

## Non-legal Protection for Minority Shareholders in China

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### **Abstract:**

Minority shareholders in China face the risk of exploitation by both managers and majority shareholders. This is due to owner absence and concentrated ownership structures. In reducing these double agency costs, non-legal protection has a key role to play. Four market forces have been identified as reducing these double agency costs: each of these will be evaluated. Whilst their effectiveness may be recognised in some countries, this paper will conclude that certain factors hamper their function, thus rendering them ineffective in today's Chinese context.

**Key Words:** Agency Cost, Market Forces, Market for Corporate Control

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\* This article is part of the author's PhD thesis. The author is indebted to his PhD supervisor David Cabrelli for his kindest and patient guidance. The author would also like to express his appreciation to Dr Robert Lane for giving useful comments.

## 1. INTRODUCTION

China has been experiencing unprecedented economic and social development due to its economic reform and open policy. This significant economic achievement of the recent past also creates a number of difficulties that must be addressed. Prevalent reports of exploitation by majority shareholders and managers have enhanced the view that agency cost in Chinese companies is exceptionally severe. Thus the capital market and economic development would be negatively affected if this agency cost was not properly addressed.<sup>1</sup> With this increasing awareness of providing protections for minority shareholders in China, many mechanisms have been adopted and enacted to reduce the agency costs.

In addressing this issue, the law can have a significant role to play. The apparent example is Company Law 2005 which was first enacted in 1992 and then revised in 2005.<sup>2</sup> This amended legislation is regarded as an investors-friendly law as it introduced many institutions to protect the interests of minority shareholders.<sup>3</sup> For example, the derivative action which aims to protect the interests of the company and the minority shareholders was introduced at the very first time.<sup>4</sup> Indeed, the legal protections, which focus on how law and regulations organise the internal structure of the company and coordinate the relationship among the constituencies, are necessary to provide protections for minority shareholders. However, this article attempts not to explore the legal methods, but to evaluate the non-legal protections as there have been a vast number of literatures examining the legal mechanisms in reducing agency costs and protecting minority shareholders. Non-legal protections, mainly market forces, could also have a key role to play in constraining the misbehaviours of directors or majority shareholders. As such, it is meaningful to explore these non-legal methods in the context of China.

As the non-legal methods mentioned here aim to reduce the agency costs and thus protect the interests of minority shareholders, this article thus will first briefly explore the double agency costs in China: vertical agency cost between shareholders and managers and horizontal agency cost between majority shareholders and minority shareholders. In addressing these issues, this article will proceed to evaluate the non-legal protections for minority shareholders in the context of Chinese contemporary society. Four types of market forces have been identified in this regards: the product market, the labour market for managers, the capital market and the market for corporate control. Although these market forces may be effective in other

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<sup>1</sup> The details of agency costs in China, please see: Shaowei Lin, "Double Agency Costs in China: A Legal Perspective", *Asian Business Lawyer*, 2012 Vol.9, pp115-135.

<sup>2</sup> The Company Law of the People's Republic of China was amended at the 18th session of the Standing Committee of the Tenth National People's Congress of the People's Republic of China on October 27, 2005. It then entered into force on January 1, 2006.

<sup>3</sup> See Junhai Liu, *Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies* (Beijing: Law Press China, 2006), pp189-298.

<sup>4</sup> See Shaowei Lin, "Derivative Actions in China: One Step Forward, Two Steps Back?", *International Company and Commercial Law Review*, 2012 Vol.23 Issue 6, Pp197-205.

jurisdictions, this article will conclude that their effectiveness in reducing the agency costs in the context of China is strongly doubted.

## 2. DOUBLE AGENCY COSTS

The theory of agency cost was first unveiled by Berle and Means in which they identified that those who control large public companies do not necessarily have substantial ownership interest in them, while conversely, those who own such corporations do not manage them.<sup>5</sup> Whilst the separation of ownership from management can ultimately increase company benefits and promote the capital market, this separation can also create conflicts when the interests of managers and shareholders are not aligned.<sup>6</sup> Thus, agency costs may arise due to this separation. Three agency problems have been identified in business firms: vertical agency problems between shareholders and managers, horizontal agency problems between majority shareholders and minority shareholders, and third agency problems between a firm itself and the other parties with whom that firm contracts.<sup>7</sup> As the latter agency problem is not relevant to the protections of minority shareholders, it will thus not be discussed in this article.

