it difficult to provide a definition. Substantialism means that legislative texts must be

11 *See* Zheng Yu, *The Legal Binding on Deemed Directors: Reason, Demand, and Method*, 3 Law and Economy 81, 92 (2024).

12 *See* Ge Weijun, *The Shadow Directors with Chinese Characteristics: An Analysis of Article 192 of the New Company Law*, 5 Law Science Magazine 114, 123-124 (2024).

13 *See* Brian Studniberg, *The Uncertain Scope of the De Facto Director Doctrine*, 2 University of Toronto Faculty of Law Review 69 (2017).

14 *See Re Unisoft Group Ltd (No 3)*, [1994] 1 B.C.L.C. 609, at 620 (Ch).

15 *See Secretary of State for Trade and Industry v. Deverell and Another*, [2000] B.C.C. 1057.

16 *See Popely & Anor v. Popely & Ors*, [2019] EWHC 1507 (Ch) 85.

17 *See* PAUL DAVIES & SARAH WORTHINGTON, GOWER'S PRINCIPLES OF MODERN COMPANY LAW, at 474 (Sweet & Maxwell, 2016).

open-ended, which favors broad provisions over detailed ones, to allow for judicial discretion when dealing with diverse situations. The second reason is that the power of a deemed director is based on the influence stemming from other legal or social relationships of various types. The limitations of human rationality hinder legislators from fully enumerating all possibilities in a single legislative act.

Nonetheless, judges must still have a certain review standard. This serves not only to provide guidance for social activities, but also to ensure the predictability of the application of the DDPs. Otherwise, future rulings will fall into disorder, thereby allowing individuals who are supposed to be deemed directors to evade their duties. Meanwhile, those who should not be considered as deemed directors may assume improper liability. Such uncertainty will adversely affect commercial activities and prevent some people from offering advice or financial assistance. The *Review of the Hong Kong Companies Ordinance* once noted, 'where personal liability is at issue, it is important that there be reasonable certainty. Measures which are vague or commercially uncertain will inevitably be difficult to enforce, thereby undermining their utility.' [18]

III. WALTER WILBURG'S FLEXIBLE SYSTEM THEORY IN THE DEEMED DIRECTOR PROVISIONS

Since the DDPs are facing an implementation challenge arising from the inherent tension between the need for legal texts to be adaptable and the need for a review standard to be certain, it is necessary to adopt *Wilburg*'s flexible system theory as a compromise approach.

A. A Primer on Flexible System: The Origin and Two Pillars

1. The Origin: Liberal Jurisprudence Versus Conceptual Jurisprudence. — *Walter Wilburg* initially proposed flexible system theory in 1941.[19] At that time, the way law addresses social realities was dominated by conceptual jurisprudence, which relied on a fixed connection between components and consequences (legal results). The legal result arises only when all components are satisfied. Such a relationship forms the external system of

18 CONSULTANCY REPORT ON THE REVIEW OF THE HONG KONG COMPANIES ORDINANCE, CB(1)1667/96-97, at https://www.cr.gov.hk/en/standing/docs/concmpny.pdf (Last visited on August 2, 2025).

19 SIEHE WALTER WILBURG, DIE ELEMENTE DES SCHADENSRECHTS (Elwert, 1941).

law, while principles and values constitute the internal system. In specific cases, judges only need to focus on the external system that is apparent in statutory provisions. However, the component model indicates the notion of either all or nothing, binding the judges to the preselected concepts and making it difficult to adjust in line with social development. Conversely, liberal jurisprudence prefers abstract provisions and emphasizes the discretion of judges in transforming the legal system into specific norms, but it often poses risks of arbitrary adjudication and threatens legal stability.[20] Therefore, *Wilburg* needed a third path to avoid the rigidity of the component model while providing judges with a definitive assessment framework. To this end, he proposed the flexible system theory based on a comparative notion of more or less with two pillars: basic evaluation and element interaction.

2. Two Pillars of the Theory: Basic Evaluation and Element Interaction. — *Wilburg* noted that the legal system has diverse fundamental values which appear as elements from principles or factors. The legal results arise from the interaction of these elements.[21] Principles, such as autonomy of will, possess a normative attribute and provide legitimacy through statutory provisions. Factors are indicators used to assess the adequacy of principles underlying the elements, with empirical attributes and inexhaustibility.[22] Unlike the component model, elements in a flexible system are not simply stacked to obtain certain legal results. The determination under a flexible system involves identifying various principles that influence a specific domain; it is then achieved through a basic evaluation of each element and their interactions.

