

## **The 2008 China Milk Scandal and the Role of the Government in Corporate Governance in China**

### Abstract<sup>1</sup>

The close association between the Chinese state and the Chinese state-controlled companies has been identified by a number of commentators. Through a case study on the exposure of the 2008 Chinese tainted milk scandal and the handling of the aftermath of the scandal by the Chinese central and local governments, this paper establishes substantial evidence of government intervention in China's large private corporations.

The paper argues that in the tainted milk scandal, the roles played by the local Hebei government and the central food safety authority have had a negative impact on establishing/maintaining adequate internal controls and encouraging socially responsible behaviour among the dairy companies. Similarly, the equally protective approach adopted by the central and local governments in handling the aftermath of the scandal may have only addressed the symptoms but not the root cause of the fundamental failure in the corporate governance of the dairy companies.

The intervention in business by government at various levels may find its justification in the common goal of promoting economic growth. Although this is one important policy objective particularly with the global economic downturn, the paper suggests that this policy has had some unintended effects upon governance of the Chinese companies.

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## Part 1: Introduction

The role of government in corporate governance seems to have increased with each round of corporate collapses and scandals.<sup>2</sup> Major corporate collapses in America and Australia in the late 1990s and early 2000s have seen additional mandatory duties and standards being introduced to strengthen company internal controls. More recently, triggered by scandals involving companies such as James Hardie, Fincorp and Westpoint, as well as the current credit crunch in the US, there has been an increasing voice calling for greater role of the government in corporate social responsibility.<sup>3</sup> In this regard, methods proposed by commentators have ranged from tougher legislation<sup>4</sup> through to government acting as “a best practice example” by adopting good corporate citizenship practices in its own agencies.<sup>5</sup> But despite the various initiatives and debate on an increased role of government in businesses, the conventional distinction between the function of the two, i.e., that government should “steer” and not “row”<sup>6</sup> has not changed.<sup>7</sup> This is so despite the current global financial turmoil that has sparked massive rescue plans being implemented by government of various nations towards their distressed financial systems and major companies.

An understanding of the role of the government in Chinese companies must be set against the unique policy objective of the Chinese state. In its 30 years transition from a planned economy to a ‘socialist market economy’ the government has never shied away from its role as an

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<sup>2</sup> Anona Armstrong, ‘Corporate Governance standards: Intangibles and their tangible value’ (2004) 17 *Aust Jnl of Corporate Law* 97.

<sup>3</sup> See for example, The Corporations and Markets Advisory Committee (CAMAC), Corporate Social Responsibility Discussion Paper, November 2005; The Parliamentary Joint Committee on Corporations and Financial Services *inquiry into Corporate Responsibility and the Corporate Responsibility –Managing Risk and Creating Value report that came out of the Inquiry in June 2006*.

<sup>4</sup> Peta Spender, ‘Weapons of Mass Dispassion: James Hardie and Corporate Law’, The Second Michael Whincop Memorial Lecture (2005) *Griffith Law Review* Vol 14 (2), 280.

<sup>5</sup> Gianni Zappalà, ‘Corporate Citizenship and the Role of Government’, the Public Policy Case Research Paper no.4 2003-04 <<http://www.aph.gov.au/library/Pubs/rp/2003-04/04rp04.htm>>.

<sup>6</sup> David Osborne & Ted Gaebler, *Reinventing Government* (1992).

<sup>7</sup> Roman Tomasic and Jenny Fu, ‘Government-owned companies and corporate governance in Australia’ *Corporate Ownership & Control*, Volume 3, Issue 4, summer 2006, 123, 126.

entrepreneur form of government.<sup>8</sup> In addition to retaining a controlling stake in most of the country's large corporatized State-owned enterprises (SOEs), the government has maintained economic growth, measured by GDP growth, a key policy priority.<sup>9</sup>

China's government-led reform has achieved phenomenal economic results, also seen in part as a "hope" amid the global economic downturn. On the other hand, the leading role played by the government in the Chinese economy will inevitably impact on the governance practices of the Chinese companies. In this regard, existing research has primarily focused on the "coincidence of the state power and state ownership"<sup>10</sup> in the corporatised former SOEs. The often blurred government-business boundary has been manifested in government intrusion in corporate management, leading to doubts on the very nature of these entities as separate legal entities. In addition, the coincidence of the role of the state as a shareholder, law maker as well as a regulator of the Chinese stock market may also lead to poor protection of other but weaker stakeholders in companies, such as minority shareholders, and tort victims,<sup>11</sup> which further raises the issue of corporate social responsibility.

Those views arguably rest on the assumption that in the absence of state-ownership, the non-state controlled companies in China would be far more independent thus comparable to their western counterparts. The 2008 China melamine tainted milk scandal, an industrial scandal that has involved almost all large to medium sized dairy companies in China, such as Sanlu, Mengnui and Yili, however suggests that the boundary between the Chinese state and its large

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<sup>8</sup> Chi Fulin, China's Economic Transition: Progress, Challenges and Objectives, a report commissioned by the United Nations Development Programme, May 2004 <<http://www.un.org.vn/undp/projects/transition2004/download/papers/country-papers-series-china.pdf>>.

<sup>9</sup> Ibid. Also see the PRC State Council's Annual; Work Report to the National People's Congress in recent years.

<sup>10</sup> For example, Neil Andrews, "When the CEO Vanished in spin: information disclosure, corporate governance and the Bank of China (Hong Kong) Holdings Ltd", (2004) 17 *Aust Jnl of Corporate Law* 71-96, 71. Tam, O. K. (1999), *The Development of Corporate Governance in China*, Cheltenham: Edward Elgar. Tenev, S., Zhang, C. L. with Brefort L (2002), *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, The World Bank Shanghai Stock Exchange, "China Corporate Governance Report 2003: Executive Summary" <<http://rru.worldbank.org/Discussions/OpenFile.aspx?id=1284>>.

<sup>11</sup> Jenny Fu 'Corporate Governance of Listed Companies in China: between State-owned Corporate Groups and Public Investors' (2006) 19(1) *Aust Jnl of Corp Law* 114.

private businesses may not be as clear as previously thought. On the outset, compared to many other sectors considered Chinese ‘pillar industries’ such as energy and resources, the Chinese dairy industry has been dominated by companies in which the state has far less significant stakes.<sup>12</sup>

Using the 2008 China milk scandal particularly incidents surrounding the Sanlu group of companies (hereafter referred to as “Sanlu”) as an example, this paper looks at the involvement of the Chinese government in the governance of China’s large privately-owned companies and the implications of the close association between government and businesses in promoting good corporate governance in China. Sanlu has been at the epicentre of the 2008 tainted-milk scandal, not only because it was from Sanlu the scandal first erupted, but also that as China’s largest infant formula producer, the group has produced most of the near 300,000 baby victims including six dead. At the time of writing, Sanlu has been placed into liquidation with a series of criminal convictions handed down against former Sanlu senior executives and other persons involved. Work on the compensation for tort victims is also being wrapped up, with most of the victim families having accepted a compensation scheme put forward by the dairy companies and backed by the government. Five months following the exposure of this major corporate scandal, the evidence suggests that the Chinese government’s handling of the scandal has been effective in maintaining economic growth and social stability, which is particularly needed during the current global economic climate. However, with its vast and complex social, economic, political and legal ramifications, the aftermath of the scandal will last for a long time.

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<sup>12</sup> The Chinese dairy industry has been dominated by four dairy industries, namely Yili, Mengniu, Sanlu and Guangming groups of companies which have all been involved in the 2008 Chinese tainted milk scandal. Yili is a Shanghai-listed company in which its largest shareholder, the Inner Mongolia government, holds about 10.5% of shares. This percentage is quite low compared to the about 45% average shareholding of the largest shareholders in the Chinese listed companies in 2002. Mengniu is a company listed in Hong Kong. The ultimate controllers of Mengniu are its founders primarily the Chairman and CEO. Sanlu, the company at the heart of the 2008 China milk scandal, is a non-listed privately-controlled company transformed from a local cooperative among dairy farmers. The fourth company, Guangming Dairy is a listed company controlled by the Shanghai Municipal government through local state assets management agencies.

China has attached great importance to corporate governance in recent years, driven partly by the need to develop its own domestic stock market and partly the mounting pressure from the globalisation of corporate governance. In addition to the introduction of some basic corporate governance structures based on both the Anglo-American outsider-based and the German-Japanese insider-based systems,<sup>13</sup> China has also strengthened its underlying legal and regulatory framework. This includes a complete overhaul of decade-old Company Law and Securities Law in 2005 and the enactment of the Enterprise Bankruptcy Law in 2006. In addition, as early as 2002 a *Code of Corporate Governance for Listed Companies* was also issued by the China Securities and Regulatory Commission (the ‘CSRC’), the watchdog for China’s stock market and around 1500 publicly listed companies. The ownership reform carried out by the local Shijiazhuang city government in Sanlu and many other formerly state-owned companies was also in part directed to improving corporate governance. The idea was that with multiple shareholders introduced, the companies will be far removed from government intervention and thus more likely to operate on the same lines with their foreign counterparts.<sup>14</sup>

The rest of the paper will proceed as follows. Part 2 sets the scene by providing a brief overview on the 2008 Chinese milk scandal and its causes. Part 3 explains the corporate governance problems revealed by the scandal and discusses the role of the close association between governments and the dairy companies in the governance failure of those companies. The unique Chinese government-business relationship exhibited in the handling of the aftermath of the scandal is explored in Part 4. The paper concludes with Part 5 which suggests that the unique Chinese government-business association, fuelled by a top-down emphasis of

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<sup>13</sup> China has so far established a dual-board system comprising a board of directors and a supervisory board. Typically found in the German companies, the supervisory board in the Chinese companies however do not have such powers as participating in management decision making or directors’ appointment (Article 126 of the PRC Company Law).

