

# *Research on the Boundaries of Finding Director's Fault in the Tort of Misrepresentation*

Xiaoqing Wu<sup>1,a,\*</sup>

<sup>1</sup>*School of Law, City University of Hong Kong, Tat Chee Avenue, Kowloon, Hong Kong, China*  
*a. xiaoqwu3-c@my.cityu.edu.hk*

*\*corresponding author*

**Abstract:** “The Chinese Security Law” adopts the principle of “presumption of fault” for the determination of directors’ joint and several liability in disputes over liability for misrepresentation, but due to the ambiguity of the standard of “fault” in the legislation, as well as the influence of the prior procedure requirement of administrative and criminal punishment in the past, the judicial practice often lacks effective argumentation for the determination of directors’ fault. Trial authorities often directly find directors at fault based on existing administrative or criminal penalties or the lack of the standard of duty of care. The People’s Court should not be bound by administrative or criminal liability and should conduct an independent review of civil liability. It is necessary to differentiate the subjective mentality of directors and make specific judgments on whether the director with a “negligence” mentality has violated the duty of care on the basis of statutory law. And courts should not equate the duty of due diligence with the duty of care, but should make a comprehensive judgment according to the director’s professional background and specific job contents. On the basis of recognizing the reasonable reliance of directors and extending the subject matter of exemptions from liability to all directors, the boundaries of the determination of the director’s fault shall be determined, and a fair and accurate decision shall be made of the elements of fault in the liability of directors.

**Keywords:** securities misrepresentation, directors’ liability, fault determination, the fault presumption, duty of care

## 1. Introduction

In tort cases of securities misrepresentation, directors, as insiders of the listed company who made the misrepresentation, are jointly and severally liable under the rule of “presumption of fault.” Such a provision means that, in the trial of the case, the court has first presumed that the director is at fault, and only if the director raises an effective defense that meets the statutory requirements to exclude his fault can he be exempted from the liability. That is to say, before the judicial authority finally determines that a director is jointly and severally liable for misrepresentation, it needs to discuss whether the defenses raised by the director are legally effective.

However, in reality, the court often does not reason in detail about the defenses raised by the directors, or even ignores those defenses, and straightly finds that the directors are jointly and severally liable based on the fact that the directors have already been administratively or criminally punished in the preliminary proceedings. For example, in the case of “Shenji Group Kunming

Machine Tool Co., Ltd. and Tibet Ziguang Zhuoyuan Equity Investment Co., Ltd. Securities Misrepresentation Liability Dispute” (hereinafter referred to as the “Zhuoyuan Case”), the court recognized that the existing administrative penalties could lead to the establishment of the elements of infringement, and directly determined that the eligible subject of joint and several liabilities should be liable for damages due to the existence of three administrative penalties [1]. Although the new “Provisions of the Supreme People’s Court on the Trial of Civil Compensation Cases for Misrepresentation in the Securities Market” (hereinafter referred to as the 2022 Judicial Interpretation of Misrepresentation) explicitly abolished the requirement of “prior procedure”, due to the lack of clarity in the legislation on the standard and extension of the duty of care, the courts still have the obligation of care to avoid overly scrutinizing the case. To avoid a detailed analysis of the duty of care, the courts have found the directors to be at fault according to the existing administrative or criminal penalties, which makes the directors jointly and severally liable by applying the “no-fault liability” in practice.

Therefore, it is essential to do in-depth research and further exploration of the subjective fault identification in the determination of directors’ liability in the case of misrepresentation, to elaborate the problems and dilemmas of applying the “presumption of fault” in practice, and to try to put forward a solution to establish a more reasonable and accurate boundary for the application of the principle of the presumption of fault and for the determination of the duty of care.

## **2. Legal Norms for the Determination of Joint and Several Liabilities of Directors for Securities Misrepresentation in China**

Article 85 of the Securities Law provides for the application of the presumption of fault in cases of misrepresentation by the directors of the accused listed company [2]. The principle of presumption of fault requires the defendant, such as the directors of the accused company, by proving that they are not at fault to mitigate or exempt their liability. This principle is a particular type under the principle of fault liability, and the main difference between the two is the main body of the burden of proof. “Fault liability” requires the infringed party to prove that the infringer’s subjective fault exists, while “Fault presumption” means that the infringers have been presumed to be at fault in an en-ante way, and they need to prove that they do not exist subjective fault.