First, the basic evaluation focuses on the adequacy of principles. For instance, when the adequacy of element A is a1, the legal result R is obtained. It has a premise that other elements are at the average level. This is one of the pillars of the system's flexibility, where the adequacy is based on reality and is not predetermined. Second, elements have their weights, and their basic evaluations can interact to achieve a combined result, which can be described as: $A \times a1 + B \times b1 + C \times c1 \ldots = R$. According to the formula, even if a1 does not reach the average, b1 and c1 are high enough to compensate a1 and thus achieve R. This is another pillar of the system's flexibility. However, in the real world, the weight of elements and the corresponding adequacy do not (or cannot) require precise quantification, and achieving relative certainty

20 *See* KEIZO YAMAMOTO, FLEXIBLE SYSTEMS THEORY IN CIVIL LAW, *in* CIVIL AND COMMERCIAL LAW REVIEW (VOLUME 23), at 180 (Liang Huixing ed., Jinqiao Culture Publishing, 2003).

21 *See* Shuhei Yamamoto, *The Structure and Method of Legal Evaluation in Tort Law (III)*, 4 Kyoto Law Review 45, 55 (2011).

22 *See* Wang Lei, *Flexible System: The 'Middle Way' of Normative Form*, 4 Law and Social Development 159, 167 (2021).

is already highly desirable.[23]

Compared to general provisions, the flexible system externalizes the fundamental values in the legal system as elements, thereby providing a certain framework for review and a platform for debate.[24] This reinforces the judges' obligation to reason around the elements, thereby minimizing the risk of arbitrariness. Compared to the component model, the two pillars of flexibility enable judges to discover the most legitimate values behind elements in specific cases and facilitate normative evaluation adaptable to complex and diverse realities.

B. Why the Flexible System Approach Can and Should Be Suggested

The domain of a flexible system has two characteristics. The first is the coexistence of multiple values for elemental interaction. The Company Law is such a domain, because article 1 on the legislative purpose clarifies several values by listing multiple objectives, such as regulating corporate organization and conduct, safeguarding legitimate rights and interests, maintaining social and economic order, and promoting the development of the socialist market economy. Moreover, the general provisions of the Company Law encompass additional principles, including the protection of the company's independent property (article 3), consideration of the public interest (article 20), and prohibition of abusing the shareholder's rights (article 21). Since the DDPs are included in the Company Law, they may also contain diverse values accordingly.

The second is dual legislation, wherein judges rely on the components provided in advance. When faced with situations where these components are ineffective, they quickly turn to general provisions and begin to create new rules freely, thereby undermining the stability of the law.[25] As for the DDPs, the core terms 'actually executing' and 'instructing' are so abstract that they may be hard to provide judges with clear enough review standards or constraints. They may resort to general provisions such as articles 21 and 22 as before without providing further explanation for their determination.[26] In this regard, a flexible system can offer a more explicit framework of elements than general

23 *See* Xie Gen & Ban Tianke, *Misunderstood and Overestimated of Flexible System Approach*, 2 Chinese Journal of Law 41, 50 (2017).

24 Shuhei Yamamoto, *supra* note 21, 60.

25 Xie Gen & Ban Tianke, *supra* note 23, 55.

26 *See* Lin Yiying, *The Legal Path to Regularization of the Controlling Shareholder Regime*, 5 Science of Law 83, 86-87 (2024).

provisions, while strengthening the reasoning obligation of judges.

As mentioned before, the DDPs require a methodology to reconcile their conflicting demands. In this regard, the flexible system theory, positioned between conceptual jurisprudence (component-based) and liberal jurisprudence (principle-based), is the most suitable third option. This approach has not only been incorporated into the principles of *European Tort Law* but also adopted by the Book of Personality Rights of *China's Civil Code*, thus establishing it as a mature approach.

However, given that the Company Law came into effect in July 2024, a more practical approach lies in referring to judicial interpretations issued by the Supreme People's Court. In this context, the flexible system can also serve as an interpretative approach,[27] and has been widely applied in China, as illustrated by article 63 of the *Interpretation on Several Issues Concerning the Application of the General Provisions of Book Three Contracts of the Civil Code*, which addresses the assessment of the foreseeability of contractual losses, and article 32 of the *Minutes of the National Court Work Conference on Bankruptcy Trials*, which concerns the conditions for the substantive consolidation of affiliated enterprises.

The approach of the flexible system in judicial interpretation has three comparative advantages. First, judges are not bound by the judgments of other courts in China. However, formal interpretations by the Supreme People's Court can prevent them from applying inconsistent standards. Second, there may be limited precedents of determining deemed directors for reference at present. The flexible system will provide judges with relatively certain guidance, reducing the difficulty of reasoning. Third, compared to revising the Company Law again, judicial interpretations can reduce legislative costs while maintaining the openness of the DDPs.