<sup>14</sup> Zhang Xu, *A review of SanLu’s History* [Huanyuan Sanlu Qianshi Jinsheng] (in Chinese) <<http://finance.jrj.com.cn/2008/09/2000072101769.shtml>>.

economic growth, may continue to shape governance practices in the Chinese companies despite the remarkable efforts undertaken by the government to improve corporate governance in China.

## **Part 2: The 2008 China Milk Scandal**

Although corporate scandals have not been rare in China, none has attracted so much global attention as the 2008 China milk scandal. In September, starting with Sanlu, a corporate group headquartered in the northern city Shijiazhuang, Hebei province, twenty-two, i.e., about one fifth of Chinese infant formula producers were found by China's food safety watchdog, AQSIQ (Chinese State Administration of Quality Supervision, Inspection and Quarantine) to contain melamine at various levels in their products.<sup>15</sup> Subsequent test carried out by AQSIQ also revealed melamine contamination in liquid milk<sup>16</sup> and milk powders for adults.<sup>17</sup>

Melamine is an industrial chemical used in producing plastics and fertilisers. Sustained consumption by human beings may cause kidney stones and kidney failure particularly among infants, for whom, kidney stones are rare.<sup>18</sup> Previously found in China-produced animal feed sold in the US in 2007,<sup>19</sup> the melamine contamination returned in 2008 and unfortunately led to as many as six infant deaths and 294,000 suffering from “urinary problems” including

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<sup>15</sup> Xinhua Net news story, *China Seizes 22 Companies With Contaminated Baby Milk Powder* <[http://news.xinhuanet.com/english/2008-09/17/content\\_10046949.htm](http://news.xinhuanet.com/english/2008-09/17/content_10046949.htm)> On 16 September, AQSIQ released test results on samples from 491 batches of baby formula produced by all 109 Chinese companies that produce infant powdered milk. 22 of the companies including Sanlu were found to contain melamine in their products ranging from 0.09mg to 2563mg per kilogram.

<sup>16</sup> Xinhua Net news story, *Most Liquid Milk in China Does Not Contain Melamine* [http://news.xinhuanet.com/english/2008-09/19/content\\_10076616.htm](http://news.xinhuanet.com/english/2008-09/19/content_10076616.htm).

<sup>17</sup> Xinhua Net news story, *Tests Find Melamine in 31 Chinese Milk Batches* [http://news.xinhuanet.com/english/2008-10/02/content\\_10141287.htm](http://news.xinhuanet.com/english/2008-10/02/content_10141287.htm)

<sup>18</sup> World Health Organisation, *Melamine-contaminated Powdered Infant Formula in China - Update 2* <[http://www.who.int/csr/don/2008\\_09\\_29a/en/](http://www.who.int/csr/don/2008_09_29a/en/)>.

<sup>19</sup> U.S. Food and Drug Administration, *Pet Food Recall (Melamine)/Tainted Animal Feed Updated: February 6, 2008* <<http://www.fda.gov/oc/opacom/hottopics/petfood.html>>.

kidney stones according to the Chinese Ministry of Health.<sup>20</sup> By 27 November 2008, 861 remained in hospital with 154 in a critical condition.<sup>21</sup> Most of those victims have been reportedly consumed formula produced by Sanlu which scored the top levels of melamine contamination among the twenty-two companies.<sup>22</sup>

If there are any similarities between the causes of the US credit crunch and the Chinese milk scandal, commercial greed amid a booming industry coupled with lax government regulation could probably carry part of the blame, although in the 2008 milk scandal, the sheer commercial greed manifested in outright forsaking social responsibility for short-term profits reached horrendous levels.

It has emerged from the trial of four former Sanlu executives and dozens of melamine-related convictions that some unscrupulous milk station operators supplying raw milk to the dairy companies were the main culprit for the scandal. They added melamine, known as “protein powder”, to diluted milk to artificially raise its protein levels. In doing so, the milk station operators took advantage of the conventional testing adopted by the dairy companies that measured the protein content by the level of nitrogen the raw milk contains. Melamine is made up of 66% nitrogen.<sup>23</sup>

Further evidence suggests that spiking source milk with melamine had long been a common practice among the milk dealers at least in Hebei.<sup>24</sup> The practice was traced back to April 2005

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20 PRC Ministry of Health, An Update on Treatment of Sanlu Tainted Infant Formula Victims[Weisheng Bu tongbao Sanlu Pai Yingyou Er Naifen Shijian Yiliao Jiuzhi Gongzuo Qingkuang] (in Chinese) <[http://www.moh.gov.cn/sofpro/cms/previewjspfile/mohbgt/cms\\_00000000000000144\\_tpl.jsp?requestCode=38386&CategoryID=4814](http://www.moh.gov.cn/sofpro/cms/previewjspfile/mohbgt/cms_00000000000000144_tpl.jsp?requestCode=38386&CategoryID=4814)>.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

<sup>23</sup> Xinhua Net news story, *Survivor leads China's milk industry*< [http://news.xinhuanet.com/english/2008-11/15/content\\_10361534\\_3.htm](http://news.xinhuanet.com/english/2008-11/15/content_10361534_3.htm)>.

<sup>24</sup> Caijing Magazine news story, *Tracing Source of Melamine*[Sanju Qingan Suyuan] (in Chinese), Caijing Magazine, Issue No. 221 <<http://magazine.caijing.com.cn/20080928/77700.shtml>>.

by the Deputy Governor of Hebei Province in a news report.<sup>25</sup> Caijing Magazine, an influential Chinese non-state media, citing Hebei local dairy farmers, went further to suggest that “the practice of spiking fresh milk with additives such as melamine had been a public secret for the past two years”.<sup>26</sup>

However, like the credit crunch in the US, the cause of the 2008 China milk scandal was complicated with much wider implications. As will be shown in Part 3, on a broader level, the commercial greed of the milk station operators could have been fuelled by the similar commercial greed of the dairy companies at the expense of adequate internal controls and the lax government regulation of a fundamental area of food safety.

### **Part 3: Failure of corporate governance and the role of the governments in that failure**

The aim of corporate governance is to ensure that companies are run by their managers in a way that maximises the interest of their shareholders. To achieve that end, the managers and the board of directors need to put in place adequate internal control systems that would ensure the company meets its legal as well as social obligations. The importance of the latter to the long term interest of the company and its shareholders has been espoused by a number of authors.<sup>27</sup>

The particular avenue through which source milk is supplied to the Chinese dairy industry does warrant extra vigilance by corporate internal controls systems, although the reliance on that avenue itself may be indicative of inadequate controls. Chinese dairy companies used to

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<sup>25</sup> 21 Century Economy Reports news story, *Deputy-Governor of Hebei: Law Offenders Started to Add Melamine to Raw Milk From Two Years Ago*[Hebei Sheng Fusheng Zhang Toulou: Bufa Fenzi 2005 Nian Yi Kaishi Xiang Niunai Chan Sanju Qingan] (in Chinese), found on China Finance Online <<http://news.cnfol.com/080918/101.1280.4781164.00.shtml>>.

<sup>26</sup> Caijing Magazine news story, *Spilling the Blame for China's Milk Crisis*<http://english.caijing.com.cn/2008-10-10/110019183.html>.

<sup>27</sup> See for example, The Parliamentary Joint Committee on Corporations and *Financial Services*, above n 3. James McConvill, ‘Directors’ duties to stakeholders: A reform proposal based on three false assumptions’, (2005)18 *Aust Jnl of Corp Law* 88.

rely on self-sufficient dairy farms where quality control over source milk was not a major concern. However, with an extraordinary rate of average annual growth at 23% since 2000 and total sales achieving 23.5% of the entire food sector in 2006,<sup>28</sup> battling over milk source has become industrial-wide. In a quest to expand milk sources in the most ‘cost-effective’ means, large dairy companies, including Sanlu, Mengnui and Yili, increasingly resorted to privately-run milk collection stations to purchase raw milk from small scale dairy farmers, instead of developing their own dairy farms. This was the case despite the fact that the practice of the milk dealers in spiking raw milk with all sorts of additives, some of which may not be detectable by the quality tests of the dairy companies, had long become the industrial knowledge.<sup>29</sup>

On the other hand, despite the string of awards and honourable titles the dairy giants had received over the years indicating strong corporate governance,<sup>30</sup> the effectiveness of their impressive internal control systems as detailed in the annual reports has also been questioned in the aftermath of the scandal. In the light of the length and scope of the melamine malpractice, a report provided by a Chinese newspaper questioned the internal control of the dairy giants in the following terms:

*The testing and quality check personnel can't have been completely ignorant or innocent. An explanation is that the milk company's rapidly expanding business scales*

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<sup>28</sup> China Economy Net news story, *China Dairy Industry Policy released*[Ruzhi Pin Gongye Chanye Zhengce Fabu] (in Chinese)<[http://finance.ce.cn/macro/gdxw/200806/17/t20080617\\_13226765.shtml](http://finance.ce.cn/macro/gdxw/200806/17/t20080617_13226765.shtml)> the news story revealed that in 2006, sales of the Chinese dairy products reached RMB 106 billion, accounting for 23.5% of the entire Chinese food sector.

<sup>29</sup> Sina news story, *Experts Confirm Milk Source Is the Problem* [Zhuanjia Kending Shi Yuannai Huanjie Wenti] (in Chinese)<<http://news.sina.com.cn/c/2008-09-13/015716283297.shtml>>.

<sup>30</sup>For example, the awards received by Mengnui included: Best Corporate Public Image Award 2007 presented by the Enterprise Research Institute of Development Research Centre of the State Council and China Credit Research Centre of Beijing University, People’s Social Responsibility Award 2007 by the People’s Daily Online. See Mengniu annual report 2008.

