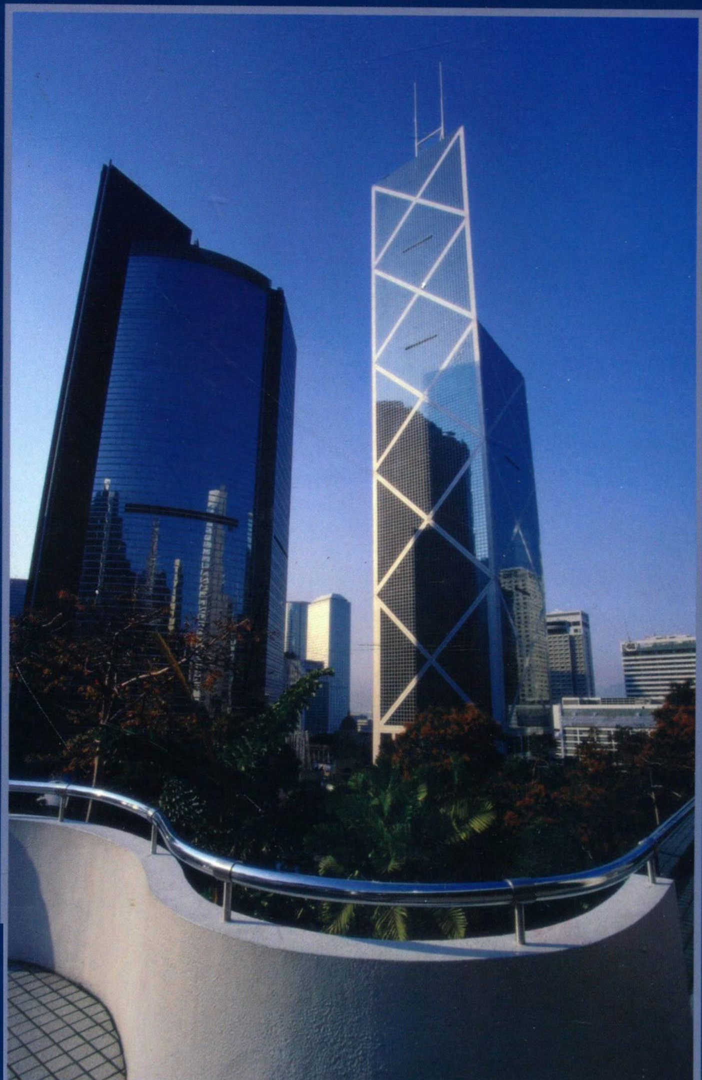
Comparative Corporate Governance in China

POLITICAL ECONOMY AND LEGAL INFRASTRUCTURE



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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2007
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Simultaneously published in the USA and Canada
by Routledge 270 Madison Ave, New York, NY 10016

Routledge is an imprint of the Taylor & Francis Group, an informa business

Typeset in Perpetua and Bell Gothic
by Keystroke, High Street, Tettenhall, Wolverhampton
Printed and bound in Great Britain
by The Cromwell Press, Trowbridge, Wiltshire

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
Yu, Guanghua.
Comparative corporate governance in China : political economy and legal infrastructure /
Guanghua Yu.
p. cm.
Includes bibliographical references and index.
ISBN 0-415-40306-5 (hard cover) – ISBN 0-415-40307-3 (soft cover) 1. Corporate
governance–China. 2. China–Economic conditions–2000– 3. Corporation law–China.
4. Securities–China. 5. China–Economic policy–2000– I. Title.
HD2741.Y825 2007
338.60951–dc22
2006028491

ISBN10: 0-415-40306-5 ISBN13: 978-0-415-40306-1 (hbk)
ISBN10: 0-415-40307-3 ISBN13: 978-0-415-40307-8 (pbk)

Comparative Corporate Governance in China

With China already assuming its place as one of the world's biggest markets, both Chinese corporations and international corporations operating in China face the challenges of corporate governance. This insightful text explores a range of issues including: executive compensation, takeover markets, the securities market, insolvency issues, venture capital markets, and their role in corporate governance models.