The subject of the implementation of misrepresentation and behavior is generally composite. Although the company has an independent legal personality, in the process of making false statements, the company’s internal personnel is the actual resolution and implementation of the relevant behavior. Misrepresentation often includes the company’s existing controller or person in charge of the financial staff’s requirements for producing relevant materials, as well as the board’s approval. Therefore, the decision-making process of the listed company to make false statements belongs to the company’s internal behavior. As the decision makers, the directors of the listed company often know the behavior of the false statements, and the possibility of fault for the false statements is greater.

Secondly, as a director of the company insiders, if the misrepresentation is not at fault, it is more capable for him of obtaining the evidence materials in a direct way to raise defense. Because the process of making false statements is within the company, obtaining sufficient evidence by plaintiffs to prove that the director’s fault is more complex, and because the specific channels and other factors that influence the information obtained are different, the degree of proof will also be different. Hence, the troubles of victim’s proof also illustrate the necessity of implementing this principle.

Therefore, using the principle of presumption of fault, the director is required to prove that there is no fault, from the logic that the director has a stronger reasonableness, and can maximize the

balance among the interests of the plaintiff and the defendant, to ensure that the director has the right to obtain the right of defense, and to achieve fairness and justice.

### **3. Problems in the Application of the Principle of Presumption of Fault in the Current Joint and Several Liability of Directors for Misrepresentation**

#### **3.1. Restricted by the Antecedent Proceedings Without Reasoning in Detail about the Defenses**

“The Judicial Interpretation on Misrepresentation” issued by the Supreme People’s Court in 2003 explicitly proposed that the plaintiff should submit the legal document that the defendant has been administratively penalized or criminally adjudicated when filing a lawsuit. Based on this provision, the administrative or criminal liability of the defendant becomes a precondition to the filing of its civil liability disputes. The administrative penalties or criminal verdicts have already explained the illegality of the director’s behavior, so the court often no longer relied on the director’s defense of the detailed reasoning, and directly found that the director should be held liable.

The 2022 Judicial Interpretation of Misrepresentation explicitly removes the requirement of antecedent proceedings in securities misrepresentation cases. Although according to the provisions of article 85 of the “Nine Minutes”, administrative penalties will lead to the establishment of the materiality of the “tort behavior” element of civil liability [3], the court should not directly determine that the director has subjective fault based on the existing penalties, and should make further examination and judgment on the defense based on the director’s fault.

However, in practice, there is still a problem of the court deciding that a director bears civil liability solely because of existing administrative or criminal penalties, and the legal practice actually adopts the principle of “no-fault liability” in reviewing the subjective elements of the director and lacks an independent review of the civil liability. For example, in the “Zhuo Yuan Case,” the court directly found that the defendant director was jointly and severally liable for civil liability based on the existence of three administrative penalties, but did not make an independent judgment on whether the director was subjectively at fault [4]. In fact, the existing penalties should not be equated with the inevitable establishment of civil subjective fault, and courts should strictly comply with the requirements of the principle of presumption of fault, do a separate review and judgment about the director’s proof of no-fault and decide whether it meets the statutory fault exclusion circumstances.

#### **3.2. Difficulties in Recognizing the Defenses of a Director**

The presumption of fault for directors in misrepresentation includes a presumption of both “willfulness” and “negligence” [5]. Directors have different requirements to prove their defenses between different subjective conditions. In the case of an accused director, the defense often points not to willfulness but to negligence. Theoretically, negligence is categorized as “overconfident negligence” and “inadvertent negligence”. For example, the director should have known or foreseen that the statement made by the company was false, but because of his overconfidence that he believed he could avoid the occurrence of the damage or because of his inadvertence, he failed to fulfill his duty of care and caused the injury [6].