IV. THE SYSTEMIC ELEMENTS FOR THE JUDICIAL DETERMINATION OF DEEMED DIRECTORS

A. Separate Legal Personality and the Element of Corporate Formality

Legal personality is a fundamental characteristic of a company, and maintaining the independence of legal personality has always been a key

27 KEIZO YAMAMOTO, *supra* note 20, 235.

principle of corporate law.[28] However, corporate operations rely on natural persons, which renders independence fragile. Therefore, all members must comply with formalities, including organizational forms and transaction procedures. Organizational forms encompass internal meeting procedures, appointment requirements, acting within authority, and timely ratification following *ultra vires* acts. Procedural norms govern transactions in the name of the company, approval rules for related parties, and subsequent accounting records. If formalities cannot be complied with, the legal personality cannot be safeguarded, thus providing grounds for its denial.[29]

Internally, directors centralize most corporate powers, and their functional role is tied to the development of corporate legal personality.[30] This linkage between status and power demonstrates the independence of the company from its members. Power belongs to the organization, and one can only exercise it legally by assuming the directorship. Meanwhile, actions taken by individuals based on their directorship can be absorbed into corporate personality. Centralizing company affairs under the board of directors could limit the ability of major shareholders to exert undue control over the company,[31] which might otherwise undermine the independence of the legal personality.

Regarding the DDPs, the term 'dual controllers' suggests merely the controlling ownership of a company. However, if they bypass the shareholders' meeting and democratic decision-making procedures without proper election to intervene in operations or usurp the powers of *de jure* directors, their personal faults then occur.[32] From another perspective, if dual controllers do not violate formalities, despite their controlling ownership, it might be inappropriate to require them to assume the same liability as *de jure* directors. Otherwise, judges will become promoters of breaching the independence of legal personality. Due to concerns that this could erode the principle, some judges refuse to consider the defendant as a *de facto* director in the UK.[33] The relationship between *de jure* directors and deemed directors parallels the relationship between corporate personality and the piercing of

28 *See* STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, LIMITED LIABILITY: A LEGAL AND ECONOMIC ANALYSIS, at 47 (Edward Elgar Publishing, 2016).

29 *See* SHI TIANTAO, CORPORATION LAW, at 39 (Law Press・China, 2014).

30 Zheng Yu, *supra* note 11, 84.

31 *See* Margaret Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA Law Review 387, 435 (2003).

32 *See* Liu Junhai, *On Civil Liabilities of Actual Controllers as Shadow Directors: Centered on Explanation of Article 192 of the New Company Law*, 7 Journal of Law Application 129, 144-145 (2024).

33 *See Revenue and Customs Commissioners v. Holland*, [2010] UKSC 51.

the corporate veil.[34] That is to say, if legal personality remains intact, there is no reason to bypass *de jure* directors and pierce the veil they embody to hold dual controllers liable merely for their ownership.

Accordingly, the separate legal personality is one of the principles of the DDPs, with corporate formality serving as the corresponding element. First, the execution of company affairs without legal appointment and the instructions to *de jure* directors both deviate from the organizational form, thereby undermining the institutional logic that power should be based on official positions rather than individuals. Second, the denial of legal personality depends on the degree of the violation of formalities. Sometimes the violation is minor and would not result in such a denial. This aligns with the evaluation of elements in terms of adequacy rather than a binary approach. Third, the formality violations and excessive control often coexist and reinforce each other,[35] because the purpose of dual controllers in becoming deemed directors is to achieve excessive control over the company. Otherwise, they would not bypass the shareholders' meeting or violate the corporate formality.

B. Parity of Power and Accountability and the Element of Duty of Diligence

To avoid unnecessary errors and opportunistic behavior, organizational governance emphasizes effective parity between power and accountability as a principle.[36] This principle indicates that those exercising corporate power must be held accountable, because such power has a public nature concerning all members, and those exercising such power are prohibited from using it selfishly or abandoning it arbitrarily. In corporate law, accountability comprises duty and liability, and the parity manifests as the mandatory fiduciary duties and the liabilities for breaching such duties. This aligns with the statuses of those exercising power within the organization. Since the DDPs primarily address the separation of power and accountability of the dual controllers, the parity constitutes one of the key principles, with two prongs targeting both dual controllers and *de jure* directors simultaneously.

On the one hand, the constraint of the parity applies to dual controllers, because their status does not legally entitle them to exercise corporate power. However, they can still intervene in operations directly (through actual execution) and/or indirectly (by instructions), resulting in the same effect as

34 Zheng Yu, *supra* note 11, 94.

35 *See* ZHU JINQING, CORPORATE LAW, at 171 (Tsinghua University Press, 2019).