Dissatisfied with the narrow focus on the board of directors and the takeover market, Yu enlarges the scope of corporate governance studies to cover both market forces and contractual mechanisms. Applying this approach, he examines how market forces and contractual arrangements can reduce agency costs in corporations in the United States, Germany, Japan and Hong Kong. *Comparative Corporate Governance in China* analyzes the political, social and economic factors that have shaped the changes in Chinese corporate law and securities regulation and makes the case that comparative corporate governance studies have significant policy implications for China's transitional economy.

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For my wife, son and daughter

Preface

China has been in great transition since the end of the 1970s. It has gradually moved from a rigid planned economy with public ownership of the means of production toward a socialist market economy. Shaped by political, social, and economic factors, the enterprises have undergone significant changes. Macro changes in the economic system and micro changes at the firm levels have called for a general reform of the legal system as a whole, with a particular focus on the reform of corporate law and securities regulation.

While there is a wealth of literature on Chinese law, the discussions and debates on corporate law tend to be descriptive or not very relevant to the transitional Chinese economy. The importance of organizational economics and modern corporate finance has not been adequately dealt with by the existing literature on Chinese corporate law. Unsatisfied with the current body of work in this area, I have devoted a considerable amount of time and energy into the study of corporate governance issues from an interdisciplinary perspective in the last decade. This book to a large extent reflects my effort in using the agency theory to analyze the political, social and economic factors, which have shaped the changes in Chinese corporate law. The essays in this book indicate how the economic theories of organization and corporate finance clarify different facets of the agency problem of enterprises in China's transitional economy; further, the essays will suggest means of utilizing the political and legal system to address this fundamental problem.

Portions of this book have been presented at workshops and conferences at the law or business schools of Seoul National University, Academic Sinica of Taiwan, Melbourne University, Macquarie University, Canberra University, Beijing University, Tsinghua University, Renmin University, China University of Political Science and Law, and Zhejiang College of Finance and Economics. I thank the participants at these workshops and conferences for their substantial contributions.

Some of the chapters of this book are derived from articles that I have published previously. Chapter 1 is based on 'The Relevance of Comparative Corporate

Governance Studies for China,' 8(1) *Australian Journal of Corporate Law* 49 (1997). Chapter 2 is based on 'Using Western Law to Improve China's State-Owned Enterprises: of Takeovers and Securities Fraud,' 39(2) *Valparaiso University Law Review* 339 (2004). Chapter 4 is based on 'Takeovers in China: The Case against Uniformity in Corporate Governance,' 34(2) *The Common Law World Review* 169 (2005). Chapter 6 is based on 'Towards an Institutional Competition Model of Comparative Corporate Governance Studies,' 6(1) *The Journal of Chinese and Comparative Law* 31 (2003). I thank the copyright holders for permission to use the material.

Many have facilitated this project. I take the author's conventional liberty not to mention all but a few here. I am specially indebted to Professors Michael Trebilcock and Bruce Chapman of the Toronto Law School and former Professor George Triantis of the Toronto Law School for their insightful lectures in the past. My thanks also go to Ms Elizabeth Byun and Ms Evangeline Lam for their editorial assistance. My special appreciation goes to my wife, son, and daughter for their patience and understanding for the time that I denied them while writing and completing this book.

Guanghua Yu
Hong Kong
July 2005

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Chapter 1

The relevance of comparative corporate governance studies

THE NATURE OF THE PROBLEM

Emphasis on the problem of separation of control and residual claims can be traced back to Adam Smith. Smith highlighted the potential pitfalls of company structures that separated management from ownership. He stated that:

> The directors of such companies being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.[1]

He predicted that due to agency problems,[2] corporations that separated management from ownership would be unable to compete with organizational forms that allied ownership more closely with control. While he was correct in suggesting that serious agency costs would arise, he was wrong in predicting that the corporate form would fail. In their seminal work, Berle and Means examined the shareholding structure of modern US corporations and explained that the separation of ownership from control weakens the check on managerial power and makes convergence of interests between managers and shareholders more difficult.[3]

