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## Theoretical Approach to Directors' Liability to Third Parties and Construction of Applicable Rules of Fault Liability

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**Abstract:** Article 191 of the new Company Law formally elevates the theory of directors' liability to third parties to a legal system recognized and protected by the Company Law. The premise of this article is that the director's liability to third parties is subjectively intentional or grossly negligent, but it does not further clarify the content of the director's subjective intentionality and gross negligence, judgment standards and other elements, which may bring about inconsistency in application. Therefore, this paper will start from the fundamental theory of the director's liability to third party system - corporate organs, fiduciary duty and legal liability theory, explore the theoretical approach of the director's liability to third party, review the controversy and problems of the fault liability of the Company Law Article 191, and construct the fault liability of the director's liability to the third party with a purpose. The rules of application of directors' liability to third parties are purposefully constructed.

**Keywords:** directors; third-party liability; statutory liability; fault liability

### 1. Introduction

As the powers of directors and boards of directors continue to expand, there have been frequent incidents of directors infringing on the interests of third parties in the course of performing their duties. These behaviors seriously disrupt the economic order, not only harming the interests of others, but also harming the company's reputation and overall interests. If the rigid application of the theory of corporate personality, a rigid emphasis on the directors can not be liable to third parties, is not conducive to the regulation and containment of the above phenomenon. How to determine whether the liability should be borne by the company or the director personally becomes an issue that needs to be carefully considered. Director's liability to third party refers to the company director's responsibility to compensate for the damage suffered by a third party due to his gross negligence in the course of performing his duties. Article 191 of the newly revised Company Law establishes the liability of directors to third parties. This undoubtedly provides a legally guaranteed remedy for the third party who suffers from the damage caused by the director's act of duty, but the premise of this provision restricts the director's liability to the third party to the director's subjective fault of intent or gross negligence. The legislative formulation of this condition is rather general, and there is still uncertainty in its application. Therefore, this article will start from the fundamental theory of director's liability to third party system, explore the theoretical way of director's liability to third party, review the controversy and problems of fault liability in Article 191 of the Company Law,

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and purposefully construct the applicable rules of fault liability of director's liability to third party.

## 2. Theoretical Approaches to Directors' Liability to Third Parties

Under the premise that the company law establishes the legitimacy of the director's liability to third party system, this paper will focus on the theoretical part to explore the basic principles of the director's liability to third party, the source of the obligation of the liability and the nature of the liability, to explore the theoretical way of the director's liability to the third party and to further construct the director's liability to the third party on the basis of the application of the fault liability rules [1].

### 2.1. Theoretical Framework of Third-Party Liability: The Nature of the Corporation and the Doctrine of Directors' Fiduciary Duties

The recognition of third-party liability of directors in company law cannot be simply equated with the recognition of the independent status of directors. From the viewpoint of the theory of company law, the theory of company organs, the operation law of the company, and the practice of the company, the claim that the status of director is independent is not in line with the legal theory and the business practice. In addition to the conclusion that directors are not independent in terms of legal theory and business practice, China has also clarified the basic principle of independence of corporate personality through legislation. Article 57 of the Civil Code and Article 3 of the Company Law specify that a company has independent personality and bears responsibility independently when it enters into a legal relationship with the outside world, but they do not give the board of directors and its members, as an internal organ of the company, an independent status. Accordingly, the independent personality of the company externally and the relationship between the company and the internal organs of the Board of Directors are the theoretical basis for the direct liability of the directors to third parties [2].

#### 2.1.1. The Nature of the Company

Among the various doctrines that prove the independence of the personality of legal persons, the theory of the body of organization of the positive theory of legal persons is the mainstream view in the academic world at present. This point of view, the company's meaning is a kind of group meaning, through the company organ formation and expression, the company organ's behavior is the company's own behavior, the legal consequences of the behavior by the company organ in accordance with the rules of representation [3]. The theory of the body of organization of the positive theory of the legal person, i.e., the theory of the organs of the legal person, has two levels of connotation: Firstly, the legal person can only carry out civil activities through the organs of the company such as the board of directors and the members of its organs [4], and these activities should be regarded as the activities of the legal person; and, secondly, the legal person will be held liable for these civil activities.

In analyzing what kind of legal relationship exists between the company and the director, there are agency, fiduciary and entrustment views in the academic and theoretical circles in various countries [5]. Among them, the common law system is represented by the agency relationship and fiduciary relationship doctrine, and the civil law system is represented by the entrustment relationship doctrine [6]. With the development of corporate practice and the refinement of the theory of corporate personality, certain doctrines in the Chinese company law system, such as agency and trust, can no longer provide a complete explanation. Specifically, the fact that the director does not have the ownership of the company's property is not consistent with the trust theory of the principal property belongs to the trustee of the premise; agency relationship focuses on the agent's behavior through the agent to make the agent and other people to form a direct civil relationship,

the subject of rights and responsibilities is still the agent; the establishment of the relationship of entrustment does not ipso facto produce the right of agency, such as the absence of a separate authorization can not be clear director's authority, rules of conduct and other issues of agency [7], rules of behavior and other agency issues. Therefore, the relationship between the company and the director can not be simply understood as agency, trust or entrustment relationship [8].