36 *See* KENNETH ARROW, THE LIMITS OF ORGANIZATION, at 91 (Chen Xiaobai trans., Huaxia Publishing House, 2014).

de jure directors exercising their authority. Therefore, they must assume the same level of accountability as *de jure* directors and act in the best interests of the company and its shareholders, rather than merely avoiding harm. On the other hand, it takes two to tango. The parity also establishes boundaries for *de jure* directors to treat dual controllers. Without the cooperation of *de jure* directors, dual controllers cannot independently execute company affairs and issue instructions. Power should not be voluntarily relinquished, so allowing dual controllers to execute affairs indicates the connivance or assistance of *de jure* directors. Regarding the receipt of instructions, courts should examine whether *de jure* directors have subordinated themselves to others and relinquished their discretion.[37] If *de jure* directors execute any instruction that serves the personal will of dual controllers, they are undoubtedly breaching fiduciary duties.

Consequently, diligent performance of duties can be the element corresponding to the principle of parity. If *de jure* directors fulfill their fiduciary duties and exercise corporate powers properly, the damage caused by dual controllers will be mitigated. Conversely, the connivance or assistance of *de jure* directors not only reflects their breach of diligent duties but also indirectly reflects the extent to which dual controllers are exercising power (diligence they should not have). Compared to those lacking legal directorship or even acting in secret, it is easier to review the conduct of *de jure* directors who act publicly.

C. Equitable Protection of Interests and the Element of Reasonable Reliance

Article 1 of the Company Law states the need to 'protect the legitimate rights and interests of companies, shareholders, employees, and creditors'. Therefore, protecting interests equitably is a fundamental principle. The most common approach to achieving equitable protection is compensatory justice, which dual controllers evade by executing or instructing without holding a directorship. If losses caused by misconduct cannot be attributed to those at fault, this principle will be violated. Furthermore, it is also inequitable to impose all liability on other *de jure* directors who did not connive with dual controllers. Thus, judges must still identify the legal connection between the aggrieved parties and the actual wrongdoers, so that the former can claim compensation directly. Such a connection is the reliance or trust held by

37 *See Secretary of State for Trade and Industry v. Deverell and Another*, [2000] B.C.C. 1057. *See also Re Hydrodam (Corby) Ltd.*, [1994] B.C.C. 161.

aggrieved parties, including internal shareholders and external stakeholders.

On the one hand, shareholders relinquish their property in exchange for the returns from the company, which depend on the directors' performance. Consequently, there is an indirect reliance of shareholders on the directors. This is often regarded as the theoretical foundation of fiduciary duties, which are defined around this fiduciary relationship.[38] When shareholders allow or are compelled to accept the results caused by dual controllers, the reliance on *de jure* directors may shift to them. As for *de facto* directors, their actual execution will identify them as insiders, thereby forming a reliance of shareholders. The same applies to shadow directors if their instructions are public.

On the other hand, counterparties like creditors may place trust in the appearance of directorship. Dual controllers can demonstrate their influence through ownership ratios or familial relationships, thereby claiming or being held out (by the company) as directors. This would cause counterparties to believe they can decide and represent the transactions of companies. The reliance of external parties on appearances is so crucial that some scholars believe the determination of directorship is based on the holding out.[39] Meanwhile, dual controllers who give instructions within the company may also execute company affairs externally. An individual can simultaneously be a shadow director and a *de facto* director, and what is important is the accountability they should bear.[40] Therefore, outsiders may also have reliance on shadow directors.

In conclusion, the key element of equitable protection is reliance. However, the reliance of shareholders (on investment returns) and the trust of counterparties (in the appearance of directorship) are not disjunctive, and it is inappropriate to rely solely on internal or external criteria, as it can easily be circumvented.[41] Of course, the determinations still require a certain degree of appearance, and titles such as executive director, chairman, or board president are far from sufficient.[42] Moreover, China adopts a system of sole legal representative with directors exercising their powers as a board, so an individual does not always have the authority to represent the company in transactions. In this sense, judges cannot accept the reasonable reliance

38 Indeed, the word 'fiduciary' is derived from the Latin words '*fiducia*', which means trust or reliance, and '*fiduciarius*', which translates into something that is entrusted or given in trust. *See* Lennar Rotman, *Fiduciary Doctrine: A Concept in Need of Understanding*, 4 Alberta Law Review 821, 838 (1996).

39 Brian Studniberg, *supra* note 13, 98.

40 *See Secretary of State for Business, Innovation and Skills v. Chohan & Ors*, [2013] EWHC 680 (Ch).