Concerning the first two agency problems, various studies have identified a relationship between ownership structure and agency cost.<sup>8</sup> In jurisdictions where ownership structure is dispersed, such as the UK and the USA, managerial agency cost is generally much more serious. That is because managers have much greater power to control a company because scattered shareholders mean that no block shareholders are able to monitor management.<sup>9</sup> Conversely, for those jurisdictions with concentrated ownership, such as Germany, the managerial agency problem is not a major issue; rather, conflicts between controlling shareholders and non-controlling shareholders are of principle concern.<sup>10</sup> In these ownership- concentrated countries, majority shareholders have both the ability and incentive to constrain the directors'

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<sup>5</sup> AA Berle and GC Means, *The Modern Corporation and Private Property* (rev ed Harcourt 1968); See also P Redmond (9ed) *Companies and Securities Law: Commentary and Materials* (Law book Co 1988) p181.

<sup>6</sup> See, e.g., Steven Ross, "the Economics Theory of Agency: The Principal's Problem", 63 *American Economic Review* 134 (1973).

<sup>7</sup> Reinier Kraakman et, *The Anatomy of Corporate Law*, ((2<sup>nd</sup> edition, Oxford, OUP, 2009) ,P36.

<sup>8</sup> See Berglöf, E. (1997). "A note on the typology of financial systems". In K. Hopt and E. Wymeersch (eds), *Comparative Corporate Governance: Essays and Materials* (Berlin: Walter de Gruyter), 151–64; Armour, J., Deakin, S. and Konzelmann, S. "Shareholder Primacy and the Trajectory of UK Corporate Governance", (2003) 41 *British Journal of Industrial Relations*, 531, 533;

<sup>9</sup> See R. La Porta, F. Lopez-De-Silanes A. Shleifer & R. Vishny, "Corporate Ownership around the World"(1999) 54 *Journal of Finance*, 475; M. Aoki, "Controlling Insider Control: Issues of Corporate Governance in Transition Economies" In Masabiko Aoki & Hyung-Ki Kim (eds.), *Corporate Governance in Transition economy, Insider Control and the Role of Bank* (EDI Development Studies 1996) .5,

<sup>10</sup> See Cheffins, B. "Putting Britain on the Roe map: the emergence of the Berle–Means corporation in the United Kingdom", In J. McCahery and L. Renneboog (eds), *Convergence and Diversity in Corporate Governance Regimes and Capital Markets*, (Oxford: Oxford University Press), 147–70; The discussion in J. Armour, R. Kraakman, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda & E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edition, Oxford, OUP, 2009) 29-32

performance. At the same time, agency problems between majority and minority shareholders are created as the former can impose their influence on the company to benefit themselves at the expense of the latter. Although these two types of agency problems can coexist, they are usually mutually exclusive as countries generally have dispersed ownership or concentrated ownership structures. However, this is not the case in China.

## 2.1 Vertical Agency Cost between Shareholders and Managers

As mentioned above, the agency problem between managers and shareholders is not a dominant issue where ownership structure is very concentrated, as block shareholders are better able to influence management. This might appear to be the position in China as many listed companies are still controlled by the government. Indeed, according to research conducted by the Chinese State-owned Assets Supervision and Administration Commission (SASAC), by the end of 2009 almost 900 listed companies were controlled by the government, of 1600 companies on the Chinese stock exchange. Further, these state-own enterprises occupied over 80 percent of the total share values of all listed corporations.<sup>11</sup> It may therefore seem that the managerial agency problem should not be a key concern in China as ownership is so concentrated that managers could not have sufficient power and discretion to gain personally at the expense of the company or other shareholders. Unfortunately, however, these suppositions are not applicable to China due to the State-owned enterprise (SOE) reform. The SOE reform which aimed to establish a modern enterprise system has increased managerial autonomy. Without an effective external checks and balances, this reform also results in many negative consequences in which the problem of owner absence is the most severe one.<sup>12</sup> Accompanying with this owner absence, the State as a majority shareholder cannot exercise its legal rights and powers to constrain the misbehaviours of management. As a consequence, the interests of minority shareholders are vulnerable to be exploited by the managers and thus a vertical agency problem may arise.

## 2.2 Horizontal Agency Cost between Majority Shareholders and Minority Shareholders

It is widely accepted that this kind of agency cost is very common in concentrated ownership jurisdictions. This is particularly so in China as SOEs are widespread. However, it is also argued that because the state, rather than other investors, is the sole controlling shareholder in listed SOEs, it is unlikely that the government will act against the interests of minority shareholders. Generally, it is true that the government has a legitimate concern to protect the interests of the company as a whole, including those of minority shareholders. However, this might not always be the case as government interests may not always align with the interests of

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<sup>11</sup> 'Guo Zi Wei Dui Shangshi Gongsi Zuo de Buchong Guiding' [A Survey on Listed Companies by State-Owned Assets Supervision and Administration Commission of the State Council] at <http://www.chinasoe.com.cn/gqxcg/2009-11-27/404535.shtml> accessed 21<sup>st</sup> September 2011.