##### **3.2.1. Difficulties in Determining the “Duty of Care” and in Proving Defenses**

First, the primary criterion for judging whether a director is “negligent” is whether he has violated the “duty of care,” but the current law is unclear about the extension and standard of the duty of care. In legislation, both the “company law” and “securities law” or related regulations, the duty of

care is defined vaguely. In practice, the trial and law enforcement agencies are also accustomed to imposing excessive requirements for listed companies' directors, which leads to the difficulty of excluding negligence.

Secondly, the breach of the "duty of care" is a subjective judgment of the adjudicator. The judgment on fulfilling the duty of care should be understood as whether the director has met the standard of being a competent manager and whether he has exercised due care [7]. Determining whether a competent manager has exercised due care is highly subjective and challenging.

Thirdly, it is pretty difficult for a director to provide contrary evidence of "negligence" as a defense. In practice, China has formed a "signature that is liable" mode for determination, no matter what kind of document misrepresentation, as long as the director in the document signed, most cases will therefore be judged to bear joint and several liability [8].

### **3.2.2. The Issue of "Due Diligence" as an Alternative Standard**

In order to overcome the subjectivity of the judgment and the difficulty of proof, the practice has developed "due diligence" as an essential standard of judgment of the director's obligations. The 2022 Judicial Interpretation of Misrepresentation replaces the duty of care obligation [9], due diligence has become an important obligation of the law given to the director, but also become an important basis for the director to defend its no-fault. But diligence and duty of care are different. For instance, from the conceptual point of view, there is a clear difference between the two. Diligence corresponds to the day-to-day affairs, which is the general requirements and overall evaluation of the director's performance of duties; and duty of care corresponds to a specific behavior or matters, which is an evaluation of whether to fulfill the obligations in the implementation of the director's performance of duties in a particular behavior, or a specific legal document signed [10]. Therefore, a violation of the duty of care due to the fault of a director's behavior does not necessarily mean a violation of the director's overall duty of diligence.

In misrepresentation cases, the allegation of joint and several liabilities against a director often arises from the fact that they have breached their duty of care regarding a particular act, such as signing a document that discloses incorrect information. However, due to the difficulty of defending against individual actions, in practice, directors often prove that they are not subjectively at fault through their overall behavior in compliance with the requirements of diligence. The director to carry out targeted evidence defense is difficult, the trial authority also due to the difficulty of distinguishing the specific cause of the proposed defense is not recognized, so the "diligence" to quantify the duty of care is still logical deficiencies, and cannot be a good solution in the practice of the director's defense of the difficulty of the problem.

## **4. The Boundaries of Determining the Fault Element in Directors' Civil Liability**

### **4.1. Necessity to Make Independent Review of Directors' Liability by Courts**

First, civil, administrative, and criminal liability fundamentally differ, and they protect different legal interests. The civil liability protects investors' civil interests, while the administrative and criminal liability includes the protection of public interests. Secondly, the diverse natures of the liability have different requirements. For example, the 2022 Judicial Interpretation of Misrepresentation requires directors to prove that they are not negligent, focusing mainly on "having exercised due diligence." Article 82(4) of the Securities Law stipulates that directors have the right to object to the disclosure of information and to make it public, therefore, from the perspective of administrative liability, directors need to prove that they have "objected to the non-compliance" to claim that they are not at fault [11].

Due to the differences in civil liability and administrative as well as criminal liability, and in conjunction with the current law that explicitly abolishes the predicate requirement, the court should conduct an independent review of whether a director is civilly liable in cases of misrepresentation to rectify the problem of conflating the three in practice. The exemption or mitigation of civil liability does not mean that administrative or criminal liability will necessarily be exempted, and for directors who have been subject to administrative penalties or criminal rulings, the court should recognize the exclusion of fault if it is determined in accordance with the civil determination that they should not be held jointly and severally liable, to achieve substantive fairness and justice.

## **4.2. Determination of the Fault Element of Directors' Liability**

### **4.2.1. Step 1: Differentiated Determination of Subjective Status**

The law classifies fault as “willfulness” and “negligence,” and when the director is defending himself, according to Article 13 of the 2022 Judicial Interpretation of Misrepresentation, it is necessary to differentiate according to the specific subjective state.