41 *See* Stephen Griffin, *Problems in the Identification of a Company Director*, 1 Northern Ireland Legal Quarterly 43, 48-49 (2003).

42 Yasue Nakamura, *De Facto Directors in Recent Court Cases*, 5-6 Ritsumeikan Law Journal 474, 502 (2015).

simply because the counterparties claim it. They should combine sufficient facts to support their determination.

V. THE APPLICATION OF THE FLEXIBLE SYSTEM TO THE JUDICIAL DETERMINATION OF DEEMED DIRECTORS

After selecting formality, diligence, and reliance as the elements of the DDPs, it is necessary to clarify the corresponding basic evaluations and then construct a flexible system to determine deemed directors based on their weight order and interactions.

A. Basic Evaluation for Each Element of Deemed Director Provisions

1. Formality. — Judges should examine the extent to which dual controllers have violated the provisions regarding corporate formality, such as resolution procedures, financial regulations, disclosure requirements, and transactional eligibility. The degree of violation roughly classifies the adequacy of formality elements into four intervals.

In interval one, there is no violation. All rules have been fully complied with. In interval two, although there are slight violations, including clerical mistakes in documents or minor procedural flaws similar to those outlined in article 26 of the Company Law, they are still tolerable and have no substantial impact. In interval three, there are typical violations. Organizational forms or transactional procedures have been violated, thus potentially challenging the validity of resolutions or transactions. For instance, all decisions are approved solely by dual controllers; the votes of dual controllers are included in the calculation; or agreements are signed without proper authorization. Such violations are isolated incidents and have not reached the threshold for piercing the corporate veil, which typically requires serious harm[43] or a complete loss of corporate independence.[44] However, even if a single execution or instruction occurs, the DDPs should apply. Otherwise, plaintiffs must prove more than one instance of misconduct, which increases the difficulty of holding dual controllers accountable. In interval four, there are gross violations that have no difference in content from those in a typical interval, but involve more frequent occurrences and a greater scale of

43 *See* article 23 of the Company Law.

44 *See* article 11 of the *Minutes of the National Courts' Civil and Commercial Trial Work Conference*.

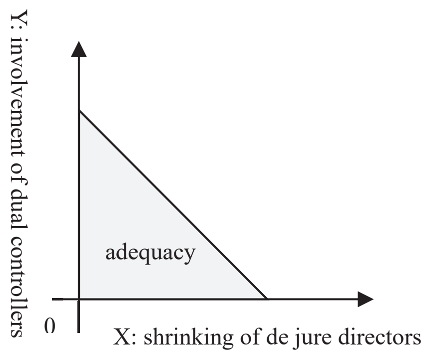
damage. In this case, the company has completely lost its independence.

As the severity of procedural violations increases, the independence of legal personality weakens. Therefore, the basic evaluation herein is: when dual controllers violate corporate formalities related to organizational form and transactional procedures, thereby typically or grossly undermining the independence of legal personality, they should be deemed directors.

2. Diligence. — This element has two prongs regarding dual controllers and *de jure* directors. Since the execution or instruction is a fact to be proved, it would be biased to solely review the dual controllers. For example, advice or suggestions may be mistakenly seen as instructions,[45] and attending meetings as an observer may be mistaken for intervening in voting. Therefore, when making a determination, judges must primarily review the conduct of *de jure* directors and its basis, along with the conduct of dual controllers as a supplementary perspective. To illustrate, the two prongs will be set as X and Y on a coordinate axis. The more the shrinking of *de jure* directors, the larger the value of X; the more the involvement of dual controllers, the larger the value of Y. Finally, the adequacy is the area of the triangle formed by X and Y, which can be roughly divided into four scenarios.

Scenario one: *De jure* directors exercise corporate powers and fulfill their duties diligently, while dual controllers do not participate in operations except during the shareholders' meeting. In this case, both X and Y equal 0, thus the adequacy is 0.

Scenario two: Dual controllers attempt to get involved, resulting in Y



being positive. However, *de jure* directors reject the instructions and maintain self-judgment, resulting in X being equal to 0. In this case, the adequacy is 0

45 While a direction, instruction, or advice may share the common characteristic of guidance, a direction or instruction implicitly carries an expectation of obedience. In contrast, advice is a mere suggestion without any expectation of obedience. Stephen Griffin, *supra* note 41, 53.

again.

Scenario three: *De jure* directors fail to fulfill their duty of diligence, resulting in damages and thus X being positive. However, except for shareholders' meetings, dual controllers never participate, nor do they take any actions that could be guidance or command. Instead, they exercise their shareholder rights properly, resulting in Y being 0. In this case, the adequacy is also 0.

