

**Legal Deterrence: The Foundation of Corporate
Governance—Evidence from China**

Zhong Zhang

PhD Candidate in Law

School of Law

The University of Manchester

Legal Deterrence: The Foundation of Corporate Governance—Evidence from China

To evaluate the Chinese government's recent market-orientated efforts to promote good corporate governance, this paper conducts a re-examination of the working mechanics for market competition and other market-based governance mechanisms to ensure good corporate governance. The finding is that the utility of market mechanisms may have been overstated. Not only are they not effective in disciplining serious one-off managerial misbehaviour which offers managers more gains than losses, even their limited value to discourage such misbehaviour as managerial shirking is also conditioned upon a successful curb on one-off misbehaviour. On the contrary, the importance of deterrence from legal liability may have been underestimated. Sufficient legal deterrence is the only effective way to curtail one-off managerial misbehaviour which is highly detrimental to corporate success. In addition, by deterring such misbehaviour, it provides for the condition upon which market mechanisms may function properly to discourage managerial shirking. In light of this, legal deterrence can be said fundamental to good corporate governance. Current experience of corporate governance from China conforms to this finding and poor corporate governance in China is better explained by the lack of credible legal deterrence. This being so, the top priority for China is to strengthen legal sanction in order to rein in excessive misappropriation and flagrant fraud. Only once this has been done will the efforts to undertake market-orientated reform yield the sought results.

Keywords: Corporate Governance, China, Market Competition, Legal Liability

A. Introduction

After an initial period of mania, the stock market in China faces the challenge of how to survive. Notwithstanding the fact that GDP in China has increased by more than

9% on average every year since 2001,¹ both the share indexes of Shanghai and Shenzhen Stock Exchange and the total value of market capitalisation have lost more than half.² Among the 70 million plus registered stock investors, a number which China took no more than ten years to reach, about 70% had sold out their investments and withdrawn from the markets.³ Before 2001, every year more than 100 companies on average conducted initial public offering (IPO) and were listed, but the number has substantially decreased after 2001 and in 2005 IPO activity virtually stopped.⁴ The government's policy to reform medium and large state-owned enterprises (SOEs) through corporatization and listing, which initiated the growth of the market, had to be brought to a halt.⁵ The stock market in Mainland China is being marginalized.

Why did share prices fall drastically while the macro-economy was growing rapidly? Why were IPOs not feasible while massive amounts of money were deposited in banks earning negligible interest?⁶ Why did so many investors flee from the market? Clearly the downturn of the stock market has a linkage to a series of corporate scandals which had broken out from the end of the 1990s. Embezzlements were widespread and it was common for companies to lose money soon after an IPO. But bad news was routinely covered up and accounting figures were blatantly falsified. Many corrupt company managers even made up stories about their companies' business prospects in order to collaborate with crooked market traders to manipulate share prices. Usually companies involved in frauds imploded after a scandal was revealed and unsophisticated minority investors suffered huge losses. Clearly

¹ Statistics available on the Website of the National Bureau of Statistics of China (in Chinese), <http://www.stats.gov.cn/>.

² In Shanghai, the Shanghai Stock Exchange Composite Index was 2245.44 at the peak on 14th June 2001 and was 998.23 at its lowest point on 6th June 2005 (Statistics available at <http://www.sse.com.cn>). In Shenzhen, the Shenzhen Stock Exchange Composite Index closed at 635.7310 in 2000 and in 2005 it closed at 278.7456; within the same period, the total market value decreased from 2,116,008.44 to 933,414.96 million Chinese Yuan, notwithstanding the fact that the issued shares increased from 158,096.84 to 213,364.81 million (Statistics available at <http://www.szse.cn>).

³ Statistics available on the website of the China Securities Depository and Clearing Corporation Limited (in Chinese), <http://www.chinaclear.cn/>.

⁴ Statistics available on the website of the China Securities Regulation Commission (CSRC), <http://www.csrc.gov.cn>.

⁵ SOEs which envisaged IPO had to choose overseas Stock Exchanges, especially Hong Kong Stock Exchange. But only a limited number of high profile SOEs had the favour of the government and were permitted to conduct IPO in Hong Kong and abroad.

⁶ The current one-year interest rate is 2.25% and bank deposits by individuals exceeded 14 trillion Chinese Yuan at the end of 2005. Statistics available on the website of the Central People's Bank of China, <http://www.pbc.gov.cn/>.

investors' confidence in the integrity of the market as well as in the management of listed companies was fading away.

Because of the scandals and frequent company failures, the Chinese government finally learned that corporatization and listing are not the panacea for the ailing SOEs. Informed by knowledge from the West, the government had recognized the importance of good corporate governance for the success of companies, which in turn is prerequisite to the sustainable development of stock market. Since the beginning of the new millennium, corporate governance has become a hot topic in China, receiving plenty of attention from the government and academics, as well as from the general public. The government has been endeavouring to improve corporate governance in China. Interestingly, theories from the West advocating the utility of competitive markets for corporate governance have been well accepted and market-based governance mechanisms, such as market competition, independent directorship, institutional shareholder activism, performance-based managerial pay etc, have been highly regarded by both the government and many policy advisers. The malfunction of the stock market as well as the lack of market-based governance mechanisms have been widely blamed as being responsible for poor corporate governance in China. Therefore, the Chinese government's efforts to promote good corporate governance have largely been focusing on making the disciplinary function of the stock market operational and introducing other market-based governance measures.⁷

To the contrary, the government seems not to be very interested in tightening up legal sanctions, in spite of the widespread misappropriation and fraud.⁸ The lacunae in legislation against misappropriation and fraud remain and there is no discussion about the need to increase the extraordinarily lenient criminal punishment and administrative penalties. Even the feeble legislation that exists is not properly enforced and both criminal prosecutions and administrative actions are sporadic. As far as private legal actions are concerned, the government is extremely cautious and the conditions imposed by the government for shareholders to bring derivative actions or securities litigation are inhibitive. As a result, shareholder actions are very rare and do not have any effect on corporate governance.

⁷ See the following section for more information.

⁸ See section D for more information.

Is this the right approach to address the problem of poor corporate governance in China? Will the market-orientated efforts bear the kind of results conceived by the government? Can market mechanisms function properly where deterrence from legal sanctions is intrinsically weak? To answer these questions, it would be helpful to re-assess the validity of those theories advocating the usefulness of market mechanisms⁹ and to ascertain whether they are applicable in China, because no doubt the Chinese government in formulating its policy is heavily influenced by those theories and corporate governance practices from the West. In particular, the unbalanced efforts of the government have a clear correspondence with the theory which favours markets over legal liability. To assess the validity of the theories, it has to in turn undertake a re-examination of the working mechanics for market mechanisms to ensure good corporate governance, because that is the basis upon which those theories are constructed.

The finding of the examination is that the value of market competition and market-based corporate governance mechanisms may have been overstated. They are incapable of disciplining such managerial misbehaviour as one-off duty-of-loyalty violations. Even their ability to discipline managers from shirking or duty-of-care violations is conditioned upon a successful curb on one-off duty-of-loyalty violations by managers. On the contrary, the importance of deterrence from legal liability may have been underestimated. Sufficient legal deterrence is the only effective way to keep control of one-off or fraudulent managerial misappropriation which is highly detrimental to corporate success. In addition, by deterring such misbehaviour, it also provides for the condition upon which market mechanisms may function properly to discourage managerial shirking. In light of this, legal deterrence can be said fundamental to good corporate governance. Current experience of corporate governance in China confirms this finding.

This paper is arranged as follows. Section B provides some background information about the legal framework and practice of corporate governance in China and the recent market-orientated reform. Applying an economic approach, Section C analyses

⁹ See text on page 13 for more information.

the working mechanics of market competition and market-based mechanisms to ensure good corporate governance. Section D examines the relationship between legal deterrence and market mechanisms and the role of legal liability in corporate governance. Section E presents the current situation of poor corporate governance in China and discusses the cause of under-deterrence. Then a brief comment is made in section F on the debate as to whether law matters in corporate governance. Finally, a conclusion is drawn in Section G.

Legal deterrence in this paper indicates the disincentive resulting from legal liability. Legal liability comes with legal sanctions which take the form of criminal punishments, administrative penalties and civil actions. Legal sanctions can target managerial misappropriations directly by imposing legal liability on managers who steal corporate assets. Legal liability against securities fraud is also critical in deterring, though indirectly, managerial misappropriation.¹⁰ Apart from market discipline, this paper examines in particular three market-based corporate governance mechanisms: shareholder voting, performance-based remuneration and independent director monitoring. As with market competition, these mechanisms differ from legal liability in that they do not involve financial obligations or non-financial punishments backed by the machinery of the state. They work in a manner similar to market competition or in combination with markets, so they are termed ‘market-based corporate governance mechanisms’.