<sup>12</sup> Details of the SOE reform in China, please see: Shaowei Lin, "Double Agency Costs in China: A Legal Perspective", *Asian Business Lawyer*, 2012(1).

minority shareholders or even the company itself.<sup>13</sup> Therefore, agency cost arises when the state, as a controlling shareholder, attempts to maximise its own benefits to the detriment of the interests of minority shareholders.

Three major forms of tunnelling activity engaged in by controlling shareholders have been identified in China.<sup>14</sup> The first is where listed companies are forced to provide soft loans or guarantees to controlling shareholders.<sup>15</sup> The second is where the assets of listed companies are transferred at an undervalued or unfair price to a third party who is involved with a controlling shareholder.<sup>16</sup> The last is where the assets of listed companies are appropriated or misused directly by the controlling shareholders.<sup>17</sup> Although new ways of tunnelling have been found,<sup>18</sup> the above three activities remain the main popular methods. In light of the deteriorating situation, many measures have been adopted to tackle these problems though they have generally proved futile in the face of the expanding scale of tunnelling. Practical research conducted by Li has found out that RMB 96.7 billion was appropriated by controlling shareholders in 2002,<sup>19</sup> with this figure doubling in 2003.<sup>20</sup> Another study has also revealed that 37 percent of the 173 listed companies had experienced the tunnelling phenomenon.<sup>21</sup>

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<sup>13</sup> Andrei Shleifer and Robert W. Vishny, "A Survey of Corporate Governance", 52 *Journal of Finance* (1997) 737, 758-61.

<sup>14</sup> The term of "tunnelling" was originally used to describe the expropriation of minority shareholders in the Czech Republic and then it was expanded to characterize the transfer of assets or resources of a company to its majority shareholders. See Simon Johnson et al., "Tunnelling". 90 *American Economic Review*, (2000) 22.

<sup>15</sup> See Shanghai Zhengquan Jiaoyi Suo [Shanghai Stock Exchange], 'Guanyu Dui Shanghai Lengguang Shiye Gufen Youxian Gongsi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Shanghai Lengguang Shiye plc] (11th 6 1999); available at <<http://static.sse.com.cn/sseportal/ps/zhs/>> accessed 4th October 2011 Shenzhen Zhengquan Jiaoyi Suo [Shenzhen Stock Exchange], 'Guanyu dui Beijing Zhongguancun Keji Fazhan (Konggu) Gufen Youxian Gongsi Yuyi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Beijing Zhongguancun Keji Fazhan plc] (28th 9 2001) available at: <<http://www.szse.cn/>> accessed 4th October 2011 also see G.H. Jiang, C.M. Lee & H. Yue, "Tunneling in China: The Surprisingly Pervasive Use of Corporate Loan to Extract Funds from Chinese Listed Companies", Johnson School Research Paper Series 31-06. <[http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=861445](http://papers.ssm.com/sol3/papers.cfm?abstract_id=861445)> accessed 4th October 2011

<sup>16</sup> See Shanghai Zhengquan Jiaoyi Suo, [Shanghai Stock Exchange] 'Guanyu Dui Hubei Xingfu Shiye Gufen Youxian Gongsi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Hubei Xingfu Shiye plc] (23rd 2 2001) available at <<http://static.sse.com.cn/sseportal/ps/zhs/>> accessed 4th October 2011.

<sup>17</sup> Zhongguo Zhengjianhui [CSRC] 'Guanyu dui Hubei Meiyera Gufen Youxian Gongsi Ji Yougian Renyuan Yuyi Gongkai Piping de Gonggao' [Notice on Public Criticism on Hubei Meiyera Gufen Youxian plc] (12th 9 2001) available at <<http://www.csrc.gov.cn/pub/>> accessed 4th October 2011 Zhongguo Zhengjianhui [CSRC] 'Guanyu dui Ningxia He Minzu Huagong Gufen Youxian Gongsi Ji Yougian Renyuan Yuyi Gongkai Piping de Gonggao' [Notice on Public Criticism on Ningxia He Minzu Huagong plc] (31st 10 2001) <<http://www.csrc.gov.cn/pub/>> accessed 4th October 2011

<sup>18</sup> See Sheng Min, "New Ways of Tunnelling Listed Companies", *New Fortune*, November 5, 2006.

<sup>19</sup> Li Shan, "Appropriation of One Hundred Billion by the Controlling Shareholder Alarms the Bell", Shanghai Securities News, April 2, 2004.