Sceptics such as Smith had noticed the potential problems resulting from the separation of residual claims and control in corporations. However, they neglected monitoring devices such as market forces and contractual mechanisms in alleviating such problems. It can be said that sceptics were either not interested in or have not paid any attention to comparative studies of monitoring devices. Recently, criticisms have been directed at these sceptics. Stigler and Friedland recognize the contribution of Berle and Means' work in that the maximizing of the present value of a firm should be modified to take account of the separate interest of the management.[4] However, they severely attacked the main theme of Berle and Means on two significant grounds. First, they claimed that empirical evidence available at the time when Berle and Means wrote their book did not establish that different types of corporate control had an effect on profits. Second, the data also revealed no relationship between the compensation of corporate executives and the type of control.[5] However, I find that the analysis by Stigler and Friedland is far from satisfactory. With respect to the relationship between corporate profit and control, any static cross-sectoral analysis based on evidence on a particular point in time is simply unable to take into account the benefits gained from the growth of a corporation and the costs resulting from agency problems. I believe that ownership does matter.[6] With respect to the relationship between remuneration of corporate executives and type of control, the data used is again static. The effect on the labour market is not considered.

Furthermore, perquisite consumption is not confined only to salaries or bonuses. Luxury offices or hotel rooms and other activities such as reduced efforts should also be included. Stigler and Friedland, however, were clearly right in their criticisms that Berle and Means failed to pay any systematic attention to the operation of the economic system.[7] Within any economic system there exist monitoring devices which curb agency costs. Although Stigler and Friedland assumed the existence of such monitoring devices, they did not examine the economic implications of these monitoring devices.

Demsetz and Lehn launched similar attacks on Berle and Means' findings.[8] Their analysis on the separation issue is simple. They argue:

> If difference in control allows managers to serve their needs rather than tend to the profits of owners, then more concentrated ownership, by establishing a stronger link between managerial behavior and owner interests, ought to yield higher profit rates.[9]

However, they did not expect to find such a relationship and their view was confirmed by the data they collected.[10] I think that Demesetz and Lehn did not satisfactorily refute the thesis of Berle and Means. The finding that there is no correlation between the profit rate and ownership concentration does not mean that agency costs are not high in management-controlled corporations. As Demesetz and Lehn pointed out, the higher costs and reduced profits that would be associated with loosening of owner control should be offset by lower capital acquisition costs or other profit-enhancing aspects of diffused ownership if shareholders choose to broaden ownership.[11]

In the same article, Demsetz and Lehn also argued that share ownership concentration levels are inversely related to the aggregate size of the firm.[12] This relationship holds because as the value-maximizing size of the firm increases, the cost of acquiring a control block will also rise, deterring control accumulation. In addition, when the benefits from control transactions are smaller than the benefits resulting from share diversification, the latter will be chosen. It seems that Demsetz and Lehn did not consider comparative studies of monitoring devices. Otherwise, they may have found that their conclusion could not be applied to Germany and Japan. Roe pointed out that most of the biggest non-financial corporations in Japan and Germany are controlled by financial institutions.[13] I believe that comparative studies of monitoring devices guided by agency theories can explain the determinants of different monitoring devices in different places.

Despite the costs in the formation and growth of corporations, the economic functions of modern corporations indicate that the formation and growth of corporations also give rise to economic benefits. Under the conditions of shareholder profit maximization, the benefits resulting from the formation and growth of corporations include reduction of transaction costs,[14] risk diversification,[15] team work,[16] special knowledge of managerial experts,[17] and economies of scale.[18]

In this chapter, I assume these benefits (without proving them as the benefits connected with the formation and growth of corporations) normally exceed the agency costs. Deviation may occur when the management of a corporation makes mistakes or pursues its own interests in expanding the size of corporations. Competition between different sized corporations, however, sifts out the more efficient enterprises.[19]

My main purpose is to examine how monitoring devices such as market forces and contractual arrangements may reduce agency costs resulting from the separation of control and residual claims and also those agency costs connected with loan transactions and bond issues. Building on Jensen and Meckling's work, I discuss agency costs in section two. Then I will canvass the roles of various monitoring devices in alleviating agency costs. While there is a wealth of literature on agency theories, the literature on agency costs resulting from the separation of control and residual claims and the literature on agency costs related with loans and bond issues has been developed along separate lines. Although a particular method of financing determines the corresponding monitoring devices, a monitoring device may serve the purpose of controlling both the agency costs of equity financing and of debt financing. As the methods of financing corporate decisions through either debt or equity are not mutually exclusive, monitoring devices dealing with agency costs of both debt financing and equity financing could coexist.