B. The Legal Framework and Practice of Corporate Governance in China and the Recent Market-Orientated Reform

The issue of corporate governance in China was ushered in by the corporatization reform of SOEs in the early 1990s. Before this, the Chinese government had experimented with several reform policies in an aim to boost poorly performing SOEs,

¹⁰ See text on page 28 & 29 for more information.

but all ended in failure.¹¹ The corporatization policy was formally announced by the Communist Party in 1993 with a degree of caution,¹² but it was soon established as the guiding principle for medium- and large-sized SOE reform. It was later decreed that all medium and large SOEs should be corporatized and that, except for a few, the majority should have multiple shareholders.¹³ To achieve this, large and medium SOEs were encouraged to issue and list shares on the two stock exchanges in Shanghai and Shenzhen opened in 1990 and 1991 respectively.

Originally, almost all listed companies are former SOEs. The common practice of listing is that an SOE sets up a new company and acts as the sole or principal promoter. The founding SOE apportions part of its assets to the new company and becomes the majority shareholder. It may also invite others to join the new company as co-promoters and minority shareholders. The rest of the shares are issued for public subscription. As a result, the state is the ultimate majority shareholder in the bulk of listed companies. It is estimated that the state controlled approximately two-thirds of the total shares of listed companies.¹⁴ However, this figure must have declined now, because in recent years the state has given up its stakes in many companies which ran into financial distress after listing.

The shares controlled by the state may be owned directly by the governments, but not all by the central government. Different levels of local governments also own a substantial number of shares of listed companies. Shares owned by governments are termed ‘state-owned shares’ and are actually registered under the name of governmental departments or shareholding companies created specifically for holding

¹¹ For a discussion of the policy evolution of SOE reform in China, see Stoyan Tenev & Chunlin Zhang with Loup Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, Chapter 1, (World Bank and the International Finance Corporation, Washington, D.C. 2002).

¹² See the Chinese Communist Party (CCP), *Decisions on Some Issues in Establishing the Socialist Market Economic System*, (passed at the 3rd Plenum of the 14th Congress of of the CCP, November 1993).

¹³ See CCP, *Decision of the 15th National Congress of the Communist Party of China* (1997).

¹⁴ See Q. Qiang, ‘Corporate Governance and State Owned Shares in China Listed Companies’ (2003) *Journal of Asian Economics*, Vol. 14, 771-783, at 774-775. Empirical research shows that, as at the end of 2001, the state was the largest shareholder in 81.6% of listed companies in China, and its average controlling stake in these companies amounted to just fewer than 50%. This figure is still only a conservative estimate of the control exerted by the state, as it is likely that the second and third largest shareholders are also under the influence or direction of the state. See Guy S. Liu & Pei Sun, ‘The Class of Shareholdings and Its Impact on Corporate Performance: Composition in Chinese Public Corporations’, *Corporate Governance: An International Review*, (2005) Vol. 13(1), 46-59.

and administrating ‘state-owned shares’.¹⁵ Further, substantial numbers are also owned by various non-shareholding SOE companies or non-profit institutions like universities, as well as by their subsidiaries. These shares are termed ‘state-owned legal person shares’.¹⁶ Legally, the SOE companies or institutions or their subsidiaries are the owners of shares in listed companies and exercise ownership rights in these shares, but governments have some control over the exercising of the ownership rights. For example, the SOE controlling shareholder of a listed company may have to seek approval from the governments before they appoint top managers to the company or sell their shares to others.

Being promoters’ shares, state-controlled shares, as well as privately owned ‘legal person shares’, are not publicly tradable on the stock exchanges. They can be bought and sold only off the stock exchanges via case-by-case transactions and the selling prices are much lower than the publicly quoted prices. The fact that the majority of listed companies’ shares could not be traded on the exchanges had been strongly criticized and widely regarded as being responsible for the failure of the stock market to have any disciplinary function.¹⁷ Responding to the criticism, the China Securities Regulation Commission (CSRC) launched a wave of belated reforms in April 2005 to enable all shares to be publicly tradable. Basically, the guiding rules¹⁸ adopted by the CSRC require that non-tradable share owners pay tradable share owners some ‘consideration’ in order for their shares to be publicly tradable, but how much and in what form this ‘consideration’ takes depend on the result of free negotiation between the two types of shareholders, being finally determined by the voting of tradable share owners. It is also stipulated that not all non-tradable shares of a shareholder, once becoming tradable, can be instantly sold out, but rather over a three-year phased period (if he wishes).¹⁹ The reform is said to be very successful and estimated to be

¹⁵ The National Administrative Bureau of State-Owned Assets, Temporary Administrative Measures Concerning State-Owned Shares in Stock Companies (No. 81, 1994), Article 2.

¹⁶ *Ibid.*

¹⁷ See Yun Tao, ‘Wu Xiaoqiu: Eight Infections from the Split of Tradable and Non-Tradable Shares’, *China Securities Journal*, 12th January 2004, available at <http://www.cs.com.cn/csnews/20040112/457126.asp> (in Chinese). See also the CSRC, the State-Owned Assets Supervision and Administration Commission, the Fiscal Ministry, the Central People’s Bank and the Ministry of Commerce, Guiding Opinions Concerning the Reform of Non-Tradable Shares in Listed Companies (23rd August 2005), Article 1(2).

¹⁸ *Ibid.*

¹⁹ *Ibid.*

finished by the end of 2006.²⁰ But it is doubtful that the alleged goal of invigorating the disciplinary function of the stock market can be achieved where the bulk of shares of listed companies are still in the control of the state and the state does not intend to divest of them, though publicly tradable. Nonetheless, the reform is significant in that it paves the way for the state to orderly pull out, if it decides one day, of SOEs through selling on the stock exchanges.

Initially, households were the main group among public investors. They trade via securities companies but hold shares in their own names. That the majority of shareholders are individuals was blamed for the wild fluctuation in share prices, because individuals are not, it was said, 'long term' investors. Partly to 'stabilize' the market and partly inspired by shareholder activism associated with institutional investors in western countries, the Chinese government adopted a policy to encourage the growth of institutional investments. Qualified foreign financial institutions have been allowed to invest in the domestic exchanges since 1st December 2002.²¹ National Social Security Funds,²² insurance companies²³ and enterprise pension funds²⁴ have also been permitted to do so. Most extraordinarily, both the number of securities investment funds and assets held by those funds grew rapidly as a result of facilitation by the government.²⁵ By the end of November 2005, the assets held by securities investment funds had reached about half of the total market value of tradable shares.²⁶ In a short period of time, institutional investments in China have increased to a percentage comparable to some developed economies.

²⁰ See the report by *Securities Times* on 14th January 2006 on the speech of the chairman of the CSRC addressed to a meeting, available at <http://www.55188.net/link/caijing/p5w.net.html>.

²¹ See CSRC and the People's Central Bank of China, Temporary Provisions Concerning the Regulation of Domestic Investments of Qualified Foreign Institutional Investors (7th November 2002).

²² See the Fiscal Ministry and the Labour Ministry, Temporary Provisions Concerning the Regulation of Investments of the National Social Security Fund (13th December 2001).

²³ See CSRC and the China Insurance Regulatory Commission, Temporary Provisions Concerning the Regulation of Stock Investments by Insurance Companies (25th October 2004).

²⁴ See the Labour Ministry, the China Banking Regulatory Commission and the CSRC, Trial Provisions Concerning the Regulation of Enterprise Pension Funds (24th April 2004).

²⁵ These funds are set up particularly for the purpose of stocks and other securities investment and invite subscription from the public. They are licensed by the CSRC. The majority are open-ended.

²⁶ See the speech by the Chairman of CSRC addressed to the International Forum on Securities Investment Funds in China on 2nd December 2004 in Shenzhen, available at <http://www.p5w.net/p5w/home/scoop/message/200512021199.html> (in Chinese). The figure does not even include unlicensed securities investment funds whose value was estimated as being not insignificant. See Xia Bin, 'Report on the Private Securities Investment Funds in China', *Securities Times* on 6th July 2001 (in Chinese).

A basic legal framework for corporate governance has been established in China. The Company Law was passed in 1993 and took effect on 1st July 1994. The Securities Law was passed in 1998 after being delayed for several years. Before that, a regulation adopted by the State Council was the governing law.²⁷ The Securities Law heavily borrowed from the US and the approach it takes to regulating the stock market is mandatory disclosure, but the law also requires that the CSRC conduct a ‘merit’ review before a public offering is permitted. The CSRC is the designated governmental agency responsible for the implementation of the Securities Law. But it was set up long before the Securities Law was passed. In October 2005, both the Company Law and the Securities Law were amended extensively primarily in an aim to boost corporate governance, but the basic framework has not been changed.