<sup>20</sup> Yongjun Zhang, "Appropriation of the Listed Companies' Assets by the Controlling Shareholders Should be Addressed Fundamentally", *Securities Times*, December 7, 2004.

<sup>21</sup> H. Zhang, Z.D. Wu, "The Characteristics of Appropriation of Public Companies' assets in China", (2003) 5 *Journal of Public Companies*, 17, 24

### 3. NON-LEGAL PROTECTION FOR MINORITY SHAREHOLDERS

In order to protect the interests of minority shareholders and companies, market forces are in place to reduce these double agency costs. Four market forces have been identified to constrain the opportunistic behaviour of managers and majority shareholders: namely, the product market, the labour market for managers, the capital market and the market for corporate control.

#### 3.1 The Product Market

The principle market for a company is that in which it sells its products. To compete in today's fiercely competitive market, it is extremely important for companies to provide high quality products. To achieve that goal, a company must impose rigid controls on all aspects of productions and sale to reduce redundant costs. If a company's product cannot be competitively priced, then it can lose its market share and induce the negative consequence that managers are likely to be dismissed. In this respect, there is little room for managers to abuse their powers to pursue personal interests by exploiting the company. For example, self-dealing directors would have greater concern in keeping the company's product competitive. Legal remedies are thereby less important as directors have restricted space to manipulate their positions.

In China, the economic miracle has undoubtedly demonstrated the success of the market economy. The transformation from a planned economy to a market-oriented economy has seen markets becoming increasingly competitive. This is also enhanced by rapid globalization. It is therefore reasonable to suggest that in practice product markets in China have prevented directors from misusing their powers to some extent and in this sense the interests of minority shareholders might be safeguarded. This assertion is supported by some practical research. Huang has examined the relationship between product market and corporate governance among 807 listed companies on the Shanghai and Shenzhen Stock Exchange. He concluded that a competitive product market can improve resource allocation and enhance supervision within the company, which together constrain the behaviour of directors, and thus improving corporate governance.<sup>22</sup>

Another practical study led by Xiao and Xia was to investigate the relationship between the product market and Board of Directors using evidence from listed manufacturing corporations in China from 2003 to 2005. This study found that product market competition can effectively increase the efficiency of the company and improve the functions of the corporate governance.<sup>23</sup> This is further sustained by Qi and Yan.<sup>24</sup> Nevertheless, the above studies

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<sup>22</sup> Lei Huang, "The Practical Analysis of Product Market Competition", *Journal of Finance and Economy*, 2010.11.pp72-74.

<sup>23</sup> Xiao Hao, Xia Xin-ping, "Product Market Competition, Board of Director and Stock Price Synchronicity- An Empirical Study Based on China's Listed Manufacturing Companies", *Journal of Guizhou College of Finance*, 2011.(1). P62-67.

<sup>24</sup> Yongjun Qi and Xiaoyan Yan, " Study of the Interactive Relationship between Capital Structure and Product Market Competition—Empirical Evidence from Chinese Listed Companies", *Journal of Guizhou College of*

neglect to address the political factors behind the listed companies under examination. As a Communist country, the Chinese government must own or control some listed companies and these state-owned enterprises or state-controlled corporations might differ in their effectiveness vis-à-vis the product market. Research conducted by Fisman and Faccin shows that state-controlled corporations can significantly increase their value because of special political connections<sup>25</sup> while this is not the case in China. SOEs in China have to fulfil a number of functions assumed by the government, such providing employment, taxation and social stability to build a harmonious society. This policy burden not only hampers the corporation's value, but also affects the efficiency of investment.<sup>26</sup> In return, SOEs receive financial subsidy from the government when their products are not competitive. Here, the product market seems to be less important for some SOEs. Empirical research on China also supports the assertion that government-controlled enterprises are less sensitive to product market competition.<sup>27</sup> Even in some private sectors, local companies do not need to worry about their products because of the local protections. The obvious example is the beer industry where any local authorities wish to protect their own beer companies and thus restrict the beer products of other areas.

### **3.2 The Labour Market for Managers**

Reference to the “labour market for managers” denotes the employment market place for managerial and director services. Managers and directors, like other employees, must look for work when they are unemployed. Disloyalty or actions harmful to a previous employer, damages their reputation and reduces their ability to obtain a well-paid job.<sup>28</sup> In this regard, the labour market for managers could act as a mechanism to constrain agency cost and protect the interests of the minority shareholders.