Scenario four: Dual controllers intervene in operations outside shareholder meetings, such as participating in board voting, expressing personal will to the board in ways other than proposals, and carrying out transactions in the name of the company. As a result, Y is positive. Meanwhile, *de jure* directors allow dual controllers to step in, such as not holding board meetings, allowing the will of dual controllers to be the sole reason for making decisions without analysis, or directly transferring their power to dual controllers.[46] This results in X also being positive, and the triangle thus reflects the adequacy of the diligence element.

If either X or Y decreases, the adequacy will also decrease. At this point, the basic evaluation herein is: when the involvement of dual controllers in operations is accompanied by the shrinking of *de jure* directors, thereby resulting in a disparity of power and accountability in governance, dual controllers shall be deemed directors.

3. Reliance. — Judicial recognition of reliance requires more than mere assertions by counterparties (including internal shareholders and external third parties). Likewise, merely claiming to be a director or have the authority to decide on transactions is insufficient. Judges still need to examine the acts of dual controllers and the company, which can be observed through the assignment below.

If dual controllers hold themselves out as directors, the value is 1. For example, they may use 'director' or a similar term in external negotiations, or may demand that managers and employees address them as directors internally. Otherwise, the value is 0. If dual controllers participate in operations, the value is 2.[47] For example, they can sign contracts, hold the company's business license and official seal, and issue directives prior to

46 For example, the multiple guarantees of the company were not approved by the authorities but were arranged verbally by the actual controller, who then had most directors pre-sign documents as a board resolution. *See* No. 178 First Instance Civil Judgment of Intermediate People's Court of Lanzhou (2023).

47 The reason why the value assigned to 'action' is 2 and to 'title' is 1 is that action has a greater impact on the establishment of reliance, and is more in line with the substantialism.

board meetings.[48] Otherwise, the value is 0. Hence, on the side of dual controllers, there are four possible outcomes: (title + no action) = 1; (title + action) = 3; (no title + no action) = 0; (no title + action) = 2.

If the company admits dual controllers as directors, the value is 1. For example, it may designate dual controllers as honorary chairmen, validate their external claims to be directors, and have their signatures on internal documents as directors. Otherwise, the value is 0. If the company supports dual controllers through concrete actions, the value is 2. For example, it may formulate resolutions in accordance with the needs of dual controllers, endorse contracts they have signed, and provide them with licenses and account books. Otherwise, the value is 0. Likewise, on the side of the company, there are four possible scores, ranging from 0 to 3.

The final adequacy is obtained by summing the scores from both sides, resulting in a range from 0 to 6. As neither side may have a value more than 3, only scores greater than 4 can reflect the combined contribution. Either side alone is insufficient to justify reasonable reliance. At this point, the basic evaluation is that when dual controllers, with the company's support, lead others to establish reasonable reliance, they should be deemed directors.

B. Ranking the Weight of the Elements in the Flexible System

The basic evaluation of three elements constitutes one pillar of the flexible system, but without the other pillar — the interaction, the implementation of the DDPs will turn to the component model. To determine a deemed director, there should be a holistic framework with a weight order. For this, formality needs to come first, then diligence, and lastly reliance.

Firstly, the principle of legal personality aims to maintain the independence of a company, thereby keeping its assets separate from those of its members. The protected object under the formality is the company as a legal entity. In article 1 of the Company Law regarding the legislative purpose, the interests of the company are prioritized over those of shareholders, employees, and creditors. In terms of the liability for shadow directors, a similar sequence also occurs in article 192. Moreover, in article 180, *de facto* and *de jure* directors also bear the same duties of acting in the best interests of the company. Hence, giving formality the highest weight

48 In the *Kaidi* case, the actual controller would first convene a special working meeting to make a decision, which would then be submitted to the board. Historically, all major matters of *Kaidi* had to be decided by him. *See* No. 607 First Instance Administrative Judgment of Beijing No.1 Intermediate People's Court (2020).

reflects the uniqueness of companies (legal personality) and aligns with the value hierarchy of the Company Law.

Secondly, the principle of parity constrains *de jure* directors and deemed directors, so judges can use the shrinking of *de jure* directors (X-axis) to reinforce adequacy when it is difficult to fully prove the involvement of dual controllers (Y-axis).[49] Compared to the formality element, the evaluation under the diligence element adopts a side-proof approach with limited justification of reasoning. After all, *de jure* directors may simply fail their duties rather than obey dual controllers. Hence, the diligence is ranked slightly lower than the formality.