The governance structure and power distribution within Chinese listed companies are rather confusing. The old Company Law did not envisage any role for independent directors in corporate governance and thus there were no provisions concerning independent directors. Rather, it stipulated a dual board system. But this dual board system is totally different from that prevalent in Continental Europe. The supervisory board has no power to appoint and dismiss managing directors. Managing directors are elected by shareholders’ meetings,²⁸ just as in the Anglo-American unitary board system. Supervisory directors themselves are partially elected by shareholders and partially elected by employees.²⁹ The law actually did not seriously expect supervisory directors to play a big role in the governance of companies, as it provided them with virtually no powers. As a matter of fact, the supervisory board was mere window-dressing and negligible in corporate governance in China before the Company Law was amended.³⁰

When the CSRC took on the issue of corporate governance, the Anglo-American system had become dominant and the inclusion of independent directors on the board had become a common practice around the world. In 2001, the CSRC issued a guiding rule mandating that listed companies should have at least two independent directors

²⁷ The State Council of China, Regulation on Issuing and Trading Stocks (April 1993).

²⁸ The Standing Committee of the National Peoples’s Congress of China (NPCSC), Company Law (1993), Article 38 & 103.

²⁹ *Ibid*, Article 52 & 124.

³⁰ See Lilian Miles & Zhong Zhang, ‘Improving Corporate Governance in State Owned Corporations in China: Which Way Forward?’ *Journal of Corporate Law Studies*, Vol. 6 Issue 1, 213-248 (April 2006).

on their managerial boards by 30th June 2002 and that by 30th June 2003 one third of directors should be independent.³¹ This rule was considered by some as important to improve the governance of listed companies, while others were more suspicious.³² The requirement has been endorsed by the new Company Law.³³ But at the same time, the new Company Law furnished supervisory directors with some new rights, albeit still short of the power to appoint and dismiss managing directors. For example, the supervisory board now has the right to propose resolutions to shareholders' meetings to dismiss managing directors and take legal actions against managing directors on behalf of the company after receiving a demand from shareholders who meet specific conditions.³⁴ Thus under the new Company Law, both independent directors and supervising directors are entrusted with the responsibility of monitoring managers. The effect of this arrangement combining elements from both the Anglo-American and German systems has yet to be tested, but the overlap is obvious and conflicts are probable.³⁵

The Chinese government has also made other moves which can be described as market-orientated in its campaign for good corporate governance. For instance, in 2002, the CSRC adopted a detailed corporate governance code aiming to promote best practice concerning governance structure, shareholder voting, board composition, the conduct of board and shareholders' meetings etc.³⁶ Further, in response to calls to introduce performance-based remuneration schemes, in 2005 the CSRC issued a rule allowing listed companies to pay their managers with stocks and stock options.³⁷

A significant contextual difference between China and western economies is that in the bulk of Chinese listed companies the state is the controlling shareholder. State ownership has been rightly recognized as the root of various governance problems in

³¹ The CSRC, Guiding Opinion on Establishing Independent Director System in Listed Companies (16th August 2001), Subsection 3 of Section 1.

³² See Sibao Shen & Jing Jia, 'Will the Independent Director Institution Work in China?' *Loyola of Los Angeles International and Comparative Law Review*, Vol.27, 223.

³³ The NPCSC, Company Law (2005), Article 123.

³⁴ *Ibid*, Article 54 & 152.

³⁵ For more discussions of this arrangement, see Lilian Miles & Zhong Zhang, *supra* note 30.

³⁶ The CSRC & the State Economic and Trade Commission, Corporate Governance Code for Listed Companies (9th January 2002).

³⁷ The CSRC, Regulative Measures Concerning Listed Companies' Incentive Scheme of Stock and Stock Option (31st December 2005).

China.³⁸ It is thus tempting to simply conclude that theories from the West are not applicable to China and that introducing western corporate governance measures will not have a significant impact unless the state divests itself of its controlling stake in listed companies. If this were true, it would be very disappointing, because the Chinese government currently has no plan to substantially reduce state ownership in listed companies and it is unforeseeable that it will do so in the near future.

That said, things are not as simple as that. On the one hand, experience from other transition and developing economies has demonstrated that privatization is not the panacea.³⁹ Despite the fact that private ownership is now the norm in many of these countries, corporate governance is poor.⁴⁰ It must be concluded that, besides ownership, there are other factors which make an enormous difference on the performance of corporate governance in a country. It is worth finding out the non-ownership factors that make the difference. We can then consciously instigate changes. China may greatly benefit from this, not just in the form of improved corporate governance, but also by reducing the costs of privatization that other

³⁸ See Cyril Lin, 'Private Vices in Public Places: Challenges in Corporate Governance Development in China', Paper presented at the Policy Dialogue Meeting on Corporate Governance in Developing Countries and Emerging Economies organized by the OECD Development Centre and the European Bank for Reconstruction and Development (EBRD) in April 2001; Iain MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies', *Journal of Corporate Law Studies*, Vol. 2 Issue 2, 289-344; Lilian Miles and Zhong Zhang, supra note 30. See generally Mary M. Shirley & Patrick Walsh, 'Public vs. Private Ownership: The Current State of the Debate', World Bank Policy Research Working Paper No. 2420 (January 2001); William M. Megginson & Jeffrey M. Netter, 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature* 39 (2) (June 2001), 321-389; John Nellis & Sunita Kikeri, 'Privatization in Competitive Sectors: The Record to Date', World Bank Working Paper No 2860 (June 2002).

³⁹ Joseph Stiglitz, *Globalization and Its Discontent* (W.W. Norton & Company, June 2002). See also Bernard Black, Reinier Kraakman and Anna Tarassova, 'Russian Privatization and Corporate Governance: What Went Wrong?', *Stanford Law Review* (2000) Vol. 52, 1731-1808; John C. Coffee, 'Privatization and Corporate Governance: The Lessons from Securities Market Failure', Columbia Law School, Centre for Law and Economics Studies, Working Paper No. 158, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=190568#PaperDownload; D. V. Vasilyev, 'Corporate Governance in Russia: Is There Any Chance of Improvement?' Paper prepared for the IMF Conference and Seminar on Investment Climate and Russia's Economic Strategy (Moscow, 2000), available at <http://www.imf.org/external/pubs/ft/seminar/2000/invest/pdf/vasil2.pdf>; Charles Oman, Steven Fries & Willem Buiter, 'Corporate Governance in Developing, Transition and Emerging-Market Economies', OECD Development Centre policy brief No. 23, available at <http://www.oecd.org/dataoecd/6/49/28658158.pdf>; Richard N. Cooper, 'The Asian Crises: Causes and Consequences', in Alison Harwood et al. (eds.), *Financial Markets and Development: The Crisis of Emerging Markets* (Brookings Institution, 1999), 17-28; Kenneth E. Scott, 'Corporate Governance and East Asia: Korea, Indonesia, Malaysia, and Thailand', *ibid*, 335-66; Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," *Brookings Papers on Economic Activity*, 1998 volume 1, 1-90.

⁴⁰ *Ibid*.

transition countries have paid. An implication of this paper is that adequate legal deterrence is a 'decisive factor' and China should pay more attention to legal sanctions in its pursuit of good corporate governance.

On the other hand, the essential problem of state ownership is, though to a much more amplified degree, the separation of ownership and control which is shared by companies with a dispersed ownership structure in some developed countries. In view of this, if agency problems resulting from separation of ownership and control can be addressed to a relatively satisfactory degree in developed countries, we should not be too pessimistic about corporate governance in China where state ownership is still in control. It is unwise to hastily dismiss any efforts as ineffective, simply on the ground that listed companies in China are not privately owned. However, we should recognize that, besides ownership, there are other differences between China and well-performing countries. Markets and other corporate governance mechanisms may need the backup of infrastructural institutions, which may not be present in China. If this is true, perhaps to build the supporting institutions is the more urgent imperative. It is argued in this paper that adequate legal deterrence is the basis for good corporate governance, which currently does not exist in China. To improve corporate governance and to enable market mechanisms to work, the Chinese government should pay more attention to legal deterrence.

C. An Economic Analysis of the Working Mechanics of Market Competition and Market-based Corporate Governance Mechanisms

The core issue of corporate governance is the agency problem resulting from separation of ownership and control.⁴¹ Managers from companies where ownership and control are separated may not work hard in the interests of shareholders as a

⁴¹ See Andrei Shleifer & Robert W. Vishny, 'A Survey of Corporate Governance', *Journal of Finance* Vol. 52, No. 2 (1997); Michael C. Jensen and William H. Meckling, 'Theory of the firm: Managerial behaviour, agency costs and ownership structure', *Journal of Financial Economics*, Vol. 3: 303-360.

whole, but rather for their own benefits.⁴² The primary concern of corporate governance is how to ensure managers maximize shareholder value and refrain from engaging in behaviour which may damage shareholders' interests.⁴³

There are different types of misbehaviour with which managers may sacrifice shareholders' interests for their own utilities. Generally, corporate law classifies directors' principal duties as the duty of loyalty and the duty of care, and thus managerial misbehaviour can be accordingly divided into duty-of-loyalty violations and duty-of-care violations.⁴⁴ Duty-of-loyalty violations are primarily interests-conflicting acts such as unfair self-dealing, enjoying excessive perks, misappropriation etc, while duty-of-care violations do not involve conflict of interests.⁴⁵ Economists dub duty-of-care violations as managerial 'shirking', which means managerial slackness and avoidance of uncomfortable changes.⁴⁶ As for duty-of-loyalty violations, some academics divide them further into traditional conflicts of interests and positional conflicts.⁴⁷ Traditional conflicts arise where dubious transactions are entered into by managers with their companies or company assets (tangible or intangible) are diverted by managers, while positional conflicts mean that management maintain or promote their positions by way of such misbehaviour as

⁴² Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933; Transaction Publishers, 1995); Michael C. Jensen and William H. Meckling, *ibid.*

⁴³ See supra note 41.