### 2.1.2. Sources of Directors' Obligations to Third Parties: Breach of Directors' Fiduciary Duties

Liability derives from obligation. The company is the bridge that builds the legal relationship between the director and the third party and is the connecting point between them [9]. Therefore, the obligations of directors to third parties are also related to the obligations of directors to the company. Taking the responsibility as the starting point, it is found that the essence of the director's responsibility to the third party is that the responsibility which should be borne by the company is extended or converted to the third party, so the director's responsibility to the third party of course originates from the director's fiduciary duty to the company [10]. The director's fiduciary duty to the company includes the duty of loyalty and diligence. As the core of directors' fiduciary duty, the nature of the duty of loyalty is the negative obligation against self-dealing and other fraudulent behaviors, the content of the prohibition of conflict of interest, not to seek personal gain. The duty of diligence refers to the duty of a director of a company to manage the company's affairs carefully and prudently, which emphasizes that the director should be careful, prudent and diligent in managing the company's affairs and act for the purpose of the company's best interests [11].

### 2.1.3. Theoretical Framework of Third-Party Liability: The Theory of Corporate Bodies and Directors' Fiduciary Duties

It should be reiterated that the regime of directors' liability to third parties is not a general provision on directors' liability. In the civil and commercial legal relations between the company and the outside world, the company becomes the subject of external liability due to its independent personality. If a third party wants a director to break through the protective shield of the company and be directly liable for his/her damages, he/she needs to find a reason worthy of special protection by the law, which is the director's malicious breach of fiduciary duty [12]. At this point, the theoretical framework of the director's liability to third parties is completed: The principle and foundation of the theory of corporate organs, and the director's malicious violation of fiduciary duty as an exception.

## 2.2. *Theories of the Nature of Directors' Liability to Third Parties: A Review of Tortious Liability and the Adoption of Statutory Liability*

Regarding the nature of directors' liability to third parties, there are two more mainstream views in the academic community, namely, the tort liability theory and the statutory liability theory [13].

### 2.2.1. Review of Tort Liability Claims

Scholars who hold the view of tort liability believe that China's legislation adopts a civil and commercial system, and the company law is a special law of the civil law, and if the company law does not provide special provisions on the liability of the directors, the relevant provisions of the tort in the civil law, which is a general law, shall apply. But there are drawbacks to this doctrine [14]. First of all, some scholars try to explain the legitimacy of the director's liability to the third party by using the common tort in civil law in terms of the fitness of the subject of the behavior theory. In the joint tort, the joint actor should be an independent individual, but based on the theory of corporate organs, the

director in the external relationship is not independent of the company's individual, there is no legal situation can not be arbitrarily break through this principle, can not be arbitrarily make the director and the company is in the same legal status of the third party liable [15]. Secondly, in the way of damage, tort liability regulation is the perpetrator of the victim to implement the direct infringement of behavior. For the perpetrator of the loss caused by others, the third party due to the loss of others suffered damage to the behavior, can not apply the tort rules for relief [16]. If the nature of the director's liability to the third party is considered to be tort liability, the third party will not be able to directly request the director to make up for the damage suffered by the third party because the infringing act has no direct effect on the third party.

### 2.2.2. Application of the Doctrine of Statutory Responsibility

According to the theory of statutory liability, the liability of directors to third parties is different from the liability in tort, which is a special liability specially stipulated by the law. In addition to the liability in tort, the directors also have to bear the special liability to third parties stipulated in the Company Law, and the degree of liability of this special liability is higher than that of the general principle of tort. The high degree of responsibility of the statutory liability for is reflected in the fact that the director's behavior in the execution of his/her duties infringes on the rights and interests of the third party, and he/she needs to bear the responsibility to the third party even if he/she does not satisfy the elements of the general tort. Considering the special circumstance of indirect damage of director's infringement of third party's right, in order to make the third party's impaired right get effective relief, this paper will adopt statutory liability theory. Special statutory liability emphasizes the director's misconduct in the course of performance of duties, but does not require that the consequences of the damage to the interests of third parties have foreseeability, this requirement can be included in the third party directly or indirectly by the damage [17].

Directors' liability in company law is not only the calculation of interests, damages and causality, but also the way to realize the good governance of the company, and the directors' liability should have its own principle and composition to realize the unity of power, responsibility and benefit of the company's governance objectives [18]. Statutory liability is the system design after considering the special characteristics of the company's commercial and governance activities, the protection of the interests of third parties, and the characteristics of the director's performance of duties, and it is a reasonable approach for balancing the relationship and interests of third parties, the company, and the director.