*led to a shortage of milk sources, which forces them to collect milk loosely, turning a blind eye to poor quality raw milk.*<sup>31</sup>

In the absence of a special investigation similar to an Australian style royal commission inquiry, questions regarding the adequacy of internal control of those companies and the role of any potential such failure in attributing to the scandal will remain unanswered. However, despite a press release on 12 September indicating that the central government would “investigate the source of the problem and punish those responsible”,<sup>32</sup> there has been no report on such investigations being carried out on directors of any other dairy companies except for the former Chairperson and CEO of Sanlu. So far, only that Chairperson as well as three other executives of Sanlu have been prosecuted and subsequently convicted for ‘producing and selling fake or defective products’ (instead of the more serious charge of “producing and selling poisonous food products” for which the maximum penalty is death) under the PRC Criminal Law.<sup>33</sup> In addition, even if a lack of adequate internal control becomes evident, there have been few reported cases in which directors of a Chinese company are brought before the court purely for breach of directors’ duties under PRC Company Law.

As well as dysfunctional internal controls, Sanlu’s case presents a special example of outright disregard for corporate social responsibility in the name of business survival demand. Although the tainted milk scandal did not erupt until September 2008, the trial of the four Sanlu executives revealed that the company had received complaints about babies sickened by drinking Sanlu-produced infant formula since December 2007, including cases of kidney

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<sup>31</sup> Yang Jianxiang, *Survivor leads China’s milk industry*, Xinhua Net <[http://news.xinhuanet.com/english/2008-11/15/content\\_10361534\\_2.htm](http://news.xinhuanet.com/english/2008-11/15/content_10361534_2.htm)>.

<sup>32</sup> PRC Central Government, *The Central Party Committee and the State Council Handles Persons Involved in the Sanlu Milk Scandal Seriously* [Dang Zhongyang Guowu Yuan Yansu Chuli Sanlu Naifen Shijian Xiangguan Zeren Renyuan] (in Chinese) <[http://www.gov.cn/jrzq/2008-09/22/content\\_1102256.htm](http://www.gov.cn/jrzq/2008-09/22/content_1102256.htm)>.

<sup>33</sup> Xinhua Net news story, *Former Sanlu Chairwoman TianWenhua Sentenced to Life Imprisonment* [Yuan Sanlu Jituan Dongshi Zhang Tianwen Hua Yishen Bei Panchu Wuqi Tuxing] (in Chinese) <[http://news.xinhuanet.com/legal/2009-01/22/content\\_10701439.htm](http://news.xinhuanet.com/legal/2009-01/22/content_10701439.htm)>. The crime for ‘producing and selling fake or defective products’ for which the maximum penalty is life sentence is provided in Article 140 of the PRC Criminal Law. The crime for “producing and selling poisonous food products” is provided under Article 144 of the Criminal Law.

stones since March 2008.<sup>34</sup> However, during the eight months from December 2007 to early August 2008 when melamine contamination was confirmed by tests reluctantly carried out by Sanlu with an external organization, the Sanlu management took extensive measures to cover up the scandal, in the name of internal inquiries being conducted by the company. These included sending representatives around the country to console victims, and buying out adverse media publicity about the company.<sup>35</sup> In spite of the management's awareness of the rising number of tainted milk victims, Sanlu neither issued any public recalls of its product nor report the matter to the Shijiazhuang city government to comply with a State Council regulation that requires major food safety accidents to be reported to government authorities within two hours.<sup>36</sup> This was so despite the fact that in May, prompted by media exposure on the 2007 incident of China-produced animal feed tainted by melamine, some senior executives "suspected" that Sanlu's product might have been contaminated with the same chemical (That suspicion however did not lead to specific tests on melamine being promptly carried out by Sanlu).<sup>37</sup> On that note, the extensive cover up by the Sanlu management has also revealed a dysfunctional board of directors. Fonterra, the New Zealand dairy giant which owed 43% of shares in Sanlu and appointed three of the seven directors to Sanlu board, claimed that "it was only told about the melamine contamination on 2 August",<sup>38</sup> the date on which the Shijiazhuang city government was also informed of the incident. It is questionable whether the Sanlu board, except the Chairwoman and CEO, had been kept informed by its executives of major business operations within the company.

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<sup>34</sup> China Youth Daily news story, *Truth of Sanlu Incident revealed*[Sanlu Shijian Zhenxiang Dabao Guang] (in Chinese), found on Xinhua Net [http://news.xinhuanet.com/politics/2009-01/01/content\\_10587575.htm](http://news.xinhuanet.com/politics/2009-01/01/content_10587575.htm).

<sup>35</sup>Ibid.

<sup>36</sup> National Emergency Plan for Handling Major Food Safety Accidents effective from February 2006[Guojia Zhongda Shipin Anquan Shigu Yingji Yuan](in Chinese), s3.2.2.

<sup>37</sup> China Youth Daily, above n 39.

<sup>38</sup> Telegraph news story, China milk scandal threatens giant dairy firm, 24 Sep 2008  
< <http://www.telegraph.co.uk/news/worldnews/asia/china/3073998/China-milk-scandal-threatens-giant-dairy-firm.html>>.

## **Relationship between government and business revealed in the Sanlu Scandal**

The 2008 China milk scandal reveals some fundamental failures or potential failures in corporate governance of the Chinese dairy companies, with forsaking internal control and social responsibility for short term profits in particular. On a broader level, the scandal also brought the relationship between the Chinese state and its large private corporations and the role of that relationship in the governance of those companies under the spotlight.

Even considering the existing research indicating the obscured boundary between the government and state-controlled companies, the close ties formed between Sanlu and the Shijiazhuang government where Sanlu was headquartered is curious. Strictly speaking, Sanlu does not fall under the strict definition of a state-controlled company. The predecessor of Sanlu was a cooperative formed among local dairy farmers, which under the Chinese Constitution, is a special form of state-ownership.<sup>39</sup> Shareholding reform in Sanlu was carried out by the Shijiazhuang city government in 2002, when the net assets of Sanlu were converted into shares with 92% of which being sold to the then Sanlu management and employees. Following a joint venture agreement with Fonterra, 56% of Sanlu was held by Sanlu Limited which was set up to represent interests of Sanlu management and employees. Fonterra held 43% of shares in Sanlu. The residual 1% Sanlu shares were held by a few small shareholders, meaning that neither the central nor the local Shijiazhuang city government owns a significant stake in Sanlu.<sup>40</sup> Public listing had also been actively pursued by Sanlu even before the

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<sup>39</sup> Constitution of the People's Republic of China, Article 6.

<sup>40</sup> Zhang Xu, A review of SanLu's history [Huanyuan Sanlu Qianshi Jinsheng] (in Chinese) <<http://finance.jrj.com.cn/2008/09/2000072101769.shtml>>. The ownership of Sanlu was initially a controversial issue in the aftermath of the Scandal. In a press conference held on 13 September, Mr. Yang Chongyong, in response to question on the relationship between Shijiazhuang city government and the Sanlu group, said, "Sanlu is a company limited by Shares. 43% of Sanlu is held by Fonterra of New Zealand, and 56% by Sanlu Limited. There are also some small shareholders in Sanlu. The government does not own any shares in Sanlu." See Hebei Vice-Governor: Government does not own shares in Sanlu [Hebei Sheng Fu Shengzhang; Zhengfu Zai Sanlu Jituan Youxian Gongsi zhong Meiyou Gufen] (in Chinese) <<http://news.cctv.com/china/20080913/103040.shtml>>.

formation of the Sanlu-Fonterra joint venture. News reports suggested that if not for the exposure of the tainted milk scandal, Sanlu could have soon been listed on the Shanghai Stock Exchange.<sup>41</sup>

The extremely cosy relationship between Sanlu and the Shijiazhuang government however is highlighted by the government's extensive delay in reporting milk contamination in Sanlu to the Hebei provincial government. It took the city government thirty-eight days, instead of two hours as required by the State Council regulation as aforementioned to forward Sanlu's report to the provincial government. This means that the central government was not informed of the matter until 9 September, nine months after the first sign of melamine contamination emerged. Other reports from non-official state media however suggested that the alarm was coincidentally raised to the central government by the former New Zealand Prime Minister.<sup>42</sup>

When asked what had caused the Shijiazhuang government to sit on Sanlu's report for more than a month, allowing the effect of melamine contamination continuing to escalate, "support for local businesses" was stated as a major consideration by a spokesman of the Shijiazhuang government.<sup>43</sup> The spokesperson even invoked a letter from Sanlu which pleaded the

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<sup>41</sup>21 Century Economic Report, *Application submitted, Sanlu hopeful of getting listed in A Share Market in 2008*[Sanlu Jituan Xiangguan Cailiao Yi Baopi Youwang 2008 nian Shixian A gu Shangshi](in Chinese), found on Hexun News <<http://news.hexun.com/2008-09-17/108945053.html>>.

<sup>42</sup>The Central Party Committee and the State Council Handle Persons Involved in the Sanlu Milk Scandal Seriously[Dang zhongyang Guowu Yuan Yansu Chuli Sanlu Naifen Shijian Xiangguan Zeren Renyuan] (in Chinese), the PRC Central People's Government website <[http://www.gov.cn/jrzq/2008-09/22/content\\_1102256.htm](http://www.gov.cn/jrzq/2008-09/22/content_1102256.htm)>. There have been different stories regarding how the scandal was final exposed. Sanlu's New Zealand partner Fonterra claimed that it was informed by its Chinese Partner of the milk contamination on Aug 2, 2008. After three unsuccessful meetings with the Shijiazhuang health officials to raise the alarm, the company reported the matter to the New Zealand Foreign Affairs Department on 22 August, which led to the issue finally being brought to the attention of the Chinese central government by the former New Zealand Prime Minister on 9 September. See Richard Spencer and Peter Foster, *China milk scandal threatens giant dairy firm* <<http://www.telegraph.co.uk/news/worldnews/asia/china/3073998/China-milk-scandal-threatens-giant-dairy-firm.htm>>.