Finally, placing the reliance element last does not imply that protecting interests equitably is not important, primarily because it offers less legitimacy and necessity for the DDPs. On the one hand, reliance cannot be established by counterparties if the instructions are concealed and unknown, which reduces the scope of application of the element. On the other hand, even in the absence of a deemed director, the counterparties still have innate trust in *de jure* directors, which ensures that their interests can still be protected equitably by holding them accountable. Similarly, maintaining the independence of legal personality also protects the interests of minority shareholders and creditors, and the courts are reluctant to pierce the corporate veil based solely on reliance.

C. The Interaction of the Elements for Determining Deemed Directors

There are two possible directions in the elemental interaction. In the same direction, all elements support one result; in the opposite direction, the elements lead to different adequacy and results. The latter highlights the advantages of the flexible system,[50] as the legal result can still be achieved. The elements do not have to be satisfied simultaneously. Even if one element is quite low, others that exceed their average level can play supplementary roles.

1. Same Direction. — The underlying principles sometimes overlap, thus reinforcing one another. For example, the independence of legal personality needs to be protected by *de jure* directors. Therefore, compliance with formality is also within their duty of diligence. Likewise, the parity of

49 *See* No. 671 First Instance Administrative Judgment of Beijing No.1 Intermediate People's Court (2019).

50 *See* Xie Gen & Ban Tianke, *supra* note 23, 45.

power and accountability based on the position is also a manifestation of the organizational form. At this point, if one element can be adequate for determination, another may also be proved to some extent.

In a case, BUESG Co., Ltd. and QSEPE Co., Ltd. jointly established Guide Co., Ltd. to undertake government sanitation projects. As the controlling shareholder, BUESG transferred the daily management and operation rights of the projects to BEEG (a subsidiary of BUESG) via an agreement without the approval of the board or the chairman. Afterwards, QSEPE, as another shareholder of Guide, persistently urged the chairman and other directors to convene a board meeting to resolve the transfer issue, yet received no response.[51]

Upon the above facts, the transfer of sanitation projects involves the corporate purpose, which is significant to Guide. However, BUESG did not submit it to the board of directors for resolution in accordance with the articles of association. This indicates illegal procedures and undermines the legal personality of Guide, thus constituting a typical violation in the basic evaluation of the formality element. Meanwhile, the chairman and most directors of Guide directly followed the transfer arrangement without reviewing its fairness and the impact on Guide's interests, nor responding promptly to shareholders' questions. Hence, they breached their fiduciary duties, and the X in basic evaluation is far greater than 0. Combined with the violation by BUESG above, the Y is also positive, indicating that the triangle for the diligence element exists.

Therefore, the adequacy of both formality and diligence is satisfied in the same direction. Assuming that the recognition of the entity as a legal person director is valid,[52] and despite the lack of evidence that BUESG asserted or was acknowledged as a director, the judges can still consider BUESG as a deemed director based on the cumulative strength of the formality and diligence elements.

2. Opposite Direction. — Although the principles overlap sometimes, the issues they regulate are not equivalent. For example, legal personality focuses on the compliance with formality, while the parity focuses on the behavior of directors. When *de jure* directors follow the procedures for meetings and voting but treat dual controllers' will as an exclusive reason, the diligence element may be adequate, whereas the formality may not be. Similarly, the

51 *See* No. 2523 First Instance Civil Judgment of People's Court of Guide County (2019).

52 As the Company Law does not explicitly prohibit legal person directors, scholars believe that legal person directors have the chance to survive in China. *See* Lin Shaowei, *The Possibility and Institutional Construction of Corporate Directors*, 4 Northern Legal Science 56 (2020).

dual controllers have never declared their control over the company, nor did the company acknowledge them as directors. Thus, the counterparties could not form a reasonable reliance. However, *de jure* directors could still fail to fulfill their duties by following the instructions secretly. At this point, even one element supports the determination, but the other may not.

In another case, Baofu Co., Ltd. is a subsidiary of Datong Co., Ltd., which has a controlling shareholder Dunan Co., Ltd. (holding 67% of the shares). Therefore, Dunan is the actual controller of Baofu. The board of Datong made a resolution agreeing to provide joint guarantees for Baofu's loan to Dunan in 2018, accompanied by meeting minutes, a voting record, and signed documentation. According to article 16 of the *Company Law of 2018* and article 38 of Datong's bylaw, the board had the power to decide on the guarantees. However, Baofu's net asset had been negative for two years before, which made it highly unlikely for the company to fulfill its commitment. Except for Director *Zhang*, who was the second largest shareholder of Datong, the remaining four directors voted in favor, and two of them were affiliated directors serving in Dunan.[53]

The resolution for the guarantee did not violate transactional procedures, and all directors were legally appointed. Thus, the formality element fell into interval one and did not support the determination alone.[54] However, as the judge stated, 'to protect the rights and interests of creditors and minority shareholders, the court's review of related-party transactions should not be limited to whether the procedures of law and bylaw have been followed … Recognizing the validity of a board resolution that harms the interests of minority shareholders solely based on procedural compliance is inconsistent with the principles of fairness and good faith.' The poor finance of Baofu demonstrates that the *de jure* directors did not make decisions in the best interests of Datong, so the X of the diligence element is positive. The judge also held that 'the board resolution was due to the abuse of rights by the controlling shareholder Dunan', which indicates that Dunan had interfered with the company affairs beyond its scope of rights, so the Y is also positive. As a result, the diligence element tends to determine Dunan as a deemed director.