⁴⁴ Paul Davies, *Gower and Davies' Principles of Modern Company Law* (7th ed, Sweet & Maxwell, London, 2003), at p380; see also Kenneth E Scott, 'Corporation Law and the American Law Institute Corporate Governance Project', 35 *Stanford Law Review* 927 (1983).

⁴⁵ For an argument dismissing the difference between the duty of loyalty and the duty of care, see Daniel R. Fischel & Michael Bradley, 'Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis', 71 *Cornell Law Review* 261 (1986). It was argued that 'there is no difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty)'. This argument has missed the difference that duty-of-loyalty violations directly bring about financial benefits but duty-of-care violations do not. Thus, in terms of whether financial conflicts are directly involved, the distinction between the duty of loyalty and the duty of care should not be dismissed. See Donald E Schwartz, 'In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley', 71 *Cornell Law Review* 322 (1986); Kenneth E Scott, 'The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley', 71 *Cornell Law Review* 299 (1986); Harold Demsetz, 'A Commentary on Liability Rules and the Derivative Suit in Corporate Law', 71 *Cornell Law Review* 352 (1986).

⁴⁶ Alchian and Demsetz, 'Production, Information Costs and Economic Organisation', 62 *American Economic Review*, 777-95 (1972).

⁴⁷ See Melvin A. Eisenberg, 'The Structure of Corporation Law', 89 *Columbia Law Review* 1461 (1989).

‘empire building’, takeover defence etc, even at the expense of shareholders’ interests.⁴⁸

When *Berle and Means* wrote their seminal book, they did not investigate governance mechanisms other than law which may have the effect of checking managerial opportunism. Since then, inspiring economics scholarship nevertheless has exposed a number of non-legal governance mechanisms which are able to discipline managers from engaging in opportunistic behaviour. First, various competitive markets (i.e. the capital, corporate control, product and labour markets)⁴⁹ and then performance-based remunerations were revealed to be able to function as constraints on managerial discretion.⁵⁰ More recently, shareholder activism associated with institutional investors⁵¹ and independent directorship⁵² stole the spotlight. In the end, competitive markets and market-based governance mechanisms have acquired particular prominence and been widely accepted as critical to addressing the agency problems resulting from separation of ownership and control. Some law and economics scholars who studied corporate law in a ‘contractarian’ perspective went a step further to even suggest that legal rules are negligible, because of the existence of various market-based substitutes.⁵³ They argued that mandatory legal rules are superfluous where private persons can protect themselves with the help of market forces. Indeed, they suggested that, because of different costs associated with legal liability, market competition has comparative advantages over legal liability and thus market mechanisms are preferable to legal liability. Their arguments are best described by the phrase ‘market primacy’. The theories suggesting the efficacy of market mechanisms in general and the market primacy theory in particular are so influential as to have

⁴⁸ *Ibid.*

⁴⁹ See H. Manne, ‘Mergers and the Market for corporate control’, *Journal of Political Economy* (1965) Vol. 73 Issue 2, 110-20 (the market for corporate control); Michael C. Jensen and William H. Meckling, *supra* n 42 (the IPO market); Eugene F. Fama, ‘Agency Problems and the Theory of Firm’, *Journal of Political Economy* (1980) Vol. 88 Issue 2, 288-307 (capital markets and managerial labour markets); Melvin A. Eisenberg, *ibid.*, (the product market).

⁵⁰ Michael C. Jensen and Kevin J Murphy, ‘Performance Pay and Top Management Incentives’, *Journal of Political Economy* (1990) Vol. 98 Issue 2, 225-264 (performance-based remuneration).

⁵¹ See Bernard S. Black, ‘Shareholder Passivity Re-examined’, 89 *Michigan Law Review* 520 (1990); Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, (Princeton University Press, 1994), 233-253; Roberta Romano, ‘Less is more: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance’, 18 *Yale Journal on Regulation* 174 (2001).

⁵² Adrian Cadbury, *Financial Aspects of Corporate Governance*, (Gee, London, 1992).

⁵³ Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law*, (Harvard University Press, 2nd edition 1996); Daniel R. Fischel & Michael Bradley, *supra* n 45.

made an impact on the communist government of China in its formulation of corporate governance policies.⁵⁴

There is already a vast literature debating the pros and cons of markets.⁵⁵ The essence of traditional criticisms is that, because of the existence of such problems as informational asymmetry, transaction costs, judgement and collective action problems etc, markets are not perfect and may fail to work.⁵⁶ This paper is not intended to join in the traditional criticisms. Rather, in an aim to evaluate the effectiveness of the Chinese government's policies and efforts to promote good corporate governance in China, it seeks to find out whether markets and market-based mechanisms can be expected to work properly and play a significant role in corporate governance where legal deterrence is intrinsically weak. To do that, it takes a closer look at how markets work to ensure good corporate governance.

(1) The Disciplinary Function of Markets

It is said that market competition can function to discipline management from engaging in opportunistic behaviour.⁵⁷ Managerial misbehaviour gives rise to additional costs and makes products of a company less competitive. Managers of uncompetitive companies could lose their jobs by being dismissed for poor performance or as a result of company failure, or at least lose the benefits generated through career advancement when business is successful.⁵⁸ Costs also accrue with poor governance in the form of more expensive capitals or not being able to raise new capitals at all, where the capital market is competitive. Further, if the management of a company performs poorly, the share price of the company would drop to a level

⁵⁴ See discussion in section B.

⁵⁵ For an account of literature questioning the usefulness of various markets, see Eilis Ferran, *Company Law and Corporate Finance* (OUP, 1999), 120-122. Most parts of *Cornell Law Review* Volume 71 Issue 2 were devoted to the debate on the primacy of markets over legal liability. See also Brian R. Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) Chapter 3; Melvin A. Eisenberg, *supra* note 47; Jeffery N. Gordon, 'Corporations, Markets, and Courts', 91 *Columbia Law Review* (1991), 1931.

⁵⁶ See Brian R. Cheffins, *ibid.*

⁵⁷ See *supra* n 49.

⁵⁸ See Melvin A. Eisenberg, *supra* n 47. See also Henry N. Butler, 'The Contractual Theory of the Corporation', *George Mason University Law Review* (1989) Vol. 11, 99-114; Daniel Fischel, 'The Corporate Governance Movement', *Vanderbilt Law Review* (1982) 35, 1259-1264.

where it is profitable for other companies to take it over. After a hostile takeover, inevitably the old management would be replaced.⁵⁹ Even if hostile takeover does not happen, under-performance of a company's share price would lead to discontent among shareholders who would eventually revolt to evict the undesirable management. Finally, a competitive labour market also plays a role in corporate governance in that competition compels managers to deliver their best performance in order to keep their existing employment and to promote their marketability for future more lucrative jobs.⁶⁰ It is thus clear that the disciplinary function of market competition stems from the potential threat that misbehaving management would lose their current and future employment. In economic terms, managerial misbehaviour imposes costs on miscreant managers in the form of losing the benefits associated with career preservation and advancement. For simplicity, we refer to this cost hereafter as the loss of unemployment. As rational men, managers would try to avoid this cost and thus an incentive is created which drives them to act honestly and work hard for the interests of shareholders.

However, managerial misbehaviour would not entail only costs. It may also produce benefits. Whilst misappropriation, self-dealing, 'empire building' or shirking may result in losing employment, they may also afford misbehaving managers financial benefits or the satisfaction of self-fulfilment or leisure time. If a manager is really rational, he would calculate both the loss and benefit an action would bring to him, and only when the benefit is smaller than the present value of future loss from unemployment would a manager choose to avoid suboptimal behaviour. Otherwise, he would choose to misbehave. Hence, we can see that the disciplinary functions of market competition espoused by the market efficacy theories are based on the assumption that the present value of future loss to a manager in the form of unemployment as a result of misbehaviour is more than the benefit he gains from it. The assumption can be described as:

$$L (\text{unemployment}) > B (\text{misbehaviour})$$

⁵⁹ See H. Manne, *supra* n 49.

⁶⁰ See Michael C. Jensen and Kevin J Murphy, *supra* n 50. See also Dooley and Veasey, 'The Role of the Board in Derivative Litigation: Delaware Law and the Current Proposals Compared', *Business Lawyer* (1989) 44, 503-526; Coughlan and Schmidt, 'Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation', *Journal of Accounting and Economics* (1985) 7, 43-46.