Theoretically it does indeed provide a strong disincentive to incompetence or disloyalty where managers wish to pursue their careers. However, this function might be undermined by real world factors. First, where managers are at the end of their careers, the market for managerial and director services may not operate well to constrain misbehaviour, as senior officers no longer seek to further their careers and their performance may not to some extent matter to them. This is particularly so in China where many senior SOE officers exploit their personal interests through self-dealings or embezzlement when they are close to retirement. This so called “59 phenomenon” is not uncommon in China because retirement pensions for SEO officers are considerably lower than for government officials operating at the same level.

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*Financial*, 2011(1) p41-45. In which it is argued that the debt ratio and product market competition intensity have notably negative effects on each other.

<sup>25</sup> Fisman R, “ Estimating the Value of Political Connections”, *The American Economic Review*, 2001. 91(4): 1095-1102.

<sup>26</sup> Qingsheng Zeng and Xinyuan Chen, “The State-Controlled Shares, Excess Employees and the Cost of Labour”, *Journal of Economic Study*, 2006(5), 74-86.

<sup>27</sup> Yimin Xu and Zhihong Zhang, “Product Market Competition, Government Control and Investment Efficiency”, *SoftScience*, 2010(12). Pp19-23.

<sup>28</sup> David Kershaw, *Company law in Context: Text and materials.*(Oxford, OUP,2009), Web Chapter A. p2.

Secondly, where managers have sufficient personal wealth, the labour market might not be an effective method of curbing misbehaviour. Thirdly, even if managers are sacked for disloyalty or incompetence, the market place may not be informed of this as the company may be concerned about damaging its reputation in disclosing this information: thus those managers may continue to serve in other companies as prestigious as in the previous. Furthermore, in the context of China's Party State, senior SOE managers are unlikely to lose their jobs merely because they are not competent or loyal to their companies. Many SOEs are controlled by the so-called *Taizidang* or offspring of party leaders.<sup>29</sup> Their removal is highly unlikely unless they commit some serious crime that might put the whole company at risk. This can be illustrated by the case of Chen Jiulin, a former head of China Aviation Oil (Singapore) Corp, sentenced to the prison for more than four years for his role in a scandal that drove the company to the brink of bankruptcy. His poor governance led to a significant loss and failure to disclose a \$550 million trading loss. He was also charged with deceiving adviser, Deutsche Bank AG. That sentence seemed to mark the end of his career as Chen was no longer eligible to work in SOEs under China's Company Law and Enterprise State-owned Assets Law.<sup>30</sup> However, Chen was nevertheless appointed to be the vice president of CGGC International Ltd (*zhongguo Gezhouba Jituan Guoji Youxiangongsi*) after his released from prison.<sup>31</sup> It is therefore conceivable that such a person could be reappointed as vice president of an SOE after causing a

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<sup>29</sup> See Zheng Yongnian and Lye Liang Fook, "Elite Politics and the fourth generation of Chinese Leadership", *Journal of Chinese Political Science*, Volume8, numbers 1-2. Pp65-86.

<sup>30</sup> Article 147 of Company Law 2005 states that "A person in any of the following categories may not serve as a director, supervisor, or the general manager of a company:

- (1) without civil capacity or with limited civil capacity;
- (2) having been sentenced to prison for the following crimes, and completion of the sentence being less than five years ago: embezzlement, bribery, conversion of property, misappropriation of property, sabotage of social economic order; or having been deprived of political rights as a result of a criminal conviction, and completion of such sanction being less than five years ago;
- (3) having served as a director, the factory chief, or the general manager of a company or enterprise which underwent bankruptcy liquidation as a result of mismanagement, and being personally responsible for such bankruptcy, and completion of the bankruptcy liquidation being less than three years ago;
- (4) having served as the legal representative of a company or enterprise whose business license was revoked due to its violation of law, and being personally responsible for such revocation, and such revocation occurring less than three years ago;
- (5) in default of personal debt of a significant amount.

Article 73 of Enterprise State-owned Assets Law states: "Where any director, supervisor or senior manager of a wholly state-owned enterprise, wholly state-owned company or company in which the state has a controlling stake is removed from office for a violation of this Law which has caused gross losses of state-owned assets, he shall not serve as a director, supervisor or senior manager of any wholly state-owned enterprise, wholly state-owned company or company in which the state has a controlling stake within 5 years from the day of removal; if the violation has caused especially gross losses of state-owned assets or he has been subject to a criminal punishment for corruption, bribery, encroachment upon property, embezzlement of property or undermining of the socialist market economic order, he shall not serve as a director, supervisor or senior manager of any wholly state-owned enterprise, wholly state-owned company or company in which the state has a controlling stake for life."

