

The Long Road Beyond Suspicion

Legal Persons in the Common Law and China

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Certain Chinese corporate principles confound both foreign lawyers and some Chinese who have studied law overseas. Foremost among these is the concept of an authorized scope of business as a restriction on a company's legal activities. A more nuanced historical understanding of this concept reveals that the current posture of Chinese company law simply tracks a particular time and place in the evolution of a country's system of jurisprudence.

As a basic element of Chinese law, Chinese legal persons are established with an authorized scope of business that is typically memorialized in their business licenses. Looking at standard business license, we see that it includes information that is primarily no different from that recorded in certificates of incorporation from a myriad of jurisdictions, such as capitalization, percentages of shareholding, legal address, date of establishment and so on.

However, the inclusion of a "scope of business" is unusual when compared with contemporary practices in other jurisdictions. The term, as recorded on a business license, catches the eye of a foreign practitioner of law right away. It stands for the Chinese corporate law principle that a Chinese legal person may only engage in those business activities which are approved (if incorporation is subject to approval) and registered in its constituent documents filed with the State.

Some legal commentators point out that this aspect of Chinese corporate law is a legacy of China's Marxist tradition of central planning. This theory maintains that it is only through an exercise of State authority that a combination of individuals is allocated the privilege to pursue certain types of business as a collective group. These restrictions on business are said to evolve from the State's role in closely supervising and guiding a socialist economy and regulating individual behaviour according to socialist morality.

I used to struggle to find a succinct way of explaining this notion to foreign clients accustomed to purchasing readymade shelf companies in jurisdictions like the British Virgin Islands or Hong Kong. In exasperation, many of my clients decried this characteristic as a troublesome socialist left-over that shows how "China just doesn't get it."

Whenever I myself was not caught up in the heat of the issue, I tried to fend off these initial impressions of negativity in my clients' reactions, but was only moderately successful until I remembered a phrase from several dog eared pages in my old law school case book on corporations.

"China only has 'special purpose' companies," I explained, one day in a flash of inspiration. "There are no 'general purpose' business corporations."

These words worked like a magical incantation on my clients. Suddenly I did not need to point to a socialist or exotically Chinese basis for the practice but had found a way to explain it to clients in terms that were closer to their own points of reference. But where did these points of reference come from?

This led me to retrieve my old case book from dusty storage in order to find out more. I could see that I had never marked, and therefore presumably never read, the first fifty pages on the legal history of corporations in the United States. These pages led me to a valuable lesson in comparative law.

Historically, companies, or legal persons, were the creations of a distrustful state that was initially unsure about the virtues of letting individuals gain commercial power through collective action. For example, in the 1600s, the charters of the British East India Company or the Hudson Bay Company were created by the British crown by granting a revocable commercial monopoly to influential merchants in exchange for revenue. Some legal historians define this as an act of “outsourcing” sovereignty to a group of oligarchs who were tied closely to government and who exercised the powers of a state in exchange for the payment of a percentage of profits earned by the enterprise. As outsourcing agents of the crown, it is easy to see how they become agents of imperialism in newly discovered worlds. We can also see the lingering mistrust felt by monarchs in creating entities that could grow to confront royal authority or disrupt the public well-being. Restrictions were needed to maintain control over these enterprises.

Among other restrictions, royally chartered companies were permitted to engage in only those commercial activities expressly authorized by the crown. Here in the 17th century we can detect some of the underlying reasons for China’s contemporary restrictions on legal persons but without the need for an attribution to Marx or socialism.

British and then American merchants who were left out of the club detested the monopoly powers enjoyed by these royally chartered corporations. This suspicion became one of numerous points of friction between colonial America’s rising ruling class of large land-owning gentry and the metropolitan authority in London. For example, the famous Boston Tea Party was a violent protest against the prices charged by the British East India Company for imported commodities.

At the time of America’s independence, the corporate form of transacting business was only a nascent concept, with only forty companies existing in the country, each of which had come into existence by an exercise of royal authority. Indeed, America’s ruling class believed in a collective of enlightened (and wealthy) individuals as the correct form of political governance and commercial endeavour. Corporate formations were suspect, as famously suggested by Adam Smith’s comment that “people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public.” Early American jurisprudence held that corporations could come into existence as a conditioned privilege bestowed by an exercise of the local legislature.