Is this assumption true? The answer is indeed yes where managerial misbehaviour involves only shirking or violations of duty of care. A manager may have more leisure time and avoid stress from demanding work when he engages in shirking, but shirking does not directly afford him financial gains. Thus, in terms of financial benefits,⁶¹ a manager derives no gains directly from misbehaviour where it involves only shirking, but the possibility of losing his job still exists. Thus a misbehaving manager would lose more than he gains.⁶² As a rational man making the best deal for himself, he would choose to be diligent and dedicated to his job rather than slack and inattentive. So, where misbehaviour involves only shirking, the assumption is correct and markets are effective to discipline. The inequality can be elaborated as follows:

$$L (\text{unemployment}) > B (\text{misbehaviour})$$
$$\text{Because: } B (\text{misbehaviour}) = B (\text{shirking}) = 0$$

Where positional conflicts are in question, the answer is not so certain. A manager may not directly derive financial benefits from acts involving positional conflicts, but he may gain indirectly. For example, where ‘empire building’ is in issue, he may reap higher remuneration when a company expands. On the other hand, such misbehaviour may eventually lead to decline or even collapse of a company and a misbehaving manager may thus lose his job. The net gain or loss from positionally conflicting acts is difficult to assess and a manager may be confused in calculating the costs and benefits of a positionally conflicting act. As a result, it is unclear whether markets are effective to discourage positionally conflicting acts.⁶³

⁶¹ In economics the term ‘utility’ is used which is not limited to the calculation of pure financial loss or gain. But non-financial ‘utility’ is subjective and different persons have different preferences. For example, in the scenario of shirking or hard-working, shirking may be a ‘utility’ for some managers, but others may prefer hard work. So it is difficult to say shirking is a gain or loss in general. Furthermore, shirking or hard-working may bring a manager both non-financial ‘gain’ and ‘loss’ which cannot be quantified. On the one hand, hard-working may give rise to positive ‘utility’ because hard-working may lead to success out of which a manager may find pleasure of self-fulfilment and self-esteem, but on the other hand, hard-working means less leisure time and more stress which is a negative ‘utility’ in general. Because of these reasons, this paper considers only financial benefits or losses. However, the validity of argument here would not be materially affected without taking account of non-financial utility, although it can be argued that not all managers work hard solely for the financial benefits from career preservation and advancement. For the potential role of the so-called ‘social sanctions’ in corporate governance, see *infra* n 69.

⁶² Only financial gains are considered. Here financial gains are zero.

⁶³ In the scenario of ‘empire building’, managers may not act consciously to maximize their personal financial interests but be driven by the desire of self-fulfilment without being aware of the damaging

However, the situation changes when traditional conflicts are considered. When traditional conflicts are involved, certainly there exists the possibility that the benefits from misbehaviour may outweigh the costs. Let's assume that a manager in a Chinese listed company currently receives annual remuneration of £80,000 and the present value of the annual income from his future employment on average is £100,000; further assume that his remaining working life expectancy is 30 years and he would lose his current job and never find a new job following an act of misbehaviour.⁶⁴ Thus his total potential loss would be £3 million. If market discipline is the only force governing his behaviour, he will choose to commit the misbehaviour rather than to honestly advance his personal interests if he can divert to himself successfully more than £3 million from the company.⁶⁵

Is it possible for him to do so? Obviously, if the total assets of the company are worth less than £3 million, the answer is no. But it would be rare that the total value of assets of a company would be less than the employment value of a manager. Further, the markets may indeed be very efficient and the negative information about misbehaviour may be transferred quickly onto the markets so that a manager is dismissed before he can divert sufficient corporate assets to himself. But, to circumvent this situation, there are various tactics for him to employ. He may misappropriate a sum big enough on one or two occasions. Or he may defraud and cover up his misbehaviour and engage in a series of misappropriations. Both types of misbehaviour can be regarded as 'one-off' misbehaviour, in the sense that the

consequences of their behaviour. In such a situation, economic analysis may not be valid. In the scenario of hostile takeover defence which may be negative for shareholder value, benefits from such defence are obvious for managers, but the potential loss is not clear. Thus market competition may not be effective to discourage managers from taking damaging takeover defence arrangements.

⁶⁴ So far it has been assumed that markets are perfectly efficient and every managerial misbehaviour will be reflected accurately and timely by the costs suffered by managers in the form of losing employment benefits. This is not the case in reality. Not every occurrence of managerial misbehaviour would result in loss on the part of managers. A manager in making a decision would take account of the probability of job loss and discount the cost according to the probability. For example, if a manager perceives that the probability of unemployment following a conflicting act is 60% and the total present value of his employment is £3 millions, he would regard his loss as £1.8 rather than £3 millions. Thus a benefit worth more than £1.8 millions may be considered by the manager as being worth misappropriating.

⁶⁵ A misbehaving manager shall use the misappropriated assets as capital to open his own business or invest in the businesses of others and thus receive returns from the capital. When the return on the capital is taken into account, the amount of benefits to lure a manager to misappropriate would be further less.

misbehaving manager may derive from it sufficient financial benefits so as to withdraw from the management job market altogether.⁶⁶ Under these circumstances, benefits to a manager from engaging in traditional conflicts to a manager may well outweigh the value of loss from unemployment. From this, we can see that, if market competition is the only governing force, a manager can gain more by engaging in misbehaviour than by honest and hard work. As a result, the disciplinary function of markets would fail to work. In other words, markets alone are not effective to discourage one-off misbehaviour, i.e. large-scale embezzlements and non-substantial but fraudulent misappropriations. Thus, the inequation has been changed as follows:

$$\begin{aligned} &\text{If: } B(\text{misbehaviour}) = B(\text{one-off misbehaviour}) \\ &\text{and } B(\text{one-off misbehaviour}) > L(\text{unemployment}) \\ &\text{Then: } B(\text{misbehaviour}) > L(\text{unemployment}) \end{aligned}$$

Worse still, when traditional conflicts are not controlled, market competition is even not effective in disciplining managers from shirking or engaging in positional conflicts. If a manager can easily enrich himself by embezzlement or self-dealing, why should he compel himself to work hard to advance his personal interests and refrain from positional conflicts? There is no longer the need for him to advance his personal well-being through work hard if opportunities are ample for him to become rich by way of one-off misappropriation. In other words, when a manager can compensate his losses from unemployment with benefits from one-off misappropriations, he no longer needs to concern himself with how to avoid the losses. He thus loses the incentive to work hard. As such, the only function of market competition to discipline managerial shirking is lost. This situation can be described as follows:

$$\begin{aligned} &\text{If: } B(\text{one-off misappropriation}) > L(\text{unemployment}) \\ &\text{Then: } B(\text{misbehaviour}) > L(\text{unemployment}) \end{aligned}$$

Because: $B(\text{misbehaviour}) = B(\text{shirking} + \text{positional conflicts} + \text{traditional conflicts})$

⁶⁶ Judge Easterbrook and Professor Fischel in their popular book (see supra n 53) used the term 'one-shot' misbehaviour but did not elaborate on it. Here it is clear that 'one-off' or 'one-shot' misbehaviour is not limited to one-time large-scale embezzlements. A series of non-substantial but covered-up misappropriations may also afford a manager financial gains sufficient enough for him to consider withdrawing from the management market altogether. These misappropriations are also 'one-off' misbehaviour in nature.

and B (traditional conflicts) = B (one-off misappropriation + other traditional conflicts)

That is, if market competition is the only governing force, a manager can gain benefits larger than losses incurred from unemployment by way of one-off misappropriations. When the benefits from one-off misappropriations are larger than the losses incurred from unemployment, the total benefits from various misbehaviours (shirking, positional conflicts and traditional conflicts) would always be larger than the losses from unemployment. Thus the condition for market competition to work (i.e. the present value of future loss from unemployment is more than the benefit from misbehaviour) is no longer present. Accordingly, the disciplinary function of market competition no longer exists.

In conclusion, market competition alone is not effective to discourage traditional conflicts of interests, in particular large-scale embezzlements and fraudulent misappropriations. When such misbehaviour is not constrained, markets would even lose the ability to discipline managerial shirking.

The analysis in this section takes an economic approach with the assumption of rationality on the part of management.⁶⁷ Further, the economic analysis has been simplified. On the one hand, it is a 'purely economic' analysis which considers only

⁶⁷ In recent years there has been strong interest in the study of 'behavioural law', which challenges 'law and economics' fundamental assumption that human beings are rational and self-regarding, drawing evidence heavily from psychological experiments. See Christine Jolls, Cass R. Sunstein & Richard Thaler, 'A Behavioural Approach to Law and Economics', 50 *Stanford Law Review* 1471 (1998). In relation to corporate governance, see Lynn A. Stout & Margaret M. Blair, 'Trust, Trustworthiness, and the Behavioural Foundations of Corporate Law', 149 *University of Pennsylvania Law Review* 1735 (2001); Lynn A. Stout, 'On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)', *Delaware Journal of Corporate Law*, Vol. 28, (2003), 1-25.