<sup>43</sup>Xinhua Net news story, *Spokesperson of the Shijiazhuang City Government: We have Undeniable Responsibility in the Sanlu Incident* [Shijiazhuang Shi Zhengfu Fayuan Ren: Sanlu Shijian Zhong Wowen You Buke Tuixie De Zeren] (in Chinese), 30 September 2008< [http://news.xinhuanet.com/newscenter/2008-09/30/content\\_10136125.htm](http://news.xinhuanet.com/newscenter/2008-09/30/content_10136125.htm)>.

government to "increase control and coordination of the media, to create a good environment for the recall of the company's problem products....to avoid whipping up the issue and creating a negative influence in society."<sup>44</sup> A Hong Kong-based newspaper reported that part of the support provided by the Shijiazhuang government to Sanlu was to assist Sanlu in importing infant formula from Australia to be repackaged and released onto the market as Sanlu product.<sup>45</sup> That association between Sanlu and the Shijiazhuang city government must have been so close that it had even "convinced" Fonterra, Sanlu's foreign partner to "work within the system" to effect an official product recall when it was finally informed of the melamine contamination by its Chinese partner. News reports suggested that Fonterra went public only after three failed meetings with the Shijiazhuang government authorities.<sup>46</sup>

It can be argued as an individual case, the implications of the role of the Shijiazhuang government in Sanlu's scandal should not be generalised. However, when the coincidence of the interests between the government and businesses is considered, one would doubt that in similar circumstances, a similarly protective approach, although maybe to a lesser extent, would not be adopted by another local government.<sup>47</sup> The share of tax revenue is one important factor that has led to the widespread local protection. With the rapid growth of the private sector and the current Chinese tax regime under which corporate tax is shared between central and local governments, many of the large private companies have become a major

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<sup>44</sup>BBC news story, China Dairy 'Asked for Cover-up' <<http://news.bbc.co.uk/2/hi/asia-pacific/7646512.stm>> ; People Net news story, *Why Reporting of Sanlu Incident was delayed* [Sanlu Shijian Weihe Chichi Bubao] (in Chinese) <[Http://paper.people.com.cn/rmrb/html/2008-10/01/content\\_112000.htm](http://paper.people.com.cn/rmrb/html/2008-10/01/content_112000.htm)>.

<sup>45</sup> Oriental Daily news story, *Sanlu Incident, Case within Case*, 30 December 2008 [Sanlu Anzhong An] (in Chinese), found on website of China Agricultural Produce Market Weekly, PRC Ministry of Agriculture <[http://www.ncpscwk.com/bglist.asp?menu\\_id=C15&NewsId=6779](http://www.ncpscwk.com/bglist.asp?menu_id=C15&NewsId=6779)>.

<sup>46</sup>Richard Spencer and Peter Foster, above n 47; Also see Wang Shanshan, *Fonterra CEO reflecting on investing in China*, *Caijing Magazine* <<http://www.caijing.com.cn/2008-12-05/110035012.html>>.

<sup>47</sup> Xinhua Net news story, *Sanlu Group Chairwoman: Related Problems emerged from tests before Milk Incident Exposed* [Sanlu Jituan Dongshi Zhang: Naifen Shijian Qian Yi Jiance Chu Xiangguan Weiti] (in Chinese) found on Sina.com <<http://news.sina.com.cn/c/2008-09-13/015716283264.shtml>>. According to the news story, an executive of the powdered milk department of Sanlu group, when commenting on the melamine malpractice by dairy farmers, told the Xinhua reporter, "This is a blain of the whole dairy industry, unfortunately, it has broken by Sanlu this time."

source of revenue for local governments.<sup>48</sup> However, on a broader policy level, local economic growth measured by GDP growth, as well as tax revenue forms an important part of the performance of the local governments, who are assessed by their higher authorities on that basis.<sup>49</sup> As such, the more milk sold by the dairy companies means not only increases in local revenue but also stronger performance of the local officials. In Sanlu's case, the company contributed 330 million yuan (US\$48.5 million) in tax revenue to the municipal government in 2007 alone<sup>50</sup> and has won the company the honour of hosting one of the top 500 enterprises in China. Conversely, the company has remained on the list of "the key enterprises supported by the Shijiazhuang city and Hebei Province." Sanlu's Chairperson and CEO, Ms Tian Wenhua was given "more than 100" national and local honorary titles including representative to the National People's Political Consultative Conference and the Hebei Provincial People's Congress.<sup>51</sup>

If the role of the Shijiazhuang government in the Sanlu scandal could be seen as an extreme example of government overstepping its fundamental role as a regulator to become a conspirator with businesses, the role of the AQSIQ, China's food safety watchdog, in attributing to the scandal reflects the cosy relationship between government and businesses in a more subtle way. In balancing the conflict between cost of compliance for businesses and the fundamental public interest in food safety, the AQSIQ has apparently leaned towards the former at the sacrifice of the latter. Rather than focusing on setting and enforcing food safety

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<sup>48</sup> Shenzhen Stock Exchange Research Institute, *An Empirical Study on the Development of China's Private Sector Listed Companies*, January 2008, <http://www.szse.cn/main/files/2008/02/25/091811911155.pdf>. At the end of 2005, accounting for more than 57% of all enterprises in China, the private sector contributed to 65% of China's GDP, and absorbed more than 75% of the urban employment.

<sup>49</sup> Xinhua Net news story, *Member of the Standing Committee of the National People's Congress Criticising Distortional Government Performance View: Local GDP Figures Shall be Disregarded*[Renda Weiyuan Pengji Nuqu Zhengji Guan: Difang GDP Tongji Ying Quxiao] (In Chinese) <[http://news.xinhuanet.com/fortune/2008-12/29/content\\_10572701.htm](http://news.xinhuanet.com/fortune/2008-12/29/content_10572701.htm)>.

<sup>50</sup> Willy Lam, *Milk scandal sours China's 'soft power'*, Asia Times <http://www.atimes.com/atimes/China/JJ10Ad02.html>.

<sup>51</sup> Xinhua Net news story, *Four Former Sanlu Senior Executives including Chairwoman Tian Wenhua Stood for trial in Shijiazhuang Today*[Sanlu Jituang Yuan Dongshi Zhang Tianwen Hua De Sining Gaouan Shijiazhuang Shoushen](in Chinese), Xinhua net [http://news.xinhuanet.com/legal/2008-12/31/content\\_10583852.htm](http://news.xinhuanet.com/legal/2008-12/31/content_10583852.htm).

standards, part of its function has been directed to providing businesses with important marketing tools through activities such as granting food quality inspection exemption qualifications and sponsoring brands and products competitions,<sup>52</sup> which to a certain extent heightened the political sensitiveness of the scandal.

The system of quality inspection exemption was introduced in 2000 to grant companies meeting certain standards the quality inspection-free status on a three-year basis. Most of the companies granted the status were “China’s famous brands” that had been recognised by the State Bureau of Industry and Commerce. The implementation of the system according to AQSIQ was to “ease the burden for companies that otherwise would undergo repeated inspections.”<sup>53</sup> This controversial system remained in place for eight years before it was scrapped by the AQSIQ in the aftermath of the 2008 milk scandal. It had since led more than 1500 companies including major dairy giants involved in the milk scandal such as Sanlu, Mengnui and Yili to enjoy the quality inspection-free status. This was so despite the fact that alarms were repeatedly raised by a series of major scandals that hinged on the fundamental issue of food safety in China, which included a separate incident in 2004 where about ten babies were killed by fake or defective infant formula in the Fuyang city of Anhui Province.<sup>54</sup>

In addition to the repeated food safety scandals, what has made the business promotion activities engaged in by the AQSIQ an inappropriate exercise is probably China’s general lax regulation on food safety. As the WHO has pointed out in the aftermath of the tainted milk scandal, “safety enforcement is dispersed among too many agencies” ranging from health, agriculture, quality inspection to industrial and commercial authority at “different levels of government,” but with no one agency holding the bottom line.<sup>55</sup> In the aftermath of the scandal, the essentially non-existent regulation of milk source has been noted by the Minister

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<sup>52</sup> China Youth Daily, above n 39..

<sup>53</sup> Caijing Magazine news story, *Food Product Inspection Waivers Revoked* <<http://english.caijing.com.cn/2008-09-18/110013644.html>>.

<sup>54</sup> China Daily news story, *Milk powders kill babies in Anhui province*, 20 April 2004 <[http://www.chinadaily.com.cn/english/doc/2004-04/20/content\\_324727.htm](http://www.chinadaily.com.cn/english/doc/2004-04/20/content_324727.htm)>

<sup>55</sup> U.N. Responds to Recent China Food Safety Scandal <<http://www.newsinferno.com/archives/4069>>

of Agriculture who attributed the regulatory vacuum to the novelty of the milk stations.<sup>56</sup> The Minister's remark is a little curious given that the irrational expansion of the Chinese dairy industry started as early as eight years ago and by the time the 2008 scandal erupted, the Chinese dairy industry had relied upon milk dealers for 60% of their source milk.<sup>57</sup>

Whilst the roles played by the Shijiazhuang city government and AQSIQ in the 2008 milk scandal can be differentiated in that the involvement of the former was more deliberate and probably more culpable, both roles perhaps find their justification in the top-down government emphasis on economic growth, motivated by practical concerns and the good intentions of the central government. In the 2008 China milk scandal, that policy priority has unfortunately produced some unintended consequences. The overemphasis on economic growth has contributed to the loss of focus of the regulatory authority in the interests of minimising businesses' compliance costs. Further, that loss of regulatory focus, manifested in part in government protection of businesses, has, directly or indirectly, contributed to the excessive-risk taking and irrational competition among the dairy companies, which further led to the companies' lax internal controls, and in some circumstances, outright ignorance of law in pursuit for profits. In Sanlu's case, with no sign of law enforcement from the Shijiazhuang city government, Sanlu continued its extensive cover up of the scandal even after the melamine contamination was confirmed and reported by Sanlu to the Shijiazhuang city government. Through the trial of Sanlu executives, it was further revealed that during the 38 days in which Sanlu's report was with the Shijiazhuang government, Sanlu continued to accept melamine tainted raw milk and used it in products other than baby formula. This was

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<sup>56</sup> Caijing Magazine news story, *Minister of Agriculture Recognises Control Vacuum on Milk Collection Stations*[Nongye buzhang Chengren Naizhan Jianguan Shikong] (in Chinese), 23 September 2008 <<http://www.caijing.com.cn/2008-09-23/110015188.html>>.