## 3. Review of the Fault Liability of Article 191 of the Company Law Based on the Theory of Textual Interpretation

In the course of the revision of the Company Law, the formulation of Article 191 regarding the subjective fault of directors has remained unchanged since the beginning. In the first review draft of the revision of the Company Law, the legislator considered that the director shall be jointly and severally liable with the company for any damages caused by the director to the third party due to the execution of his/her duties on the premise that the director has the subjectivity of willfulness or gross negligence. In the second revised draft, the legislator added the expression "the company shall bear the liability" and placed it before the conditions for the director to bear the liability, and then changed the liability of the director from "joint and several liability" to "liability", but in the case of the director's liability, the director shall bear the liability. ", but in the subjective fault of the director to assume responsibility for the elements have not been modified, reflecting the legislator in the issue of caution and persistence. Although the nature of the director's liability to third parties for special statutory liability, but in the examination of its fault liability provisions, can still rely on civil law tort liability theory [19]. This article will use the method of textual interpretation to explain the fault liability of directors' liability to third parties in Article

191 of the Company Law, and at the same time review and analyze the potential problems therein [20].

### *3.1. The Burden of Proof of Fault Needs to Be Clarified*

Article 191 of the Company Law sets the prerequisite for a director to be liable to a third party as having a subjective fault of intent or gross negligence, with the director's fault to be proved by the third party, and the third party to bear the consequences of failing to prove the fault [21]. In practice, the subjective fault of the director's damage to the interests of third parties is blurred by the barrier of the company and difficult to identify. The powers of the directors and the board of directors are mostly internal and process-oriented, and in some cases, the resolutions of the board of directors need to be approved by the shareholders' meeting. Even for matters that do not require the approval of the shareholders' meeting [22], prior authorization must be obtained from the shareholders' meeting. Based on this characteristic, it may be difficult for a third party to bear the burden of proof that a director is subjectively grossly negligent, and the allocation of the burden of proof needs to be clarified.

### *3.2. Failure to Objectify the Criteria for Determining Negligence and the Vague Content of the Duty of Care*

Intentionality means that the perpetrator has a relatively clear understanding of the act itself and the consequences that the act is bound to or is likely to cause, and that knowledge of the act itself and its consequences precedes the act, and that knowledge after the fact does not belong to this category; the consciousness factor refers to the attitude held by the perpetrator towards the result of the act, and is generally divided into positive realization of the result, and negative indulgence of the result. Negligence, on the other hand, refers to the failure to take the preventive measures that should have been taken despite the fact that the occurrence of the result could have been foreseen, i.e., the violation of the duty of avoidance with respect to the result that could have been foreseen. Whether or not the perpetrator has intent can be proved from whether or not his/her behavior violates laws and regulations, his/her ability to foresee the possible consequences of the damage with the cognitive ability and knowledge he/she possesses, the relevant documentary evidence related to the behavior, and his/her attitude to remedying the damage after it occurs. Subjective with intent can be directly from the behavior of the actor to judge, but the determination of negligence usually also need to judge whether the actor violates the relevant duty of care. The duty of care, usually not a specific, clear legal requirements of the obligation. Because the content of the duty is not clear, the standard of negligence should be objectified. Negligence standard objectification, specifically for the negligence standard should be engaged in certain occupations, activities of people usually should be the degree of attention as a judgment standard, even if the perpetrator due to personal subjective factors do not meet the objective degree of attention, should also be responsible for the corresponding. Clearly and objectively determine the standard of gross negligence of the director's liability to the third party, which not only helps to avoid different judgments in the same case, but also helps to regulate the director's performance of duties and improve the director's motivation to perform his duties, and is also conducive to the protection of the third party's rights and interests.

Duty of care means that the perpetrator should take reasonable care to avoid causing damage to the person or property of others. In order to adapt to the modern trend of expanding the scope of the protection of rights and interests in tort liability, and in order to effectively balance the protection of the legitimate rights and interests of the victim and the preservation of the freedom of the perpetrator, it is possible to define fault as a kind of behavior and to use the infringement of the rights and interests of the victim by the violation of the duty of reasonable care as a criterion for the perpetrator to bear the responsibility for the infringement of rights and interests. This rule can also be borrowed in

the special statutory liability of a director to a third party as such, to protect the interests of the third party while protecting the director's freedom of reasonable and lawful office behavior. Among the subjective faults of intentionality and gross negligence, intentionality is easier to identify and judge than negligence due to the higher degree of malice, and thus the duty of care is generally used to determine whether the actor constitutes a negligent tort.