A detailed discussion of 'behavioural law' is beyond the scope of this paper, but a brief observation is recorded here. First, 'behavioural law' does not suggest and there is no evidence to support that human beings are systematically other-regarding and irrational. It can only be said that there is some irregularity in human beings' self-interestedness and rationality. In other words, the self-interestedness and rationality of human beings are only 'bounded'. This is generally admitted even by 'behavioural law' scholars themselves. See Christine Jolls, Cass R. Sunstein & Richard Thaler, *ibid*; Christine Jolls, Cass R. Sunstein & Richard Thaler, 'Theories and Tropes: A reply to Posner and Kelman', 50 *Stanford Law Review* 1593 (1998). Second, there are convincing criticisms regarding the applicability of the results of laboratory experiments to real life, the ways such experiments are conducted, and the overstatement and over-reading of the experimental results. See Gregory Mitchell, 'Taking Behaviouralism Too Seriously? The Unwarranted Pessimism of the New Behavioural Analysis of Law', 43 *William & Mary Law Review* 1907; Gregory Mitchell, 'Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioural Law and Economics' Equal Incompetence', 91 *Georgetown Law Review* 67-167 (2002).

financial gains and losses.⁶⁸ Various non-financial utilities (such as leisure time, avoidance of stress, psychological satisfaction out of reputation⁶⁹ etc), some of which come with honest and hard work and others of which are linked to managerial misbehaviour, have not been taken into account. On the other hand, it assumes that markets are perfectly efficient so that the unemployment costs resulting from misbehaviour is accurately priced and imposed timely on liable managers. ‘Purely economic’ and simplified the analysis is, it is nevertheless sufficient to conclude that market competition is not omnipotent, even if such problems as asymmetrical information, transaction costs, judgement and collective action problems etc do not exist. Markets are not effective to control serious managerial misbehaviour which offers managers gains more than losses. Even its limited value to control managerial shirking is based on the prerequisite that the opportunities for managers to enrich themselves by way of such misbehaviour are rare. If such opportunities are ample and managers have no concern regarding punishment for fraud, the disciplinary function of market competition can be ignored. This seems to be a common sense and one does not need to be an economist to appreciate it,⁷⁰ but this common sense seems to have become obscured with the rise of market efficacy theories. A sketchy re-examination of the working mechanics of market competition however shows that such a common wisdom should not be questioned lightly.

(2) Institutional Investor Activism and Performance-Based Remuneration

The growth of institutional investments and a number of high profile shareholder revolts led by institutional investors in the US in the 1980s gave rise to the expectation of change in traditional shareholder passivity. Shareholder activism was

⁶⁸ For the possible role of morality and the non-financial elements of ‘social norms’ and ‘social sanctions’ in corporate governance, see infra discussion Section D.

⁶⁹ Reputation is not solely a non-financial utility. On the contrary, its financial implication is significant and the working of market discipline cannot be separated from reputation. As far as the non-financial elements of reputation are concerned, it is doubtful that they can play a big role in dissuading managers from misappropriation and fraud where financial stakes are significant but law is extremely weak. See infra discussion at Section D.

⁷⁰ It has long been recognized that market competition is not effective in assuring contractual performance where the short-term gain from non-performance exceeds the discounted value of future income stream. See Benjamin Klein and Keith B. Leffler, ‘The Role of Market Forces in Assuring Contractual Performance’, *Journal of Political Economy* 89, 615-41.

thus proclaimed to have arrived by some commentators. Many claim that institutional investors play an important role in corporate governance,⁷¹ while others are less optimistic.⁷² Some empirical studies show that institutional shareholder activism matters little in improving corporate governance.⁷³ Whatever the controversy, in theory institutional shareholders should be more active in corporate governance, because they hold a much bigger stake in companies compared to individual shareholders.

However, shareholder activism suffers the same problem as market competition does: it is incapable of disciplining one-off duty-of-loyalty violations. To a large degree, the mechanics for institutional investor activism to encourage good corporate governance are very much like that of market competition: institutional investor activism means that institutional investors actively participate in company elections; as a result, entrenched underperforming managers are ousted; because management have a concern that they may be banished for underperformance, they are pressured to maximize shareholders' interests and not to engage in opportunistic activities. It can be seen that the function of institutional investor activism in encouraging good corporate governance is very similar to the disciplinary function of market competition. To be accurate, markets and shareholder activism can be said a combined mechanism rather than two. On the one hand, market discipline needs the help of shareholder voting to oust incompetent management. On the other hand, active participation in the corporate elective process by shareholders is informed by information from markets. Because the working mechanics of shareholder activism are similar to or combined with that of market competition, the impotence of markets is shared by shareholder activism. Specifically, institutional shareholder activism in the form of active participation in corporate elections is not effective to discipline managers from engaging in one-off misappropriation. The ability of shareholder

⁷¹ See Bernard S. Black, *Supra* n 51; Mark J. Roe, *Supra* n 51.

⁷² See Stephen M. Bainbridge, 'Shareholder Activism and Institutional Investors', *University of California Los Angeles School of Law, Law-Econ Research Paper No. 05-20* (September 2005). See also Gerard McCormack, 'Institutional Shareholders and the Promotion of Good Corporate Governance', in Barry Rider (eds.), *The Realm of Company Law: A Collection of Papers in Honour of Prof. Leonard Sealy* (Kluwer Law International 1998), 131-160.

⁷³ Bernard S. Black, 'Shareholder Activism and Corporate Governance in the United States', in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (Palgrave Macmillan, 1995); Jonathan M. Karpoff, 'The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings', working paper, available at <http://faculty.washington.edu/~karpoff/Research/SAPaper.doc>.

activism to discipline managerial shirking is also lost where fraudulent self-enrichments are not brought under control and gains for managers from misbehaviour outweigh the present value of future losses from unemployment.

Possibly, performance-based remuneration such as stock options plays a more significant role than institutional investor activism in encouraging good corporate governance,⁷⁴ though after Enron and WorldCom its down-side has attracted more criticisms.⁷⁵ The merit of performance-based remuneration is that, it is said, it restores the connection between the interests of management and shareholders. By linking remuneration with corporate performance, the performance-based remuneration scheme ensures that the interests of shareholders and management are aligned and incentives are thus created for management to maximize corporate value.

However, reality is not as simple as the theory. Actually, it is fair to say that the interests of managers and shareholders are never separated in a competitive market economy: the increase in company value brings benefits not only to shareholders but also to managers, because by enhancing company value managers reap the benefits from job preservation and career advancement. Even without performance-based remuneration, market competition aligns the interests of management and shareholders. What performance-based remuneration does is to increase the magnitude of benefits to management from productive behaviour and the costs incurred from counter-productive behaviour. It is thus clear that the mechanics for performance-based remuneration to encourage good corporate governance are not new and not different from that of market competition. Both seek to induce productive behaviour by feeding managers benefits and to discourage counter-productive behaviour by imposing costs on them. Both are voluntary rather than compulsory backed by law. Therefore, performance-based remuneration is similarly not effective to discourage one-off managerial self-enrichments.

This is not difficult to understand. When there are opportunities for a manager to engage in self-interested activities such as misappropriation, the benefit he can obtain

⁷⁴ See Michael C. Jensen and Kevin J. Murphy, *supra* n 50; Coughlan and Schmidt, *supra* n 60.

⁷⁵ See John C. Coffee Jr., 'What Caused Enron?: A Capsule Social and Economic History of the 1990's', 89 *Cornell Law Review* 269 (January 2004).

may be more than that provided by a performance-based remuneration scheme. As such, performance-based remuneration may not be attractive enough to induce a manager to shun opportunities for misappropriation. When a manager decides to commit misappropriation, it is inconceivable that he can be persuaded by a performance-based remuneration scheme to work hard for the interests of shareholders. Hence, where misappropriation is not deterred by other means, performance-based remuneration adds nothing to managers' incentive to promote shareholders' interests. Worse still, performance-based remuneration may be counter-productive where misappropriation is not deterred. When a manager is acquiescent to misappropriation and fraud, it is almost predictable that he may fraudulently inflate the accounting figures and thus collect the benefits provided by a performance-based remuneration scheme. As a result, shareholders suffer more loss with than without performance-based remuneration.

In summary, just as with market competition, both shareholder activism and performance-based remuneration are not effective in discouraging managers from engaging in one-off duty-of-loyalty violations. If one-off duty-of-loyalty violations are not deterred, managerial shirking cannot be disciplined. Further, introducing performance-based remuneration schemes may be counter-productive, if one-off duty-of-loyalty violations are not controlled and if frauds are not deterred.