<sup>57</sup> Sina news story, *Tracing the Origin of the Chinese Dairy Industry Crisis: Opportunities for Establishing a Rational Industry Missed Out During Eight Years of Development*[Zhongguo Naiye Weiji Suyuan: banian cuoshi duoci jianli zhixu qiji](in Chinese), 09 October 2008 <<http://news.sina.com.cn/c/2008-10-09/094616423192.shtml>>.

explained by one of the Sanlu executives on trial as “the company could not afford to lose its milk source to its competitors”.<sup>58</sup>

The close association of the businesses with government particularly the local government in the exposure of the tainted milk scandal leads us to a brief examination of the approach adopted by the central and local government in the aftermath of the scandal. Given the broad economic and societal impact of the scandal, some of the measures adopted by the governments at various levels were not surprising, especially if we take into account the massive bail out packages that have been adopted by governments of various nations during the recent global financial crisis, but others have clearly reflected continuing government intervention in business in the interest of economic growth and social stability, which is interrelated with the former objective.

#### **Part 4: Handling of the tainted milk scandal**

Apart from leaving behind close to 300,000 baby victims, the exposure of the 2008 China milk scandal, involving almost all of the large and medium-sized Chinese dairy companies, has clearly thrown its fast expanding dairy industry into a deep crisis. Whilst the Sanlu group of 30 subsidiaries and entities became essentially insolvent, other dairy giants including Yili and Mengniu were clearly hit hard. Dairy sales slumped with lost consumer confidence and worldwide bans on Chinese dairy products.<sup>59</sup>

The significant importance the central government attaches to the scandal is shown by a broad range of measures the government promptly adopted in the aftermath of the scandal. Massive dairy product recalls were issued, food safety standards tightened and free medical

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<sup>58</sup> China Youth Daily, above n 39.

<sup>59</sup> China Securities Daily news story, *China Dairy Crisis, Industry Restructuring Inevitable* [Zhongguo Ruyue Weiji- Hangye Xipai Buke Bimian] (in Chinese), China Securities Daily, 22 September 2008 < [http://www.cs.com.cn/xwzx/05/200809/t20080922\\_1591661.htm](http://www.cs.com.cn/xwzx/05/200809/t20080922_1591661.htm)>.

examination and treatment were also ordered for melamine affected children. Charges have been laid against more than twenty milk station operators, “protein powder” producers and the disgraced Sanlu Chairman and executives. A number of government officials at both central and local levels have also “stepped down” or been sacked (though no charges have been reportedly laid against any of them).<sup>60</sup>

Needless to say one of the most contentious issues arising from the milk scandal is compensation for the near 300,000 victims who were fed Sanlu’s lower end infant formula product by their middle to low income families. Should the scandal occur in a mature market economy such as Australia, it is likely that one would expect a flood of lawsuits brought to the court by the families of tort victims or these days more probably, class actions being pursued on behalf of those victims against the tortfeasor companies as well as the Shijiazhuang city government should it be evident that the government had played a role in exacerbating the loss or injury suffered by the victims. If any dairy company, such as Sanlu, became insolvent or nearing insolvency due to massive debts owed to their tort and contract creditors, external administration such as voluntary administration or liquidation may be applied to the company.

In the aftermath of the tainted milk scandal, whilst the other dairy giants have apparently survived the incident with a great deal of self-help and some help from the government (in the form of government subsidies provided to both companies and dairy farmers and massive media campaigns to restore consumer confidence), Sanlu, the corporate group most seriously affected by the scandal, was clearly on the verge of bankruptcy. Media predicated that whilst Sanlu’s fifteen billion yuan brand name had become worthless, the company at the outbreak of the scandal faced potential claims of 0.7 billion yuan from its trade creditors alone. This

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<sup>60</sup> Xin Hua net news stories, *Updates on Sanlu Infant Formula Incident*[Sanlu Pai Yingyou Er Naifen Shijian Gundong Baodao] (in Chinese) 20 September 2008 <[http://news.xinhuanet.com/newscenter/2008-09/20/content\\_9935963.htm](http://news.xinhuanet.com/newscenter/2008-09/20/content_9935963.htm)>.

means that with the 1.224 billion yuan net assets accumulated by the end of 2007, Sanlu might not be able to meet all potential claims in tort and contracts against the company.<sup>61</sup>

Strangely, during the four months from the eruption of the scandal on 11 September to 23 December 2008 when Sanlu was finally declared bankrupt by the Intermediate Court of Shijiazhuang city in response to a bankruptcy application filed by a state-owned bank, no other claims or application for external administration against the company had been reportedly heard by any Chinese courts.<sup>62</sup> It was not that no one had sued. China News Weekly (a local media), reported that on 29 October the families of nine Sanlu tainted milk victims took the corporate group to a local court in Shijiazhuang. The court officials refused their application materials straightaway, stating that ‘given the wide impact of the incident,’ it is ‘waiting for a compensation plan to be issued by the government.’<sup>63</sup> No written court order in relation to those applications was subsequently issued.<sup>64</sup> Other news reports indicated similar occurrences with courts in other provinces, which included court’s refusal to hear a collective action brought by a group of volunteer lawyers on behalf of sixty-three families.<sup>65</sup> In terms of bankruptcy applications, a report carried by Beijing Commerce suggested that as early as September 2008, a Beijing-based Sanlu sales agent submitted a bankruptcy application against Sanlu in the Shijiazhuang Intermediate Court, the court now hearing

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<sup>61</sup> ChinaNews news story, *Compensation Claims against Sanlu Suspended: Who to Compensate the Victims?* [Sanlu Suopei Zhanbu Lian, Shuilai Peichang Shouhai Zhe?](in Chinese) 11 November 2008 <<http://www.chinanews.com.cn/cj/xfsh/news/2008/11-11/1445254.shtml>>.

<sup>62</sup> Xinlu Net news story, *The non-judicial acceptance of tort claims associated with the milk scandal explained by Vice-president of the Hebei Lawyers Association* [Jieshi Huaner Minshi Peichang An wuyi Huo shouli Hebei Lvxie jieshi](in Chinese) <[http://news.xinhuanet.com/legal/2009-01/07/content\\_10615043.htm](http://news.xinhuanet.com/legal/2009-01/07/content_10615043.htm)>.

<sup>63</sup> China News, above n 61.

<sup>64</sup> PRC Civil procedure Law, Article 112. The article provides that “when a people’s court receives a statement of complaint or an oral complaint and finds after examination that it meets the requirements for acceptance, the court shall place the case on the docket within seven days and notify the parties concerned; if it does not meet the requirements for acceptance the court shall make an order within seven days to reject it”.

<sup>65</sup> Xinmin Net news story, *Lawyers call for support for tainted milk victims to take up legal actions: issuing certificates to victims recommended* [Lushi Huyu Zhichi Sanlu Shouhai Zhe Susong: Jiye Xiang Huaner Fa Queren Shu] (in Chinese), 9 October 2008; New York Times news story, *Court compound pain of Chinese tainted milk*, 17 October 2008 <<http://www.nytimes.com/2008/10/17/world/asia/17milk.html?fta=y>>.

Sanlu's bankruptcy case, but was refused of the application with no reason clearly given.<sup>66</sup> If the relatively small number of reported court petitions could be partly explained by the traditional Chinese mentality to resort to government rather than court redress for dispute resolutions, the lack of judicial access for those few petitions could probably only be explained with political factors.

It is not that the current Chinese law has not provided any redress for tort victims. The General Principles of Civil Law enacted in 1986, which sets out a basic framework for Chinese civil and commercial legislation, imposes on manufacturers as well as sellers the liability for economic loss and physical injury caused by defective goods.<sup>67</sup>

That general statement has been reinforced in at least two pieces of legislation on consumer protection, i.e., the Law for the Protection of Consumer Rights and Interests (hereafter referred to as the Consumer Protection Law) and the Law on Product Quality Liability. Article 35 of the Consumer Protection Law, echoed in Article 43 of the Product liability Law, enables a "consumer or other victim" who has suffered economic loss or physical injury because of defective goods to claim compensation from the seller as well as the manufacturer. In relation to the heads of damages, a tort victim can claim "medical expenses, nursing expenses during medical treatment, the reduced income for loss of working time and other expenses".<sup>68</sup> Should a consumer or victim be "disabled" by the defective product, such compensation should also include "the victims' expenses on self-help devices, living allowances, compensations for disability and the necessary living cost of the persons supported by the disabled". Further, should death be caused, the defendant will also need to "pay funeral expenses, death compensation and the necessary living cost of the persons supported by the deceased during their lifetime."<sup>69</sup> Although neither compensation for pain and suffering ("mental and spiritual

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<sup>66</sup> Beijing Commerce news story, *Sanlu Bankruptcy, Disappear or Reborn?* [Sanlu Pochan an, Shi Xiaoshi Haishi Niepan] (in Chinese) 5 January 2009 < [http://news.xinhuanet.com/fortune/2009-01/05/content\\_10604233.htm](http://news.xinhuanet.com/fortune/2009-01/05/content_10604233.htm)>.

<sup>67</sup> PRC Civil Procedure Law, Article 122.

<sup>68</sup> Consumer Protection Law, Articles 41 and 42, echoed by Article 44 of the Product Quality Liability Law.

<sup>69</sup> *Ibid.*

loss” in Chinese terms) nor exemplary damages have been provided in any Chinese legislation, it is not rare for the court to award such compensation either under the head of “compensation for disability” “compensation for death” or in accordance with a judicial opinion issued by the Supreme People’s court, namely, the ‘Explanation on Several Issues Relating to the Assessment of Compensation for Mental Loss in Civil Litigation’<sup>70</sup> to guide decision-making by lower courts.