In section three, I will compare special features of monitoring devices in Germany, Japan, the USA and Hong Kong. As monitoring devices can simultaneously affect both agency financing and debt financing, I conclude that monitoring devices in these countries are not static and countries can learn from each other, although it should be borne in mind that the adaptation of foreign laws is subject to local political and economic conditions. I will then demonstrate in section four the relevance of comparative studies of monitoring devices for China's economic reform. In contrast to Roe, I believe that comparative studies of monitoring devices have significant policy implications.

AGENCY COSTS AND MONITORING DEVICES

Jensen and Meckling define an agency relationship in equity financing as a contract under which one person (the principal) engages another person (the agent) to perform some services on its behalf which involves delegating some decision-making authority to the agent.[20] In the corporate law context, the principals refer to shareholders and the agents refer to directors and managers. If the principals and agents are rational, there is good reason to believe that the agents will not always act in the best interests of the principals. This has been well documented by Berle and Means.[21] The divergence of interests will cause three types of costs – the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.[22]

The monitoring expenditures by the principals refer to the costs incurred by the principals to provide incentives for the agents through contract and to monitor the activities of the agents. The bonding costs are necessary because it is to the benefit of the agents to spend resources in order to guarantee that they will not take certain actions which will harm the principals or to ensure that the principals will be compensated if the agents take such actions.[23] The agents benefit from these expenditures as these costs serve the purpose of signalling to the principals that the agents are relatively good and reliable. Inefficient managers and directors are more likely to fail in corporations. Hence, it is less likely for them to make these promises. Therefore, bonding costs tend to alleviate the ex ante adverse selection problems.[24] The residual loss is inevitable as it is generally impossible for the principals or the agents to ensure that the agents will make optimal decisions from the principals' viewpoint at zero cost. Agency costs of equity financing may include lapses in managerial competence or effort, managerial entrenchment or empire building and excessive managerial compensation or perquisite consumption.

Similarly, there are agency costs in debt financing. The agency costs associated with the existence of debt claims for the corporation include the opportunity wealth loss caused by the impact of debt on the executives by the bondholders and the bond issuers or loan users, and the bankruptcy and reorganization costs.[25] The opportunity wealth loss refers to wealth transfer transactions that reduce efficiency. When the debt/equity ratio is very high, bond issuers and borrowers will have a strong ex post incentive to engage in risky activities which promise very high payoffs if successful but have a very low probability of success. If they do well, the bond issuers or borrowers capture most of the gain. On the other hand, if the riskier projects turn out badly, the creditors or bondholders bear most of the costs.[26]

Specifically, at least four types of wealth-redistributing transactions can be identified.[27] First, firm assets of the debtor or bond issuer are distributed to shareholders of the debtor or bond issuer. The most explicit form of wealth transfer is the distribution of firm assets to shareholders after debt has been issued. The distribution of firm assets to shareholders includes the payment of dividends or the repurchase of stock. The removal of assets decreases the expected value of the firm at maturity and devalues existing debt.

Second, wealth transfer transactions may be carried out by the subsequent issuance of debt of equal or higher priority. As the issuance of new debt of equal priority increases the amount of competing claims, the value of existing debt is reduced if the use of the new capital does not increase the present expected value of the firm at maturity by at least the amount of the new debt.[28] Existing creditors are also worse off if secured debt of higher priority is issued as this reduces the claims of the existing creditors if the new debt is not properly used.