Obviously, formality and diligence lead to opposite results in this case. However, the judgment did not disclose whether Dunan explicitly instructed *de jure* directors who voted in favor. If so, it is still possible to determine

53 *See* No. 3428 First Instance Civil Judgment of Intermediate People's Court of Hangzhou (2019).

54 The compliance of the resolution procedure in this case has two parts. First, the guarantee was for the subsidiary, and the bylaw of Datong stipulated that the board had the power to decide. Second, the *Company Law of 2018* did not require the affiliated directors to abstain from voting, so their participation was legal.

a deemed director, because the adequacy of reliance and diligence would exceed their average level, and then compensate for the inadequacy of the formality which is the primary element in the flexible system.

3. Further Discussion. — The above two cases raise another topic: when the controlling shareholder is a legal entity (i.e., BUESG or Dunan), should the court determine its human directors as the deemed directors of the subsidiary (i.e., Guide or Datong)?

When directors of the parent company issue instructions, under the legal authorization of the bylaw or a shareholders' meeting, to directors of the subsidiary in the best interest and on behalf of the parent company, they do not violate the formality of the parent company. However, directors of the subsidiary fail to fulfill their duty of diligence, resulting in damage to other shareholders of the subsidiary. If directors of the parent company are determined as deemed directors of the subsidiary, this not only lacks the adequacy of the formality element of the subsidiary (as in the *Datong* case), but also denies the legal personality of the parent company. Based on the primary position of the formality element, the instructions should be absorbed by the parent company as acts of its agents, and judges should only determine the parent company as a legal person director. Regarding the additional losses incurred due to being a deemed director, the parent company can hold its directors accountable internally on the grounds of fiduciary duties. On the contrary, when the instructions by the directors of the parent company violate its formality, the court could directly determine the parent company's directors as deemed directors of the subsidiary.

VI. CONCLUSION

The DDPs have re-established the link between power and accountability, thereby strengthening the constraints on dual controllers. To avoid loopholes arising from rigidity, the DDPs are designed as standards of conduct with openness. However, if there is no certain review standard, the practice of the DDPs may deviate from its legislative intent. In response, this article introduces a flexible system approach for judicial interpretations, which is designed as follows.

When the plaintiff requests the controlling shareholder or actual controllers to assume civil liability pursuant to the third paragraph of articles 180 and 192 of the Company Law, the people's court shall carefully review the conduct of dual controllers, taking into account the following elements comprehensively: (1) violating the formality rules of the Company Law; (2) causing directors, supervisors, and senior management personnel to fail to perform their duties diligently; (3) inducing reasonable reliance of the company, shareholders or any others. If the above elements exist, the people's court may determine that the controlling shareholders or actual controllers, who do not serve as the directors of the company, have the duties of loyalty and diligence, and then bear joint and several liability for the damage they cause.

Although it is difficult to assign precise values to each element and calculate the overall level of adequacy, this approach still makes two advances. First, since the principles are predefined and each element has corresponding practical experience when evaluated separately (e.g., piercing the corporate veil), judges are less likely to exercise excessive discretion as they are provided with stable and clear guidance. Second, the basic evaluation of each element features a segmented structure, which refines review standards toward greater precision and specificity.

(Edited by Gong Li)

中国公司法下认定实质董事的动态系统论

内容提要 为强化对控股股东与实际控制人的规制，中国《公司法》在第 180 条和第 192 条引入了实质董事条款。通过法律拟制，信义义务与连带责任可直接施加于无合法董事职位的双控人，从而解决传统上基于身份带来的问责鸿沟。然而，由于“实际执行公司事务”和“指示”等核心概念的开放性，加之法官在认定时需要清晰的审查标准，条款面临施行上的挑战。为此，有必要在最高人民法院的司法解释中采取动态系统论。该系统包含了程式、勤勉和信赖三个评价要素，分别对应法人格独立、权责对等与利益公平保护等规范原则。基于要素的分段式评价与互补式协同，动态系统论将给予法官相对明确的框架来避免裁判的肆意，并保持实质董事条款对复杂的商业现实的适应能力。