The rise of businessmen acting in a collective characterized the early 19th century American economy and provoked a fear in people like James Madison, who felt that government should protect the rights of the existing “minority of opulence” against the majority who were seeking to rise above their station through “crass” commercial exploits. These patrician worries were stoked by the Supreme Court of the United States in 1819. In *Dartmouth v. Woodward*, the Supreme Court recognized corporations as possessing legal rights on the basis of their charters as contracts and thus not susceptible to revocation by a state government. This decision initiated the gradual process by which federal courts held that corporations are capable of holding property rights, and entitled to constitutional protections, in a manner comparable to natural persons.

The pro-business emphasis of *Dartmouth v. Woodward* was in keeping with the times. By the 1830s, new forms of industrialization and technology had pried loose the powers of the gentlemen-gentry of Madison’s era and found a comfortable home in the corporate form of business, which provided opportunities for growth and the concentration of power in the hands of a new and increasingly vocal class of merchants whose goals were worryingly non-transparent to political leaders. On the other side of the Atlantic Ocean, the aspirations of the rising merchant class was given voice when the British Parliament enacted the Joint Stock Companies Act in 1844, allowing companies to be incorporated without a royal charter or an act by Parliament.

Nevertheless, throughout the 19th century in America, the lingering mistrust felt about corporations was reflected in the company laws enacted by state legislatures. Given the uncertain impact that such corporate forms could have on the public well-being, company laws in the mid-19th century America, like their counterparts in today’s China, stipulated that corporations could only be established for a specific business purpose as set out in their charters. Other elements of these early company laws are reminiscent of today’s foreign investment regulations in China,

such as limited terms for the existence of a company, the requirement of unanimous shareholder agreement on mergers and limitations on the structure of capital holdings.

Reluctance gave way to the demands of an increasingly sophisticated economy. During the remainder of the 1800s, states began to remove restrictions on corporations from their legislation. In 1896, New Jersey permitted corporations to be established to pursue any lawful business. In 1899, Delaware passed a similar law involving fewer taxes and registration procedures, thus becoming the preferred state for incorporation in the United States, a distinction that it holds to this day. Once a general business corporation became accepted as a principle of jurisprudence, the company laws of all other states followed suit, with the concept becoming so common in the United States by the late 20th century that it is no longer remarked upon. Indeed, the rarely-used term “special purpose company” has a musty ring to it.

Be that as it may, controversy still remains in America about the wisdom of such entities. While some commentators see the rise of a general purpose company as the triumph of a form of corporate democracy that facilitates the conduct of business by the individual, tensions, echoing the worries of Madison, certainly still exist. In 2003, the hugely successful Canadian documentary *The Corporation* revisited populist suspicions about companies and their impact upon social well-being.

Where does this historical comparison leave us regarding the permitted purposes of a company under Chinese law?

First, it is very useful to be armed with this information in order to deflect or dampen a foreigner’s negative reaction. After all, nation-states seem to go through a process of initial suspicion followed by gradual acceptance of the concept of a general purpose company. The intangible nature of a corporation initially triggers discomfort in societies where there is primarily an agricultural means of production and an undeveloped national economy. Such corporate creatures are permitted to come into existence at these stages of development as a privilege granted by a state and subject to review and alteration by the state. As a nation’s economy enters into a greater stage of sophistication, economic necessity wears down state suspicion and sets in motion the process of legislative reform that permits a legal person to pursue the same broad scope of business activities as a natural person.

Second, China’s jurisprudence appears to be travelling along the same path taken by common law jurisdictions over a century ago. For instance, in recent years, the local counterpart of the State Administration for Industry and Commerce in Beijing has begun, in some circumstances, to issue business licenses for domestic enterprises for general business purposes. Here is a development that suggests the retirement of a nettlesome restriction and an increasing comfort with a market economy.

However, State unease about corporate forms can still be found in the sometimes bewildering layers of operational regulation in China. This edition’s article on the licensing regime for real property projects illustrates the complexity of post-formation regulation of companies. It is hard to find a jurisprudential explanation for these restrictions that demonstrates a shared historical experience with common law jurisdictions. Rather, the myriad of restrictions on the real property market show the ongoing influence of abstractions in the regulation of business sectors. What is clear is that Chinese jurisprudence is at a stage of development suspended between predictability for individual decision-making in business and the State’s need to correct aberrant behaviour leading to chaos. This is a subject that will be taken up in the next edition of the SGLA Law Journal.

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