In relation to the forms of litigation, the Civil Procedure Law of the PRC provides for actions brought by individuals as well as a “collective action” which shares certain similarities with an Australian style class action. A Chinese “collective action” under the Civil Procedural Law, enables the persons comprising a class to “elect representatives from among themselves to act for them in the litigation”<sup>71</sup>. “Where the object of action is of the same category and the number of persons comprising one of the parties is large but uncertain in number at the commencement of the action, the people's court may issue a public notice...informing those entitled to participate in the action to register their rights with the court within a fixed period of time.”<sup>72</sup> The acts of such representatives in the litigation shall be valid for the class they represent.<sup>73</sup> A Chinese collective action differs from an Australian class action in that any “modification or waiver of claims or admission of the claims of the other party or pursuing a compromise with the other party by the representatives shall be subject to the consent of the party they represent.”<sup>74</sup> The court decision in a collective action is binding not only upon those who have registered their rights with the court, but also those “who have not registered their rights but have instituted legal proceedings during period of limitation of the action.”<sup>75</sup>

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<sup>70</sup> An Explanation on Several Issues Relating to The Assessment of Mental and Spiritual Loss in Civil Litigation by the Supreme People’s Court [Zuigao Renmin Fayuan Guanyu Queding Minshi Qinquan Jingshen Sunhai Peichang Zeren Ruogan Wenti de Jieshi] (in Chinese) in 2001.

<sup>71</sup> PRC Civil Procedure Law, Article 54.

<sup>72</sup> PRC Civil Procedure Law, Article 55 (1).

<sup>73</sup> PRC Civil Procedure Law, Article 55(3).

<sup>74</sup> PRC Civil Procedure Law, Article 55(4).

<sup>75</sup> PRC Civil Procedure Law, Article 55(4).

The fairly comprehensive Chinese law on consumer protection is not totally in accordance with the lack of involvement of the court in the aftermath of the milk scandal. It is true that the Chinese law, having followed the civil law tradition, is in many cases drafted in a too broad and abstract a manner to provide the court with clear guidance. However, that gap caused by the lack of clear, detailed and operative rules has been frequently filled in the past by the judicial creativity of the court, primarily in the form of judicial opinions issued by the Supreme People's Court. The aforementioned Explanation issued by the Supreme People's Court on the assessment of compensation for mental loss in civil actions is one example. However, that sort of judicial creativity' would probably not be invoked in handling such politically sensitive disputes as those arising from the tainted milk scandal. The highly sensitivity of the scandal, especially the potential bad publicity a slew of law suits could cause has apparently led the courts to default their primary dispute resolution responsibilities to the government.<sup>76</sup>

Apart from the compensation for tort victims, the government intervention is also manifested in the handling of the demise of Sanlu. The placing Sanlu into liquidation would be a good test case for the newly enacted Enterprise Bankruptcy Law (hereafter referred to as the 'EBL'). The EBL, enacted in August 2006, was to replace an old bankruptcy law which had operated on a trial basis for two decades and applied to SOEs only. Drawing upon international experience in insolvency law and practice, the new legislation provides for bankruptcy procedures including liquidation, compromise as well as an American style reorganisation.

However, although Sanlu eventually did not avoid a court-ordered liquidation, a court-ordered liquidation was never intended by the Hebei and Shijiazhuang government when the scandal first broke. This was despite the fact that in the past most government interventions in enterprise bankruptcy had concerned with state-owned enterprises. As discussed below, for

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<sup>76</sup> New York Times news story, above n 69. In Sanlu's case a member of the Sanlu restructuring team organised by the Shijiazhuang government told China News Weekly that "The Supreme People's Court has given the Hebei Province three to Six months to resolve the issues. The court cannot refuse to accept complaints by consumers forever." See The China News news story, above n 67.

Sanlu, having the company taken over by another company rather than placing it into liquidation was preferred by the government clearly for economic considerations. The value of the “intangible assets” accumulated by Sanlu over the past twenty years, ranging from its advanced production and marketing systems to its extensive network for source milk could be better realised through a takeover. In addition, the government saw that there is a greater chance for Sanlu to repay its debts if business in Sanlu continues.<sup>77</sup>

The plan emerged on 26 September, when the shares of Shanghai-listed Beijing Sanyuan Food were suspended and the company announced that Sanyuan received a government notice to consider a Sanlu merger plan.<sup>78</sup> Commentators said Sanyuan has been selected to takeover Sanlu for two reasons: first, the company is the major Chinese dairy company that has not been implicated by the scandal (largely due to its reliance on self-sufficient dairy farms for source milk) and secondly, Sanyuan is a state-controlled company which makes it easier to push.<sup>79</sup>

The proposed Sanyuan merger with Sanlu has been widely regarded as “an impossible mission” from a pure market sense.<sup>80</sup> Whilst Sanlu has been Chinese dairy giant controlling about 30 subsidiaries and other forms of business entities around the country, Sanyuan, with annual sales amounting to only 10% of Sanlu, was largely unknown by consumers outside Beijing. Despite Sanyuan’s claim that the acquisition would raise its market competitiveness by adding to its current liquid milk business an extra line of business in powdered milk, industry suggested that problems such as business integration and cash flow, particularly with

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<sup>77</sup>Beijing Commerce News Story, *Sanlu Bankruptcy, Disappear or Reborn?* [Sanlu Pochan an, Shi Xiaoshi Haishi Niepan] (in Chinese) 5 January 2009< [http://news.xinhuanet.com/fortune/2009-01/05/content\\_10604233.htm](http://news.xinhuanet.com/fortune/2009-01/05/content_10604233.htm)>.

<sup>78</sup> China Economy Net news story, *Sanyuan May Take over Tainted Milk Brand Sanlu*, 27 September 2007 <[http://en.ce.cn/Business/Enterprise/200809/27/t20080927\\_16935772.shtml](http://en.ce.cn/Business/Enterprise/200809/27/t20080927_16935772.shtml)>.

<sup>79</sup> Xinhua Net news story, *Insiders comment on Sanyuan Sanlu merger; Sanyuan left without free will* [Zhiqing renshi tan Sanyuan Binggou Sanlu; Sanyuan Shenbu Youji] (in Chinese) , 4 January 2009<[http://news.xinhuanet.com/fortune//2009-01/04/content\\_10598930.htm](http://news.xinhuanet.com/fortune//2009-01/04/content_10598930.htm)>.

<sup>80</sup> Shanghai Securities Daily news story, *Wandashan Watching Sanlu Restructuring: Sanyuan Likely to Fight Alone*[Sanlu: Wanda Shan Pangguan Sanyuan Huo Gudu Poju] in Chinese, 5 November 2008 [http://cs.xinhuanet.com/cqzk/05/200811/t20081120\\_1659972.htm](http://cs.xinhuanet.com/cqzk/05/200811/t20081120_1659972.htm).

the indeterminable amount of potential claims faced by Sanlu, could eventually drag Sanyuan into insolvency. In addition, the fundamental problem that had led to the collapse of Sanlu, i.e., the heavy reliance on milk dealers for its source milk, could pose a potential threat to the Sanyuan's branding. However, with the backing of Beijing and Hebei governments, the takeover negotiation continued for months, though not always smoothly.<sup>81</sup>

The Sanyuan takeover plan was not successful, and was followed by an order of the Shijiazhuang Intermediate Court placing Sanlu into bankruptcy liquidation as petitioned by a local branch of a state-owned bank, a Sanlu's creditor.<sup>82</sup> On 12 January 2009, a public notice was issued by the court, inviting creditors to file their claims with the bankruptcy administrator appointed by the court within 30 days.<sup>83</sup> With news reports indicating that some core enterprises in the Sanlu group have resumed production under a lease agreement with Sanyuan, commentators say that the "government-led bankruptcy" of Sanlu will probably work more favourably to Sanyuan, as it provides Sanyuan with the opportunity to acquire Sanlu's assets through bankruptcy auctions without taking over its debt.<sup>84</sup>

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<sup>81</sup> Xinhua Net news story, *Sanyuan Taking over Sanlu, A sensitive Case*[Sanyuan Binggou Sanlu: Guanxi Mingan de Juzhong Ju] (in Chinese), 2 January 2009< [http://news.xinhuanet.com/fortune/2009-01/02/content\\_10590487.htm](http://news.xinhuanet.com/fortune/2009-01/02/content_10590487.htm)>

<sup>82</sup> Article 70 of the EBL provides that 'A debtor or creditor may, according to the provisions of the present Law, apply directly with the people's court for rectification against the debtor. Where any creditor applies for bankrupt liquidation against its debtor, after the people's court accepts the application for bankruptcy and before the debtor is announced bankrupt, the debtor or its capital contributor whose capital contribution makes up 1/10 or more of the debtor's registered capital may apply with the people's court for rectification.' In Sanlu's case, it appears that the bankruptcy proceedings have proceeded as liquidation in stead of a reorganisation, as no application for reorganisation has been filed with the court before Sanlu was declared bankrupt.

<sup>83</sup> Caijing Magazine news story, Sanlu Bankruptcy Proceedings Commenced: Creditors to File Claims, [Sanlu Pochan An Qidong Zhaiquan Ren Dengji](in Chinese)<<http://www.caijing.com.cn/2009-01-13/110047651.html>>. Article 14 of the EBL provides that the court hearing the bankruptcy proceedings shall "within 25 days from the date it has accepted a bankruptcy application, notify known creditors and issue a public notice to that effect". Under Article 45, once the court has accepted an application for bankruptcy, it must also set a time limit for creditors to file their claims, and that time limit should be within a range of no less than 30 days but not more than three months from the date the public notice of the court's acceptance of the bankruptcy application was issued.