(3) Monitoring by Independent Directors

It is clear from the foregoing discussion that taking one-off duty-of-loyalty violations under control is crucial to good corporate governance. Not only is such misbehaviour fatal to the success of companies, but also bringing such misbehaviour under control is a precondition for markets and market-based institutions to work. So, the critical question is how the fraudulent diversion of company assets can be reduced to a minimum. The foregoing discussion has demonstrated that market competition, shareholder activism and performance-based remuneration cannot be relied on to curb such misbehaviour. Therefore, solutions have to be sought from other sources.

Independent directorship has now become a paradigm institution of corporate governance and corporate governance codes all over the world require that public companies should instate some independent directors on their boards.⁷⁶ One aspect of the importance of independent directors is that they can ‘monitor’ the executives.⁷⁷ Specifically, in relation to the prevention of diversion of corporate assets by executives, independent directors are better positioned to decide whether a transaction entered into by executives with their company is a good deal for the company. Because independent directors do not participate in the day-to-day business of a company and usually have no personal interests in the company apart from the directorship, they can exercise an impartial judgement over the fairness of executives’ self-dealings. As a result, by requiring that transactions entered into by executives with their company are approved by independent directors, damaging transactions can be avoided. It has been a norm of corporate law that transactions involving conflicts of interests should be decided by disinterested directors and interested directors should abstain from participating in the decision-making.⁷⁸ By taking away from executives the decision-making power regarding such transactions and giving the power solely to independent directors, managerial misappropriation by way of self-dealings can be prevented.

However, the argument holds only if executives are honest. If they are dishonest and determined to line their pockets with companies’ money, there are many tactics for them to use to escape monitoring by independent directors. They may conceal the fact that they are interested in a transaction. They may disclose false or misleading

⁷⁶ E.g. see New York Stock Exchange’s Listed Company Manual (2004), s.303a.01 (‘Listed companies must have a majority of independent directors’); the UK Listing Authority’s Combined Code on Corporate Governance (2003), s.1A.3 (‘The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors)’); the German Corporate Governance Code (2005), s.5.4.2 (‘To permit the Supervisory Board’s independent advice and supervision of the Management Board, the Supervisory Board shall include what it considers an adequate number of independent members.’); the Italian Corporate governance code (2002), s.2.1 (‘The board of directors shall be made up of executive directors and non-executive directors. The number and standing of the non-executive directors shall be such that their views can carry significant weight in taking board decisions.’) and s.3.1 (‘An adequate number of non-executive directors shall be independent’).

⁷⁷ The role of independent directors is frequently described as having two principal components: monitoring and strategic development. These two functions of independent directors were traditionally believed contradictory but this view has been rejected by the *Higgs Report*. See Derek Higgs, ‘Review of the Role and Effectiveness of Non-Executive Directors’ (DTI, January 2003), Chapter 6.

⁷⁸ See Luca Enriques, ‘The Law on Company Directors’ Self-dealings: A Comparative Analysis’, *International and Comparative Corporate Law Journal*, Vol. 2, Issue 3 (2000), 297-333.

information concerning the terms of a transaction. Or, they may execute a transaction secretly and not put to the board of directors to decide a transaction that is required by law or company charter to be approved by the board. These are tactics that are currently routinely employed by management or controlling shareholders of listed companies in China.⁷⁹ Indeed, if custodians decide to steal the assets entrusted to them for protection, who can prevent them from doing so? Certainly not independent directors. Independent directors can be ‘monitors’, but it is too much to expect them to assume the role of the police and FBI. It is unreasonable to suppose that they can stop or uncover deliberate fraud perpetrated by executives. They rely on executives for information. If executives do not provide information or supply false information, what can independent directors do? As commentators have rightly pointed out, ‘if auditors are nervous about their ability to detect fraud when they have full access to the corporate books, how can an independent director be expected to detect dishonesty hidden in the neat and professionally turned-out documents presented to him for board meetings?’⁸⁰

It can be seen that, if managers are determined to misappropriate, independent directors are powerless and cannot be relied on to control fraudulent diversion of company assets. Independent directors may have a role to play to check dubious managerial self-dealings, but they are useless in combating fraudulent managerial misappropriation. The other monitoring functions of independent directors, like monitoring the authenticity of financial information disclosed to the public, would similarly fail, if managers are not afraid to cheat and also auditors have no concern about legal liability for failing to live up to the professional standards required by law. The inability of independent directors to protect companies from being looted by crooked managers in turn implies that independent directors cannot be the guardians for markets and market-based governing institutions. As a matter of fact, independent directors have a role to play in corporate governance only if executives are honest and deterred from fraud by other means.

⁷⁹ See following discussion for more information.

⁸⁰ See Sibao Shen and Jing Jia, *supra* n 32.

D. Legal Deterrence as the Foundation of Corporate Governance

(1) Legal Liability: The only Effective Way to Discourage One-Off Misappropriation

So far it is clear why market competition and other market-related governing institutions are not effective in discouraging one-off managerial misappropriation. In the fiduciary relationship between shareholders and managers where managers are entrusted with the custody of corporate assets and the management of corporate business, there always exist the opportunities where misbehaviour (defection) generates substantial benefits for the misbehaving manager. While shareholder voting or market competition may impose on misbehaving managers costs by way of terminating the fiduciary relationship or ostracization, the costs cannot be guaranteed to be larger than the benefits. When benefits from misbehaviour are larger than costs, a manager as a rational man would in all likelihood choose to defect rather than to cooperate. The strategy of performance-based remuneration, which basically is to increase benefits from cooperation and costs from defection, does not change the position altogether. Benefits that shareholders can offer to their managers are limited and it is still quite possible that misbehaviour generates more benefits than costs. As far as *ex ante* monitoring by independent directors is concerned, it is ineffective as well, as long as corporate assets are in the custody of managers and their incentive to defect remains, which is true, because the imbalance of losses and gains has not been addressed.

It is thus clear that, where benefits from misbehaviour are larger than costs, it has to ensure, in order to induce a manager not to defect, that the illegitimate benefits from misbehaviour would be taken away from him or other sanctions such as incarceration or fines would be imposed so as to cause him losses larger than the benefits. This involves the use of physical forces, because a misbehaving manager would not surrender his acquired interests or subject to sanctions voluntarily. Competitive markets, which are basically voluntary institutions, are not endowed with the ability to do so. The business community can ostracize a misbehaving manager, but has no right

to force him to disgorge the misappropriated benefits. Shareholders or independent directors also cannot resort to physical forces to take back the misappropriated assets or impose punishments without the sanction of the state. In a modern society, the state has a 'monopoly on the legitimate use of physical force'⁸¹ and grieved persons have to turn to the government for redress, if it entails the use of physical forces. Such a process of redress creates exactly what we call 'legal liability'. That is why market discipline and other market-related governing mechanisms are not able to discourage one-off managerial misappropriation⁸² and legal liability is the only solution.

Legal liability is the mechanism through which infringed legal rights are rectified, damaged interests are restored and illegality is punished.⁸³ It is created and sponsored by the state with the backup of physical forces. It has the effects to remove illegitimate gains, inflict additional costs and restore misappropriated properties or compensate damages. Actually it is the only feasible way to take away illegitimate benefits from tortfeasors involuntarily.⁸⁴ Legal liability may not just take away illegitimate benefits. It may also impose punishment on corrupt managers in the form of fines, disqualification and/or incarceration etc, leaving them with negative net gains. As a result, managers are deterred from engaging in misbehaviour, for fear of suffering losses more than gains. It can be seen that the unique attribute of legal liability to be equipped with the ability to take away illegitimate benefits from corrupt managers and even impose punishments distinguishes it from voluntary market mechanisms and enables it to deter one-off misappropriation and fraud. Because

⁸¹ Marx Weber, *Politik als Beruf (Politics as a Vocation)*, 1918.

⁸² Another explanation is that, according to game theory, market forces are applicable only to repeat market players. Benefits from misappropriation may be big enough to induce a manager to withdraw from markets and become a one-time player. Thus markets fail to dissuade him from misappropriation. But this explanation does not explain why market forces are only applicable to repeat market players. Furthermore, the traditional argument that information asymmetry leads to market failure is also an explanation. Because managerial misappropriation inevitably involves fraud, the problem of asymmetric information is aggravated. Thus markets fail to work. In view of this, frauds are the central problem. To combat frauds is fundamental for markets and market-based governance mechanisms to work and in turn critical to good corporate governance. But similarly this explanation does not explain why market mechanisms are incapable of discouraging frauds. The inability of markets to sever illegitimate benefits may be a better explanation of why market forces are not effective for one-time participants as well as why market competition cannot discipline frauds.

⁸³ See John P. Humphrey, '[On the Definition and Nature of Laws](#)', *Modern Law Review*, Vol. 8 (1945) No 4, 194-203.