<sup>31</sup> Although it is argued that his appointment is not against the law because the crime he committed was in Singapore and the penalty execution does not necessarily extend to the mainland of China, it is quite quibble for this argument as what Chen Jiulin had done was obviously proved to be an inappropriate person to run the state-owned enterprises. See <<http://baike.baidu.com/view/134742.htm>> accessed 21<sup>st</sup> September 2011.



loss of state assets; the function of labour market for managers is consequently highly questionable in this Party-State.

### 3.3 The Capital Market

Another non-legal protection for minority shareholders is the capital market. This mechanism operates on the principle that high agency cost will lower company's share price as shareholders will exercise their exit rights by selling their shares. Lower share price has the following minimum consequences: first, it makes it difficult for a company to raise finance on the capital market. Secondly, it can be easily acquired by other companies. In order to avoid this, directors and managers must reduce agency costs, thus disincentivising their exploitation of minority shareholder interests. Nonetheless, the key question is how the capital market reflects share price.

The rationale behind this assertion is the 'semi-strong efficiency' hypothesis, known as the 'efficient capital markets hypothesis'.<sup>32</sup> This theory holds that capital markets are efficient and can incorporate all publicly available information into the price of a company's shares. It does not presume that *everyone* is aware of the information available to the public and makes their decisions according to a proper analysis of this information as it is obviously impossible for every investor to investigate relevant information before buying or selling shares. Instead, it assumes that there are some market participants who are strong and smart enough to alter share prices in the right direction.<sup>33</sup> Such participants might be the highly informed and skilled investors investing their own or other people's money, or those investors who themselves are not very informed but rely on market professionals such as research analysts or securities.

In theory, it may be correct that publicly available information could inform capital markets which are efficient enough to reflect this information in share prices. However, the extent to which this hypothesis is merely an attractive theoretical idea or empirical reality has been a subject of intense debate. It would take a whole book to discuss this issue which therefore is beyond the scope of this paper. However, recent events in capital markets indicated that this hypothesis has increasingly less support. For example, the technology bubble in the late nineties and the recent subprime mortgage crisis appear to indicate that the market was pricing available information inaccurately. The counter-argument is that this hypothesis has weathered previous crisis such as the 1987 stock market crash.<sup>34</sup> Moreover, some studies demonstrated that investors are paying more attention to the internal regulations of companies, indicating the effectiveness of the capital market hypothesis.<sup>35</sup> This controversial debate is still ongoing and

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<sup>32</sup> See E. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 *Journal of Finance* 383. E. Fama, "Efficient Capital Markets II" (1991) 46 *Journal of Finance* 1575.

<sup>33</sup> R. Gilson and R. Kraakman, "The Mechanisms of Market Efficiency", (1984) 70 *Virginia Law Review* 549.

<sup>34</sup> See R. J. Shiller, *Market Volatility* (MIT, 1990).

<sup>35</sup> J. Gordon, "The Mandatory Structure of Corporate Law", (1989) 89 *Columbia law review*, 1549; R. Romano, "Empowering Investors: A market Approach to Securities Regulation", (1998) 107 *Yale Law Journal* 2359.

divides economists. As Lo observes, even after several decades of research and study, the question whether markets are efficient has not yet been solved and there is still no consensus among the economists.<sup>36</sup>

If we assume that the capital market is efficient and the hypothesis of semi-strong efficient is correct, we must acknowledge that information publicly available to the market should also be accurate. Three types of information have been categorized by Kershaw.<sup>37</sup> The first category concerns the company's financial position and includes financial statements; the second is the regulations or legal rules set out in the corporate statute or constitution. The last category encompasses any information about managerial misbehaviour or incompetence. These categories of information must be made accessible to the public to properly reflect a company's shares price. However, given the widespread financial fraud occurring in today's China, the price of shares does not actually reflect the value of a company.<sup>38</sup> In addition, it is generally believed that the Chinese capital market is a policy market rather than a real capital market. This so-called policy market has two implications: first, the market is extremely vulnerable to variation in the government's policy; secondly, policies regulating the capital market are changeable.<sup>39</sup> This capital market, which is so characteristic of the market in China, is relevant to the background of the economic reforms started in 1978. The 'cross the river by feeling its stones' paradigm was promoted by Deng Xiaoping, the former leader of China, in order to implement the reform policy and break down resistance to it.<sup>40</sup> This paradigm had a positive influence on almost every aspect of China – a state with little experience and knowledge of market economics at that time. However, the paradigm has now become an obstacle for the development of the capital market as the price of shares does not mirror the value of a company owing to unpredictable policies.<sup>41</sup> Wang and Ye have also concluded that the 'cross the river by feeling its stones' paradigm unquestionably leads to the policy market, which incurs the ineffectiveness of the capital market.<sup>42</sup>

In light of the above discussion, the capital market could to some extent effectively constrain managerial misbehaviour in general. However, it is strongly doubted that it could reduce

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<sup>36</sup> A. Lo, "Efficient Markets Hypothesis," in *The New Palgrave: A Dictionary of Economics*, Ed. L. Blume and S. Durlauf, (2edn, palgrave Mcmillan, 2007).