<sup>84</sup> Xinhua Net news Story, Sanlu to be declared bankruptcy: Rumoured in favour of Sanlu [Sanlu Jiang Xianggao Pochan Chuanyan lihao Sanlu Shougou] (in Chinese) 23 December 2008<[http://news.xinhuanet.com/fortune/2008-12/23/content\\_10547631.htm](http://news.xinhuanet.com/fortune/2008-12/23/content_10547631.htm)>

With the commencement of Sanlu bankruptcy proceedings, will a slew of law suits brought by the tort victims be triggered? At the time of writing, it is not clear how many tort claims would be integrated into Sanlu bankruptcy liquidation (with the 30 day time limit for filing claims yet to expire), the evidence however suggests that with the “pre-arrangement” of the central and local government, only a minority, if any, claims will end up in court. On 10 December, after three months of contention surrounding the issue of the victims compensation, the Ministry of Health, issued a media release stating that "relevant departments are now considering a compensation plan for the Sanlu infant milk powder incident," and “the Ministry was compiling information about the victims who may receive compensation”.<sup>85</sup> So far there has been no further information on the details of the plan and how it would interact with the Sanlu bankruptcy procedure. However, on 30 December 2008, one week after Sanlu was declared bankrupt, the state media China Daily revealed that the twenty-two dairy companies involved in the infant formula scandal (including Sanlu) had committed 900million yuan (US\$131 million) as “one-off compensation”<sup>86</sup> to all tort victims. In terms of the standards of compensation, the newspaper indicated that

*families of children who died after drinking the contaminated milk will each receive 200,000 yuan (US\$29,000), and seriously sickened children will receive about 30,000 yuan (US\$4,400) each. Those suffering minor kidney problems from the tainted milk will each receive 2,000 yuan (US\$292).*

In addition, the twenty-two companies will establish a 200 million yuan fund to be managed by the China Dairy Industry Association to “cover medical bills for any lingering problems related to the tainted milk.”<sup>87</sup> Further comment made on the operation of the fund by the Vice-Chairman of the Hebei Lawyers Association suggested that the fund will allow the tort victims

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<sup>85</sup>Xinhua News Story, Relevant Chinese Departments Considering a Compensation Plan for Problem Powdered Milk Victims [Zhongguo Xiangguan Bumen Zhengzai Taolun Wenti Naifen Shijian Peichang Fangan] (in Chinese), 10 December 2008< [http://news.xinhuanet.com/newscenter/2008-12/10/content\\_10484532.htm](http://news.xinhuanet.com/newscenter/2008-12/10/content_10484532.htm)>.

<sup>86</sup>China Daily News Story, 22 dairy firms to pay \$160m in compensation, 30 December 2008 < [http://www.chinadaily.com.cn/cndy/2008-12/30/content\\_7351554.htm](http://www.chinadaily.com.cn/cndy/2008-12/30/content_7351554.htm)>.

<sup>87</sup>Ibid.

to have access to insurance coverage with a leading state-controlled insurance company, as arranged by the dairy companies, for the “full amount of medical bills related to the tainted milk incurred before they turn to 18 years of age”.<sup>88</sup>

Although this appears to be purely enterprise conduct, a non-state media source suggested that the 902 million yuan contributed by Sanlu one week before it was declared bankrupt was raised “with the assistance” of the Shijiazhuang government.<sup>89</sup>

Further reports provided by the State media Xinhua indicated that the implementation of the compensation scheme has been highly successful. The overwhelming majority (90.7%) of the near 300, 000 victim families have taken up the offer made by the dairy companies.<sup>90</sup> This is so despite previous reports on various criticisms surrounding the adequacy of the compensation proposed. For example, one report indicated that “many parents find the 2000 yuan for ‘the minor kidney problems’ too inadequate to accept.”<sup>91</sup>

The fact that most tort victim families have given up a judicial redress for their claims against the dairy companies is not surprising. Lying at the bottom of the priority for distribution of bankruptcy assets together with other unsecured creditors,<sup>92</sup> there is no guarantee that they

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<sup>88</sup> Xinlu Net news story, *The non-judicial acceptance of tort claims associated with the milk scandal explained by Vice-president of the Hebei Lawyers Association* [Jieshi Huaner Minshi Peichang An wuyi Huo shouli Hebei Lvxie jieshi](in Chinese) < [http://news.xinhuanet.com/legal/2009-01/07/content\\_10615043.htm](http://news.xinhuanet.com/legal/2009-01/07/content_10615043.htm)>.

<sup>89</sup> China News news story, *Shijiazhuang Official Claims Raising Fund for Sanlu's Debt Repayment by a Guarantee on Government Office Buildings Untrue* [Shijiazhuang Guanfang Cheng Diya Zhengfu Dayuan Chou Sanlu Peikuan Yiwu Xuyou](in Chinese), 8 January 2009 < <http://www.chinanews.com.cn/gn/news/2009/01-08/1520359.shtml>>.

<sup>90</sup> Xinhua Net news story, *Over 90% of Tort Victims of the Problem Powdered Milk Incident Voluntarily Accepted the Compensation* [Chao 90% Yingyou Er Naifen Shijian Huaner Jiazhang Yi Jieshou Zhudong Peichang](in Chinese) 24 January 2009 < [http://www.he.xinhuanet.com/news/2009-01/24/content\\_15543516.htm](http://www.he.xinhuanet.com/news/2009-01/24/content_15543516.htm)>.

<sup>91</sup> China Daily news story, *22 dairy firms to pay \$160m in compensation* < [http://www.chinadaily.com.cn/cndy/2008-12/30/content\\_7351554.htm](http://www.chinadaily.com.cn/cndy/2008-12/30/content_7351554.htm)>. Other criticisms on the inadequacy of compensation plan related to the scope and the period of the insurance coverage and the lack of involvement of the families of the tort victims in the formulation of the scheme.

<sup>92</sup> The order of distribution of bankruptcy assets established by Article 113 of the EBL is as follows: (1) bankruptcy expenses and common benefits debts (certain debts incurred by the debtor company after the commencement of the bankruptcy proceedings such as those arising from agency by necessity or personal loss or injury caused by the company property; (2) unpaid wages and other welfare payments; (3) unpaid social insurance premiums and taxes; (4) unsecured claims; Where the insolvent assets are not enough to satisfy the

could receive more than what the dairy companies have provided, not to mention the formidable legal and financial difficulties these families could encounter in filing their proofs of debt with the bankruptcy administrator. The admissible forms of proof of debt under Article 47 of the EBL include judgement and arbitration and pending judgment and arbitration debts.<sup>93</sup> Without a court having heard their claims, the tort victims do not have judgements or pending judgements to submit to the bankruptcy administrator as proof of debt. Now they have thirty days (the time limit given by the bankruptcy administrator for filing claims and proofs of debt) to lodge their claims with the Shijiazhuang Intermediate Court, as Article 21 of the EBL provides that once a bankruptcy application against a debtor company has been accepted by the court, any civil claims against the debtor can only be lodged with that court hearing the bankruptcy case.<sup>94</sup> Assuming that the court is prepared to hear such claims from the tort victims, the tight deadline for them to prepare and lodge their cases could be a further hurdle to conquer.

On the other hand, even if their proofs of debt are accepted by the bankruptcy administrator, the tort victims may find that there are insufficient assets to satisfy their claims, particularly due to a separate debt repayment agreement Sanlu has entered into with its sales agents. The validity of the agreement, apparently an unfair preference/voidable transaction with a related party under the Australian Corporations Act,<sup>95</sup> is also questionable under the EBL. On 10 October Sanlu repaid 30% of its total 1 billion yuan debt owed to the sales agents to “ensure prompt recalls of the company’s problem product”.<sup>96</sup> The repayment was made through Sanlu Trading Co., a wholly-owned subsidiary of Sanlu. In the meantime, Sanlu, “in the name of

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debts in the same ranking, the *pari passu* rule will apply. Note that there is currently a debate among the Chinese legal scholars on whether the debt owed to tort victims by Sanlu should be classified as common benefits debt.

<sup>93</sup> Note in relation to the forms of proof of debt, the EBL has adopted a much narrower approach compared with s553 (1) of the Australian Corporations Act which includes “all debts payable by and all claims against the company (present or future, certain or contingent, ascertained or sounding only in damages)” arising before the commencement of the winding up.

<sup>94</sup> PRC Enterprise Bankruptcy Law, Article 21.

<sup>95</sup> The Australian Corporations Act 2001 (Cth), ss 588FE(2) and s588FE (5).

<sup>96</sup> Shijiazhuang City Government Report on Sanlu Bankruptcy Case (full text), Xinhua Net <[http://news.xinhuanet.com/fortune/2008-12/25/content\\_10557898.htm](http://news.xinhuanet.com/fortune/2008-12/25/content_10557898.htm)>.

Sanlu trading”, also committed that it will make a “certain percentage” of further repayment “at around 10 January 2009” and pay off the remaining within half a year after production in Sanlu resumes.<sup>97</sup> In the evening of 23 December, the day on which Sanlu was delivered the bankruptcy order, at the petition of hundreds of sales agents gathering at the Sanlu headquarters and before the Hebei provincial government, the “certain percentage” which had been committed by Sanlu was clarified as “30%” after a meeting held between the “the Hebei Provincial Communist Party Committee, the Provincial government, and the Shijiazhuang Party Committee and the government”. The Hebei and Shijiazhuang governments also agreed to “guarantee the coordination of the full repayment should Sanlu have difficulties in repaying the debts”.<sup>98</sup> The written statement issued by the Shijiazhuang government reveals the real concern that prompted the government to commit to the separate repayment to Sanlu’s sales agents:

*“The sales agents participating in the petition reached 300. The general mood was calm. No irrational behaviour such as protest emerged. The incident has been dealt with smoothly.”*<sup>99</sup>

In strict legal sense, the validity of both the payment made by Sanlu for the compensation of tort victims and the separate repayment agreed it has entered into with the sales agents is doubtful under the EBL. Once the Sanlu’s bankruptcy procedure has commenced, any agreement for the further repayment of debts by Sanlu to its sales agents is void under Article 16 of the EBL. In addition, both the payment made by Sanlu to the China Dairy Industrial Association as tort victims compensation and the first 30% instalment payment it made to the sales agents may have constituted voidable transactions under Article 32 of the EBL. The Article says that where a debtor company is insolvent or nearing insolvency, any separate repayment made by the company to any individual creditors within six months before the

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<sup>97</sup>Shijiazhuang City Government Report on Sanlu Bankruptcy Case (full text), Xinhua Net <[http://news.xinhuanet.com/fortune/2008-12/25/content\\_10557898.htm](http://news.xinhuanet.com/fortune/2008-12/25/content_10557898.htm)>.