Firstly, for a director who engages in misrepresentation activities with positive acts, such as organizing, directly or indirectly participating in the misrepresentation acts, as well as concealing a material matter, the court may directly find that the subjective fault has been established without the need for further determination, and the director’s joint and several liabilities are thus established [12].

Secondly, it is difficult to determine whether a director who does not engage in misrepresentation with a “willful” intent is guilty of “negligence.” According to the current regulations, the focus of negligence is whether the director has breached the duty of care. Due to the different professional backgrounds and specific job contents, different directors should not be subject to the same standard of duty of care, and in a dispute over liability for misrepresentation, the determination of the director’s negligence may be based on the different actual circumstances of different directors, which may lead to the determination that some directors are negligent, and some are not. Therefore, the duty of care of directors should be differentiated on the basis of the difference in negligence.

The doctrine categorizes “negligence” as “minor negligence,” “ordinary negligence,” and “gross negligence.” “Minor negligence” refers to a slight breach of the duty of care by the perpetrator; “ordinary negligence” refers to a breach of the duty of care by a “good manager” [13]; and “gross negligence” refers to that the perpetrator has failed to fulfill the duty of care that an ordinary person should fulfill [14]. The Supreme People’s Court clarified in its “Reply to Proposal No. 0111 of the Fifth Session of the 13th National People’s Congress” that Article 13 of the 2022 Judicial Interpretation of Misrepresentation corresponds to “willfulness” and “gross negligence” and therefore, ordinary or minor negligence does not constitute fault. However, as a kind of good manager, the director has the obligation to ensure that the company’s decision-making is in accordance with laws and regulations in the process of managing the company and cannot infringe on the rights and interests of outside investors. So, directors who constitute general negligence should also be recognized as constituting negligence, and the negligence of directors can be limited to “ordinary negligence” and “gross negligence.”

On the one hand, it should be clarified the standard of directors’ duty of care for non-specialized areas. The directors of a listed company must have a certain amount of professional knowledge and skills, so the standard of the duty of care of the directors should be slightly higher than ordinary people. However, directors also have their own division of labor, and the duty of care should not impose excessive professional requirements on directors. For example, a director who is responsible for legal affairs will inevitably have less specialized knowledge in the field of accounting than a

director who specializes in the management of the company's accounting affairs, so the director should not be held to a lower duty of care in his or her non-specialized field. When a director fails to detect and deal with misrepresentation in a non-specialized area in a timely manner, he or she should be deemed to be generally negligent.

On the other hand, the standard for specialized areas should be clarified as well. Directors who undertake specific professional work should be subject to special duty of care requirements in their area of specialization. For example, directors with a background knowledge of law should be subject to a stricter duty of care with respect to the law. Therefore, when a director fails to detect or deal with misrepresentation in his or her area of specialization in a timely manner, this should constitute gross negligence.

#### **4.2.2. Step 2: Determination of the Extension of Directors' Duty of Care**

China's duty of care at the legal level only has literal expression, for the extension of duty of care, the specific standards are not clear provisions, which in turn led to the judgment of whether the director constitutes negligence in practice has difficulties [15]. Chinese current obligation to diligence instead of duty to pay attention to measure, but the two cannot be completely equivalent. In order to maximize the possibility of each director of the accuracy of the fault judgment, the courts to determine whether the director of the duty of due diligence, should be based on the specific type of work engaged in the content of the individual judgment. For example, in the case of Jiangsu Baoqianli Video Technology Co., Ltd. Misrepresentation Liability Dispute, the court held that "when judging whether the directors should be jointly and severally liable, should not be based only on the company's directors failed to fulfill their obligations of due diligence, but should be based on the division of responsibilities of the perpetrator to make judgments" [16].