Third, wealth transfer may take the form of increasing the risk of the assets of the borrower. After the issue of debt, debtors have the opportunity of switching to a riskier investment strategy that enables shareholders of the debtors to benefit from all the upside risk and participate in the downside risk only to the extent of their investment. In the transactions, creditors or bondholders must share in the downside risk up to the amount of their investment but cannot share in the upside benefits beyond the face value of their debt. The frequency of these wealth transfer activities increases when the debtor is close to insolvency. Finally, debtors may gorge valuable investment opportunities. Managers of the debtor have incentives to pass up valuable investment opportunities when profits from the investment would accrue to debt holders and not to their shareholders.[29]

Bonding costs refer to the promises made by the contractual parties to reduce adverse selection problems and moral hazard problems. For instance, the provision of firm-specific assets as security to the creditor is a type of bonding cost. In the case of the debtor not being able to pay the due debt, some valuable assets of the firm may be lost. Monitoring costs refer to the costs incurred by the creditor to check whether the debtor has misbehaviours which violate any contractual provisions and to check the management of the debtor's business. Since management is a continuous decision-making process, it will be almost impossible to completely specify the conditions without having the bondholders actually perform the management function.[30] In other words, unnecessary detailed provisions and continued monitoring of the debtor may result in some efficiency losses.

Bankruptcy costs include reduced claims, legal and liquidation or reorganization fees. Weiss estimates that bankruptcy costs for large corporations in the USA are approximately 3 per cent of the firm's assets at the time of bankruptcy.[31]

In addition to these direct costs, indirect costs include inefficient use of assets, loss of customers or suppliers, loss of warranties on the part of consumers before, during or after the process.

Agency theorists have adopted the concept of the nexus of contract in corporations developed by theorists of property rights.[32] In this way, agency theorists are able to analyse contractual arrangements between shareholders, directors, managers, and creditors without being hindered by the 'black box' (the artificial form of a corporate person) as discussed in neoclassical economics.[33] Within agency theorists, the individual agent is the elementary unit of analysis.[34] The key to understanding the agency problem is to recognize that parties to a contract bear the agency costs of the relationship. Therefore, self-interested maximizing agents have the incentive to minimize the agency costs in any contractual relationship.[35] Jensen and Meckling have argued, however, that the debtor (owner–manager) bears the entire wealth effects of the agency costs of debt and captures the gains from reducing them.[36] Jensen and Smith further explain:

> When bonds are sold, bondholders forecast the value effects of future decisions. They understand that, after issuance, any action which increases the wealth of the stockholders will be taken. Therefore, on average, bondholders will not suffer losses unless they systematically underestimate effects of such future actions. But the firm (and hence its stockholders) suffers losses, agency costs, from all nonoptimal decisions motivated by wealth transfers from debtholders. Therefore, by reducing these agency costs, contractual control of the bondholder–stockholder conflict can increase the value of the firm.[37]

I have difficulty accepting the argument that the debtor (owner–manager) bears the entire wealth effect of the agency costs of debt financing since misbehaviours of the debtor are fully anticipated at the time the debt is issued. In the first place, the distinction between ex ante adverse selection problems[38] and ex post moral hazard problems[39] is not clearly drawn. Creditors may be willing to incur screening costs in order to find good and worthy credit users. Both screening costs incurred by creditors and singling efforts made by the credit users are for the purpose of solving the adverse selection problem.

The ex post moral hazard is much more difficult to estimate. The claim that all future possible misbehaviours can be anticipated before the transaction excludes the uncertainty of the ex post moral hazard problem, hence, ex post adjustment. This seems to be inconsistent with reality where people conduct business on the basis of uncertain or imperfect information. Knight takes the view that profit derives from uncertainty.[40] In addition, it is difficult to argue that the debtor (owner–manager) bears the entire wealth effects of the agency cost of debt financing. If some creditors have less information on potential credit users, they will lose out on the market. If they extend huge loans to debtors who later become insolvent, these creditors suffer losses too. Although such creditors may shift some or all losses to other credit users, the result does not entirely support Jensen and Smith's argument. Shifting losses to future transactions and sustaining losses from credit transactions are different issues. Furthermore, not all losses can be spread to other credit users. Whether losses can be shifted depends upon the elasticity of the supply and demand curves. If the supply function of credit is positively sloped, borrowers do not bear the full incidence of increased costs.[41] Similarly, it can be proven that agency costs of equity financing are not entirely borne by agents such as directors and managers. Shareholders also bear part of the efficiency loss. A ready example is state-owned enterprises in socialist countries. Given the large number of these firms, the people of the country (in theory, the owners of these enterprises) bear the cost of having a very low standard of living. Part of the loss is obviously due to agents' deficiencies while another part of the loss can be attributed to collective action problems on the part of the owners.