<sup>98</sup>Ibid.

<sup>99</sup> Ibid.

court has accepted a bankruptcy application against the company may be avoided by the bankruptcy administrator. The net assets of Sanlu, as indicated by the Shijiazhuang government on 24 December, was evaluated as -201 million yuan on 31 October. This means that Sanlu's payment to the Dairy Industrial Association on 17 December took place when the company had become insolvent and its first 30% debt repayment to the sales agent on 10 October may have contributed to the insolvency of the company.

However, it is questionable that the bankruptcy administrator, headed by an official of the Shijiazhuang State-owned Assets Supervision Commission,<sup>100</sup> will exercise its power to reclaim any of those payments which have been made or committed by Sanlu "under the support of the city and provincial governments".<sup>101</sup> The fact that the aforementioned Sanlu Trading Co., the wholly-owned subsidiary of Sanlu (which has entered into the separate debt repayment agreement on behalf of Sanlu with Sanlu's sales agents), has been excluded from the bankruptcy order against Sanlu is also indicative of the opposite.<sup>102</sup> As such, the statement made in Fonterra's media release on its website that "Sanlu will now be managed by a court-appointed receiver who will assume responsibility for an orderly sale of the company's assets and payment of creditors"<sup>103</sup> is probably only wishful thinking. The Sanlu bankruptcy liquidation is still ongoing. However no matter what the final outcome is, it is likely to be one that is manipulated by political rather than judicial decisions.

From a utilitarian perspective, the handling of the tainted milk scandal by the central and local Hebei governments arguably have achieved the maximum results for the maximum number of

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<sup>100</sup> Sina news story, *14 member Sanlu Bankruptcy liquidation team formed*[Sanlu Pochan Qingsuan Xiaozu Shisi Ren Zucheng] (in Chinese) 31 December 2008<<http://finance.sina.com.cn/chanjing/b/20081231/07105705498.shtml>>.

<sup>101</sup> Shijiazhuang City Government Report on Sanlu Bankruptcy Case (full text), above n 106.

<sup>102</sup> Xinjing Daily News Story, *Sanlu to be sold through bankruptcy auction; total debts estimated at near 2 billion yuan*[Sanlu pochan paimai huanzha, guji sanlu zong fuzhai jin 20 yiyuan] (in Chinese), 25 December 2008, found on Xinhua Net<[http://news.xinhuanet.com/fortune/2008-12/25/content\\_10555709.htm](http://news.xinhuanet.com/fortune/2008-12/25/content_10555709.htm)>.

<sup>103</sup> Sanlu Bankruptcy Order, <<http://www.fonterra.com/wps/wcm/connect/fonterracom/fonterra.com/our+business/news/media+releases/sanlu+bankruptcy+order>>

parties involved. With government support, the dairy business will go back to normal and resume, at least to a certain extent, its pre-scandal trend of growth. The tens of thousands of baby victims could also expect some compensation and there is no guarantee that they would be better off by going through the court procedures. Nor should the over 10,000 Sanlu employees worry too much about their career prospects. The Party Secretary of Sanlu has declared that “whoever wants to buy Sanlu must also take Sanlu’s employees”.<sup>104</sup> As such, with damage to economic growth having been kept to the minimum, social stability could also be maintained.

However, from a corporate governance perspective, one may ask how the government-business relationship exhibited in the aftermath of the 2008 Chinese milk scandal would contribute to the governance of the Chinese companies, which according to the CSRC (China Securities Regulatory Commission) underlines the healthy and sustained development of the Chinese stock market in the long term.

On the one hand, with strong government intervention in Chinese companies, not only state-owned but also the large private corporations (which are supposed to conform to the concept of the modern corporation), one may doubt whether there is much room left for market forces to play a role in keeping good corporate governance. It has been suggested that as well as internal monitoring mechanisms, the external market forces, such as the market for corporate control and the product markets are important monitoring mechanisms in disciplining corporate governance by helping to align the interests of the company managers with those of the shareholders. The handling of the tainted milk scandal by the Chinese central and local governments however suggests that the function of the market forces in relation to corporate governance may be limited under the current stage of economic development and policy in

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<sup>104</sup> Xinhua’s news story, *Sanlu Communist Party Secretary: Whoever wants to buy Sanlu must also take Sanlu’s employees* [Sanlu Dangwei Shuji: Xiangmai Sanlu bixu Jieshou Quanbu Zhigong](in Chinese)<[http://news.xinhuanet.com/local/2009-01/11/content\\_10638134.htm](http://news.xinhuanet.com/local/2009-01/11/content_10638134.htm) >  
<[http://news.xinhuanet.com/local/2009-01/11/content\\_10638134.htm](http://news.xinhuanet.com/local/2009-01/11/content_10638134.htm)>.

China. Government intervention may not allow the advantages of the modern corporate form to be fully exploited by the Chinese private corporations.<sup>105</sup>

Another problem, probably a more fundamental one, exhibited by the government handling of the tainted milk scandal, has been the unfortunate compromise of the “the rule of law”. The importance of legal regulation and enforcement in keeping good corporate governance has been postulated by a numerous authors. For example, the function of insolvency law, as indicated in the 1982 Cork Report (which has in part prompted the Hammer inquiry into Australian insolvency law completed in 1988),<sup>106</sup> is not only to distribute the insolvency assets among creditors, but also through investigative and disciplinary measures to “uphold business standards” and “commercial morality.”<sup>107</sup> The importance of a tort system in keeping the stability of corporate law has also been explained by commentators such as Kraakman.<sup>108</sup>

China has been proud of itself for having established a “basic legal framework for socialist market economy” within a short thirty years of reform.<sup>109</sup> Both the exposure and the handling of the 2008 milk scandal however seem to confirm commentators’ view that China’s system still looked ‘more like a system of rule by law rather than a system of the rule of law’.<sup>110</sup> The Chinese system of rule by law itself is far from perfect as far as corporate governance is concerned. The frequent use of political rather than judicial settlement of corporate disputes as

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<sup>105</sup> Roman Tomasic and Jenny Fu, Government-owned companies and corporate governance in Australia, *Corporate Ownership & Control*, Volume 3, Issue 4, Summer 2006, 123-132, 126.

<sup>106</sup> The Law Reform Commission Report No.45 General Insolvency Inquiry 1988.

<sup>107</sup> Report of the Review Committee on Insolvency Law and Practice (Cmd 8558., 1982).

<sup>108</sup> Reiner Kraakman et al, *The Anatomy of Corporate Law; A Comparative and Functional Approach*, Oxford University Press, 2004.

<sup>109</sup> China Ministry of Commerce, *Achievements in the Area of Trade and Economic Legislation After Thirty Years of Reform and Opening Up*[Gaike Kaifang Sanshi Nian Jingmao Lingyu Fazhi Jianshe Chengjiu](in Chinese), found on Hexun News< <http://news.hexun.com/2008-12-19/112568577.html>>; China Net News Story, Director of State Council Legal Office: 30 years in China’s Legal Development[Guowu Yuan Fazhi Bangong Shi Zhuren: Woguo Zhengfu Fazhi Jianshe Sanshi Nian] (In Chinese), <[http://www.china.com.cn/policy/txt/2009-01/07/content\\_17069154.htm](http://www.china.com.cn/policy/txt/2009-01/07/content_17069154.htm)>.

<sup>110</sup> Roman Tomasic and Jane Fu, ‘Regulation and Corporate Governance of China’s Top 100 listed companies: Whither the Rule of Law?’, Paper presented at the Research Committee on the Sociology of Law Annual Conference, Paris, July 2005, 5.

exhibited by the tainted milk scandal means that the capacity of law to enforce compliance and deter violations by corporations may be limited. On a broader level, when such poor examples in legal compliance are frequently set by the government, a culture of disregard and ignorance of law among the Chinese companies and citizens may ensue, which is neither conducive to the keeping of good corporate governance/corporate citizenship nor the sustainable economic development in China.

## **Part 5: Conclusion**

The close association between the Chinese state and the Chinese state-controlled companies has been identified by a number of commentators. Through a case study on the 2008 Chinese tainted milk scandal this paper establishes substantial evidence of government intervention in China's large private corporations.

In the tainted milk scandal, the roles played by the local Hebei government and the central food safety authority have had a negative impact on establishing/maintaining adequate internal controls and encouraging socially responsible behaviour among the dairy companies. Similarly, the equally protective approach adopted by the central and local governments in handling the aftermath of the scandal may have only addressed the symptoms but not the root cause of the fundamental failure in the corporate governance of the dairy companies.

The intervention in business by government at various levels may find its justification in the common goal of promoting economic growth. Although this is one important policy objective particularly with the global economic downturn, the paper suggests that this policy has had some unintended effects upon government-business relationships and the governance of the Chinese companies.

“In government we trust” was the comment made by one Chinese family visited by the Chinese Premier in the aftermath of the tainted milk scandal, a phrase reflecting the traditional Chinese mentality to resorting to the government for resolution of social crisis. However, with continued government intervention in businesses and the enforcement of law against them, future corporate scandals could inevitably continue to involve the government in shouldering liabilities for corporations, and the effect of any legal reform on corporate governance in China would be incremental at best.