According to the general duty of care requirements established by China's civil tort, the rational person standard should be adopted to determine whether the behavior of the actor is reasonable. Tort of the rational person standard for directors of third-party liability duty of care construction has reference significance, but can not be blindly copied, should take into account the more civil behavior, commercial behavior of profit-seeking, the risk is more prominent. In order to establish an objective, uniform and reasonable director's duty of care to third parties in line with commercial practice, the following aspects should be considered. Firstly, while considering the profit-seeking and risky nature of commercial behavior, directors should be encouraged to perform their duties with a certain degree of risk-taking spirit. Secondly, the characteristics of the director's position and content should be taken into account to avoid the standard for determining negligence becoming an equal and objective one that ignores the professional characteristics of the perpetrator, resulting in substantial unfairness. Finally, and most importantly, the scope of the duty of care cannot be expanded arbitrarily. Based on the theory of legal person organs, the director directly to the third party liability is not the general provisions of the company's liability, its application has strict premise. In summary, the content of the duty of care should be the director of the company's fiduciary duty to the expansion of the violation of fiduciary duty, based on the fiduciary duty but with some difference. The aforementioned fiduciary duty is used to judge whether the director to perform the duties of infringement of the rights and interests of third parties, while the duty of care is used to measure whether the director to the extent of intentional or gross negligence infringement of the former is the nature of the standard, the latter is the degree of requirements.

#### **4. Construction of Specific Rules Applicable to Fault-Based Liability**

##### *4.1. Principles of Attribution: Allocation of the Burden of Proof of Fault*

Due to the strong process and internal nature of the director's duties, while adopting fault liability as the mode of attribution of liability of the director to the third party, attention should be paid to the content and extent of the third party's proof of the director's willfulness or gross negligence. The basic content of the third party's proof is that the director failed to pay the necessary attention to the decision-making and behavior and did not comply with the rules of business judgment, and the extent of the director's intentionality and gross negligence may be enough. Thereafter, it is up to the director to bear the burden of proof that he or she is not at fault, and to prove that his or her behavior is obligatory, reasonable, and lawful by using relevant internal documents, information, and other evidence.

##### *4.2. Objective Construction of the Content of the Duty of Care: Directors' Fiduciary Duty, Business Judgment Rule*

In order to avoid the undue expansion of the application of directors' liability to third parties, which may cause damage to the independence of the company, the content of the directors' duty of care to third parties should include the duty of trust and the rule of business judgment, which also takes into account the requirements of the duties of the directors and the characteristics of the performance of their duties.

A director's fiduciary duty to the company is a code of conduct for directors in the performance of their duties, and has a guiding role in the performance of their duties. In addition to its ex ante guiding function, the fiduciary duty also has an ex post evaluating function. Accordingly, the content of the fiduciary duty can be used as the standard and

limit for judging whether the director has performed his duties properly. Once the director's performance of duty is not in accordance with the requirements of the duty of trust and justice, then the performance of duty is infringing. In the director's liability to third parties, the violation of fiduciary duty due to intent or gross negligence is a breakthrough to break the independence of legal personality and require the director to be directly liable to third parties, which is an exceptional case and cannot be extended arbitrarily.

The business judgment rule is a rule that respects commercial practices and protects the directors' right to make business decisions. It can protect directors from liability for business judgment errors and incentivize directors to take reasonable risks and focus on risky but rewarding long-term projects. The business judgment rule can determine whether the directors have fulfilled their fiduciary duties and ensure that the directors' performance of their duties is justified and reasonable while at the same time guaranteeing the directors a certain degree of discretion in making business decisions [23].

To sum up, on the one hand, the setting of fiduciary duty of the person in charge of the company is not more good, obligation constraints should also have a certain limit, in the construction of the fiduciary duty should also follow this concept, can be used to establish the rules of commercial judgment to the person in charge of the company's exemption mechanism, in order to avoid excessive constraints on the reduction of business decision-making and the implementation of the efficiency, as well as to avoid the suppression of the company in charge of the person's subjective initiative. On the other hand, the behavior with aggression is not the only condition of legal culpability, the aggression reaches a certain degree of intolerable for the law, only when the actor can be required to bear the corresponding legal responsibility for their own behavior. Considering the characteristics of commercial activities, the rule of business judgment should be introduced in judging the degree of harmfulness of a director's conduct.

## 5. Conclusion

The amendment of the Company Law has responded strongly to the long-standing discussion of the third-party liability system for directors in the academic and practical circles, clearing up some of the controversies over the system and building a legal safe haven. However, confined to the ambiguity of the legislative expression, the director's liability to a third party system in the specific application of the process there is still a long way to explore, improve the road. In the face of this dilemma, the existing theory of corporate organs and the theory of directors' fiduciary duty provide a solid theoretical foundation for the interpretation and application of the system at this stage. With the enrichment of legal practice and the soundness of the legal system, we have reason to believe that the system of directors' liability to third parties will be further improved.

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