<sup>37</sup> David Kershaw, *Company law in Context: Text and materials.*(Oxford, OUP,2009), Web Chapter A. p5.

<sup>38</sup> Su Pei, "The Financial False and its Countermeasures in Chinese Listed Companies", *Journal of Changzhou Institute of Technology*, 2005 (3). pp51-54.

<sup>39</sup> Xi Wang, "The Implications of 'Cross the river by feeling its stones'", *China Institutional Economics Annual Conference Papers*, 2008.

<sup>40</sup> Xiaoping Deng, *Selected Works of Deng Xiaoping*, (Beijing: Renmin Publisher,1993,Volume3) , P174.

<sup>41</sup> Yunlan Zhou and Mengyi Yuan, "Study on Policy Market in Chinese Stock market", *Finance and Accounting Monthly*, 2011(4), pp21-24.

<sup>42</sup> Xi Wang and Mao Ye, "An Expatiation of the Policy Market Phenomenon in China's Stock Market", *Academic Research*, 2011(1) pp81-90.

agency cost in the context of modern China owing to the prevalence of financial fault and the uncertain policy market.

### 3.4 The Market for Corporate Control

The market for corporate control has been regarded as a central mechanism for constraining the misbehaviour of managers and directors since it was first unveiled by Henry Manne.<sup>43</sup> The basic idea behind this theory is that self-dealing or inefficient management may induce a low company share price, resulting in a corporate takeover threat. If a company is successfully acquired, those self-serving managers may be removed. In light of the risk of being sacked, managers have to try their best to increase company profit and act in the best interests of the company as a whole rather than pursuing their own interests to the detriment of the company. In this sense, the market for corporate control could reduce agency cost and constrain managerial misbehaviour.<sup>44</sup> However, this theory is based on the assumption that the market is efficient or at least relatively efficient: incompetence or the abuse of managerial discretion for self-benefit would be reflected in the capital market by lowering the value and share price of the company. Accordingly, an acquirer can seize this opportunity to acquire the company and remove bad managers.

However, several factors need to be considered to assess how this mechanism operates in practice. First, it should be noted that takeovers are not easy to execute. Indeed, they are a very expensive way of changing the management of a company as they involve substantial transactions costs.<sup>45</sup> Accordingly, a prudent bidder must consider the current value of a company and the agency costs incurred by its managers as well as the costs of acquiring the company before making a takeover decision. Generally, only when there is a profit-making opportunity in the value delta,<sup>46</sup> will a bidder offer to buy controlling company shares. Nevertheless, as Kershaw points out, agency costs alone are not normally large enough to activate a bid.<sup>47</sup> Even if they cause a significant reduction in a company's shares, Coffee considers that internal corporate governance mechanisms would be instigated before a bidder arrives on the scene.<sup>48</sup> Moreover, the evidence that corporate governance could be improved or agency costs reduced after takeovers remains ambiguous. Singh and Weisse have found that the main motivation behind corporate takeover is not to improve an acquired company's

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<sup>43</sup> H. Manne, "Mergers and the Market for Corporate Control" (1965) 73 *Journal of Political Economy*, 110.

<sup>44</sup> F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law*, (Harvard, 1991), 112.

<sup>45</sup> A Peacock and G Bannock, *Corporate Take-overs and the Public Interest* (Aberdeen University Press 1991).

<sup>46</sup> The share delta is the difference between the traded value of the share and the value of the share without a discount to take account of such costs.

<sup>47</sup> David Kershaw, *Company law in Context: Text and materials*.(Oxford, OUP,2009), Web Chapter A. p10.

<sup>48</sup> J. Coffee, "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance", (1984) 84 *Columbia Law Review* 1145.

competence but to build the business empire.<sup>49</sup> Also, the empirical evidence in the UK has shown that takeover markets are not notably related to poor performance.<sup>50</sup> Furthermore, Koulouridas argues that the threat posed by the market of corporate control could fuel managerial incentives for self-interested acquisitions.<sup>51</sup> Some managers may not wait to become targets if they know they will be ousted following a takeover. Consequently, they may attempt a defensive takeover to protect their own personal interests as the threat of replacing them is enough to make them act in their own interests. In this sense, the market for corporate control may increase agency cost and harm the interests of the minority shareholders.