Having defined agency costs, we will now examine monitoring devices which play the role of curbing these costs. As mentioned, there are many monitoring devices including market forces and contractual mechanisms. In the first place, the capital market exerts pressure to orient a corporation's decision process towards the interests of the residual claimants.[42] Whether this monitoring device is effective depends upon the efficiency of the capital market. Now it is generally accepted that stock prices quickly respond to publicly available information about the corporations. When a shareholder makes her or his initial investment, the price paid for securities of a corporation reflects the expected agency costs at that time fairly accurately. However, information costs money and foresight is not perfect, and managers may shirk or divert wealth from the shareholders after the fact. The unique nature of capital markets makes it possible for them to play a role in detecting and signalling unanticipated opportunism by managers when it occurs, and in this way the share price can discipline such conduct. By incorporating the consequences of management misconduct into such prices, capital markets furnish shareholders with a relatively unambiguous signal of corporate performance. So if the price of a corporation's shares increases faster than those of other similar corporations on the market, the investor can predict that the corporation is being well managed and monitored. However, if the share price of the corporation underperforms rivals, the spectrum of managerial incompetence or shirking is raised. If faced with the latter case, the shareholder has the option of selling his shares. Any sale of a company's share affects the share price in precise proportion to the total number of shares sold. Thus, the more shareholders selling their shares, the lower the price of the corporation's stock will be.

Not all the shareholders are willing or able to exit and another alternative is to voice their opinions.[43] The force of their voice depends upon the proportion of their shares relative to the existing shares of the corporation. For those corporations which have to rely on the stock market for future capital, the decrease in the price of its shares affects the cost of the firm's future capital. For other corporations which do not rely on the stock market for future capital, the market of corporate control, which we will examine later, may constrain the behaviour of the management.

External monitoring by a takeover market may also influence corporations because of the unrestricted nature of its residual claims.[44] Because the residual claims are freely alienable and separable from roles in the decision process, hostile bidders can circumvent the existing managers and gain control of the decision-making and approval process. The benefits of takeover transactions must be viewed both ex ante and ex post.[45] Ex ante, a regime with takeover markets makes incumbent managers more careful in aligning their interests with those of the residual claimants. Ex post, if managers do shirk and seek perquisite consumption, vigilant acquirers will respond quickly as the gains the acquirers expect vary in direct relation to the level of agency costs incurred by the shareholders of a given corporation. By displacing inefficient managers, the acquirers expect gains from such transactions although part of the gain is shared with the shareholders of the target corporation. When takeover transactions discipline managers, they also move productive resources to higher value users. Empirical studies in the USA support this position when the proper benchmark is used.[46] Further, defensive tactics by directors are likely to be harmful to the shareholders of the target corporation.[47]

Competition in product markets helps to control agency costs.[48] Under consumer sovereignty, if a corporation supplies a product that was popular with consumers because of quality, price, or style, then the corporation's market share will increase. If a corporation's product fails to capture an adequate market share, this will signal to the shareholders that they may need to discipline the managers. Although discipline of senior management is accomplished through the board of directors, shareholders can threaten to alter the composition of the board through their voting rights if the board refuses to discipline managers.

In loan transactions, failure of a company on the product market may result in default. If that occurs, the creditor will react quickly to exert its influence over the management of the borrower. Even if the creditor refuses to voice its opinion, the exit option of terminating further relationship with the borrower will send out signals to other stakeholders who may choose to exert their influence through voice.[49] While the product market is quite effective in forcing out inefficient firms in the process, the shareholders or creditors of a corporation may find the effect of this market comes too late ex post.