In addition, the director's duty of care is essentially a kind of supervisory duty, because the director makes the relevant resolution but does not participate in the daily implementation, so the director's duty of care is mainly embodied in the leadership and monitoring role of the company. Therefore, the extension of the duty of care cannot be fully summarized by "due diligence." In the process of decision-making and execution of the misrepresentations made by the company's management, the directors failed to do timely supervision and caused damage, which also belongs to the breach of duty of care. U.S. case law also provides for the duty of directors to supervise, in a narrow sense, the board of directors should make prudent decisions in accordance with the law and supervise the management to implement the decisions of the board of directors; in a broad sense, the directors should also keep abreast of the day-to-day production and operation of the company to ensure that no unlawful or illegal behavior occurs [17]. The directors' duty of care should be expanded, and it is necessary to further clarify and specify the content and standard of the duty of care in future legislation, so the directors will have a clearer understanding of their duty and will be able to defend themselves with more than adequate and targeted evidence.

#### **4.2.3. Step 3: Establishment of Reasonable Reliance by Directors**

Directors fulfill their duty of care to protect the interests of the company and investors, but the protection of the legitimate interests of directors is also an issue that should be emphasized. China has not yet established a reasonable trust protection system for directors, and as managers of the company, it is necessary to establish such a system to safeguard the legitimate rights and interests of directors and to improve the motivation to perform their duties. According to the existing provisions, misrepresentation of the director's fault exclusion does not explicitly provide for the inclusion of "the director relies on external expert conclusions for decision-making." In fact, when directors do not understand the field, depending on professionals is more likely to encourage them to make a

reasonable assessment of the decision-making issue. Therefore, directors may rely on expert opinions in the process of making relevant decisions, but such reliance should be based on a reasonable foundation and not be unconditional.

Relevant statutes and judicial interpretations should clarify the criteria for directors to apply reasonable reliance on expert opinions. The following steps should be followed to determine whether reasonable reliance has been established: firstly, whether the director has taken the initiative to engage an outside professional organization or person to assess the issue. If the report is issued by a neutral professional third party, the director may rely on the report. But whether such reliance is reasonable needs to be judged in the second step; secondly, the director's reliance on the report should be established on the basis of sufficient investigation, and if the director fully relies on the report without any investigation, such reliance is also unreasonable; thirdly, a reasonable mechanism of differentiation should be established, and the standard for reasonable reliance should be raised for directors who have certain specialized knowledge of the matter under investigation. Since such directors are not the same as non-professional directors, and directors with a certain degree of expertise should exercise their independent judgment to analyze whether the report is reasonable for adoption by the company and whether it involves false information.

To sum up, the improvement of the protection mechanism of directors' reliance interests is conducive to the directors to make more accurate judgment on the company's affairs, and at the same time to achieve the common protection of the legal interests of the directors.

## 5. Conclusion

The Securities Law specifies the principle of "presumption of fault" for the determination of the subjective fault of directors in misrepresentation cases, and imposes the burden of proving no fault on the accused director. However, in practice, the court is still affected by the past administrative or criminal punishment prior to procedure. And since the extensions of the director's duty of care are not yet clear, the court often directly determines the establishment of joint and several liabilities without reasoning the defenses that the director raised.

In view of the above problems, the trial authorities should make independent judgments on whether directors should bear civil liability without interference from administrative or criminal penalties; the legislature should differentiate between the subjective state of mind of the directors and determine whether negligence is constituted on the basis of further clarification of the standard of the duty of care, and at the same time, establish a mechanism of reasonable reliance on the part of the directors in order to safeguard their lawful rights and interests.

There is still room for improvement in the Chinese securities misrepresentation cases in the director's fault determination. Legislation, judicial, and law enforcement authorities should pay attention to the problems arising in practice, the legislature should make more thorough and careful consideration of the existing provisions, and then continuously improve the statutes. Meanwhile, the judicial and law enforcement authorities should independently review the case according to their competence, and avoid of mixing up different types of responsibilities. By paying attention to the problem from multiple angles, clarifying the boundaries and scale of the determination of a director's fault, and preventing the arbitrary determination of a director's fault, it can not only protect the rights and interests of directors, improve the enthusiasm of directors in performing their duties, but also safeguard the interests of the company and investors, and establish a safe, efficient, and fair market.

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