When it comes to China, the effectiveness of the market for corporate control faces greater challenges. Empirical research conducted by Zhang has found that the extent to which transfer of corporate control improves a company's performance depends on the status of ownership concentration and its variation during the process of transformation.<sup>52</sup> Here, the function of the market for corporate control in China is obviously not useful. Indeed, several factors contribute to this: first, the ongoing reform of share trading has not proved unproblematic. This reform seeks to change split shareholding structures into one single form that could be freely transferred to the general public in order to implement the principle that the same shareholding should have the same right. It was expected that most non-tradable shares owned by central or local governments in listed companies would be reduced to an acceptable level and the modern corporate governance of SOEs could be established. However, the basic ownership structure of companies remains unchanged even after several years' reform,<sup>53</sup> and State investment companies are still the block holders of those listed companies. This makes it more difficult for the market for corporate control to function. Secondly, the visible hand of government prevails almost everywhere in the market despite the demise of the planned-economy. It is fair to say that the history of the market for corporate control is the history of government intervention, as the government remains continuously concerned with enterprise ownership partly because the traditional concept that the Communist state should control companies and markets has not completely vanished. In light of government intervention, accurate prediction of whether a takeover would be successful is extremely difficult because decision making power is in the hands of the government. Therefore, the market for corporate control's disciplinary function in

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<sup>49</sup> A Singh A singh and B Weisse, "Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets", *ESRC Centre for Business Research*, University of Cambridge Working Paper No.250, 28. Available at <[www.cbr.cam.ac.uk/pdf/WP250.pdf](http://www.cbr.cam.ac.uk/pdf/WP250.pdf)> accessed 21<sup>st</sup> September 2011.

<sup>50</sup> J Franks and C Mayer, "Governance as a Source of Managerial Discipline", *Prepared for the Company Law Review, Committee E on Corporate Governance*, (first draft 14 January 2000; revised 10 April 2000) 18.

<sup>51</sup> Athanasios Koulouridas, "The Law and Economics of Takeovers: An Acquirer's Perspective", (London: Hart Publishing, 2008), p39.

<sup>52</sup> Mubin Zhang, "The Study on the Effectiveness of the Market for Corporate Control in Chinese Listed Companies", *Nanjing Social Science*, 2007 (11). Pp28-36.

<sup>53</sup> Danyang Du, "The Exploration on the Ownership Structure after Share Trading Reform", *Shandong Social Science*, 2008(8) pp 112-114.

detering bad managers is weakened. Thirdly, the incomplete legal system of mergers and takeovers in China also casts doubts over the efficiency of the market for corporate control. Although several laws and regulations have been published to regulate mergers and takeovers, including the Measures for the Administration of the Takeover of Listed Companies Law and the Administration of Disclosure of Information on the Change of Shareholdings in Listed Companies, many problems persist because of imperfections in these regulations and an absence of other relevant laws. For instance, some of the regulations which were drafted under reforms concerning split shareholding structures are not suitable for addressing problems in capital markets after the reform of share-trading while the corresponding laws and regulations are still deficient. Fourth, it is also argued that the history of capital and stock markets in China is far too short, which inevitably creates some problems. Only in 1990, were two national stock exchanges authorised to be established: the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991. It is widely recognised that China's economic miracle could not have been achieved without the establishment of these stock markets, though many problems have emerged over the last twenty years. One of these problems is the extremely strict regulation of Initial Public Offerings (IPO).<sup>54</sup> This means that the motives for acquiring a company do not necessarily include improvement of its performance in corporate governance but can sometimes be merely to obtain listed status. These numerous limitations in China would undoubtedly weaken the effectiveness of the market for corporate control.

#### 4. CONCLUSION

Unlike other countries which have either vertical or horizontal agency cost problems, China has both. This is the result of China's SOE reform and its concentrated ownership structure. In order to reduce these agency costs, legal and non-legal mechanisms must be put in place to constrain the opportunistic behaviour of managers and controlling shareholders. While much literature has focused on legal mechanisms owing to the law's key role in this respect, the effectiveness of non-legal mechanisms in reducing agency cost should not be neglected. Four market forces have been identified and discussed in this article. Although these market forces may be effective in some other countries, their functions are hampered in the context of modern China owing to the aforementioned reasons discussed above. However, this does not mean that market forces are not indispensable in protecting the interests of minority shareholders. Rather, it represents the necessity for reforming and improving these non-legal mechanisms so as to provide better protections for minority shareholders in China.

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<sup>54</sup> See Securities Daily News, 27, April 2011. Available at <<http://finance.qq.com/a/20110427/001039.htm>> accessed 21<sup>st</sup> September 2011.

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