⁸⁴ As far as civil remedies for duty-of-loyalty violations are concerned, corporate law is different to some degree between the UK and US on the one hand and Continental Europe on the other. In continental Europe a generic violation of the duty of loyalty gives rise only to liability for the resulting damages to the company, whereas in the UK and US duty-of-loyalty violations are also subject to remedy of disgorgement of profits. See Luca Enriques, *supra* note 78, 303.

deterrence by way of legal liability is the only feasible way to discourage one-off managerial misappropriation which is fatal to corporate success and a successful curb on one-off managerial misappropriation is a prerequisite to the proper functioning of market discipline and other market-related governance mechanisms, a conclusion can be drawn that effective legal deterrence is the foundation of corporate governance.

Legal liability can be caused by civil actions, administrative penalties and criminal punishments separately as well as collectively. There are vast amounts of literature debating the relative merits of different forms of legal liability. Generally, criminal punishments and administrative penalties are more severe than civil sanctions, but various obstacles exist for them to be effectively enforced.⁸⁵ Because of the problem of enforcement, they may not be advantageous in term of deterrence.⁸⁶ Civil remedies are less severe, but its deterrent effect is not negligible.⁸⁷ Significantly, there exist fewer obstacles for civil remedies to be enforced than for the enforcement of criminal and administrative sanctions.⁸⁸ Nevertheless, the importance of criminal and regulatory punishments cannot be rejected. As a matter of fact, criminal, administrative and civil sanctions should be complementary rather than alternative if an optimal result of deterrence is to be achieved.⁸⁹

Legal liability can target managerial diversion of company assets directly or indirectly. First of all, because of the seriousness of the misbehaviour, criminal punishment of managerial thefts or embezzlements is a staple in criminal legislation around the

⁸⁵ Daniel C. Langevoort, 'The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation', 47 *Washington & Lee Law Review*. (1990), 527, 531; Daniel C. Langevoort *et al*, 'Securities Laws and Corporate Governance: The Advent of a Meltdown?' Panel Discussion and Q & A, (Reliance National, May 13, 1999), available at <http://securities.stanford.edu/research/reports/19990513.html>; Barry Rider, 'Policing the City: Combating Fraud and Other Abuses in Corporate Securities Industry', 41 *Current Legal Problems* 47 (1988); John M. Naylor, 'The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other (Part ii)' *Company Lawyer*, No.5 (1990), 83, 89.

⁸⁶ See Gary Becker, 'Crime and Punishment: An Economic Approach', *Journal of Political Economy*, Vol. 76 (1968), 169-217; John C. Coffee, Jr., 'Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions', 17 *American Criminal Law Review* 419 (1980), 423, 456-68.

⁸⁷ Gary Becker & George Stigler, 'Law Enforcement, Malfeasance and Compensation Enforcers', 3 *Journal of Legal Studies* (1974), 1-18. Rafael La Porta, Florencio Lopez de Silanes & Andrei Shleifer, 'What Works in Securities Laws?' *Journal of Finance* Vol. 61 Issue 1 (February 2006), 1-32.

⁸⁸ See Bruce Benson, *The Enterprise of Law: Justice Without the State*, (Pacific Research Institute for Public, 1990); John C. Coffee, Jr., *supra* n 85; John M Naylor, *supra* n 85.

⁸⁹ Braithwaite, *Corporate Crime in the Pharmaceutical Industry*, (London: Routledge & Kegan Paul, 1984) 324, cited in R. A. G Monks and Neil Minow, *Corporate Governance*, (3rd ed, Blackwell Publishing 2003).

world, notwithstanding the difficulty of enforcement. In some countries, the government may have jurisdictions to impose penalties such as fines, disgorgement, disqualification etc on managers who line their pockets with company assets. As far as deterrence by way of civil action is concerned, it is critical to give shareholders the right to take derivative actions, because entrenched management would not sue themselves.⁹⁰ Sanctions stipulated by these laws target misappropriation directly. Contrary to this, securities law does not target managerial theft directly. Rather, it regulates information disclosure. But securities law has become more and more important for corporate governance. In some countries its importance in ensuring good corporate governance may have well exceeded the importance of company law.⁹¹ Indeed some academics argue that improving corporate governance provides the most pervasive justification for ongoing mandatory disclosure.⁹² On the one hand, the functioning of various corporate governance mechanisms relies on the availability of accurately and timely disclosed information, which is mandated by securities law. On the other hand, by providing them with information, mandatory disclosure not only helps shareholders or public agencies enforce company law or criminal law which directly targets managerial misappropriation, it also deters managerial misappropriation in the first place, because managers who envisage to misappropriate would worry about the publicity of their misbehaviour.⁹³ Hence is the saying that ‘sunshine is the best disinfectant’.⁹⁴

(2) An Evaluation of the Market Primacy Theses

The fallacies of the market efficacy theories in general and the market primacy theory in particular have so far been fully revealed. When market mechanisms are incapable of stopping one-off duty-of-loyalty violations and when even their limited value to discourage duty-of-care violations is conditional on the suppression of managerial misappropriation by legal sanctions, it is hard to believe that market mechanisms are

⁹⁰ See Ian Ramsay, ‘Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action’, *University of New South Wales Law Journal*, Vol. 15, No. 1 (1992), 149; Arad Reisberg, ‘Shareholders’ Remedies: The Choice of Objective and the Social Meaning of Derivative Actions’, *European Business Organization Law Review*, Vol. 6, No. 2 (2005), 227.

⁹¹ Robert B. Thompson & Hillary A. Sale, ‘Securities frauds and corporate governance: Reflections upon federalism’, 56 *Vanderbilt Law Review* 859 (2003).

⁹² Merritt B Fox, ‘Required disclosure and corporate governance’, 62 *Law and Contemporary Problems* (3) (1999), 113.

⁹³ *Ibid.*

⁹⁴ A maxim coined by the late Justice Louis Brandeis of the Supreme Court of U.S. in *Olmstead v. U.S.* 277 U.S. 438 (1928).

superior and have comparative advantages over legal liability in ensuring good corporate governance. On the other hand, if legal deterrence is the only effective way to combat managerial fraud and embezzlement, it is not correct to claim that legal liability can be substituted and are therefore negligible. Because of the vital importance of legal liability in deterring managerial fraud and embezzlement, legal deterrence occupies a foundational rather than a negligible position in corporate governance upon which the whole system of corporate governance stands.

It was argued that duty-of-care violations are ‘probably the single largest source of agency costs’.⁹⁵ This is hard to believe, if the statement is a general comparison between two types of violations. In a particular jurisdiction where duty-of-loyalty violations have been satisfactorily checked, the statement may be true. But generally, duty-of-loyalty violations, particularly fraud and misappropriation, are no doubt far more serious. They are not only fatal to company success, but also destructive to the function of non-legal liability mechanisms. That is why liability for duty-of-loyalty violations is far harsher than for duty-of-care violations all over the world. Thus we can see that such a concern over agency costs resulting from duty-of-care violations may be justifiable for a particular country, but it would be completely wrong if we generally conclude that duty-of-loyalty violations are insignificant compared to duty-of-care violations.

It was also charged that legal liability comes with different costs so that it may not be desirable as a corporate governance mechanism. For example, it is said that legal liability may give rise to a tendency for managers to act in a risk-averse rather than risk-neutral way in managerial decision-making; that the threat of legal liability may cause managers to be less willing to make firm-specific human capital investments; and that there also exist the costs associated with errors made by judges, because judges are not better qualified than managers to decide whether a transaction is in the best interests of shareholders. All of these incidents are harmful to shareholder value.⁹⁶

⁹⁵ See Daniel R. Fischel & Michael Bradley, *supra* n 45 at 291.

⁹⁶ *Ibid*, at 265, 270.

First of all, an observation that can be made about this accusation is that it makes no distinction between liability arising from violation of duty of care and duty of loyalty. While the alleged costs may be true to a degree with regard to duty-of-care liability (although the costs have been exaggerated and are not in line with reality and the business judgement rule⁹⁷), they are totally irrelevant as far as duty-of-loyalty liability is concerned. The threat from legal liability over misappropriation has nothing to do with either authentic risk-taking by managers in managerial decision-making, or firm-specific human capital investments by honest managers. Legal liability against intentional misbehaviour would not give rise to ‘over-deterrence’. Moreover, courts may have difficulty in assessing managerial efforts, but it is hard to claim that they are not in a better position than managers to assess the merit of conflicting managerial behaviour. Last but not least, it should be pointed out that, because legal liability is indispensable in deterring managerial misappropriation and fraud, we couldn’t discard legal liability even if the alleged costs were true or costs other than those listed above may exist. The correct approach is to see how costs associated with legal liability can be reduced rather than to reject legal liability because of the existence of costs. In other words, costs, whether genuine or falsely alleged, are not a reason to downplay the importance of legal liability, especially the liability against managerial misappropriation and fraud. If legal sanctions are not enforced rigorously for the reason of alleged costs, the performance of corporate governance in a country is predictable.

Whilst academic discourse about corporate governance has not yet clearly indicated that even the limited value of market competition is based on sufficient legal deterrence, the fact that market competition is not effective to discourage ‘one-off’ misbehaviour has long been recognized.⁹⁸ Judge Easterbrook and Professor Fischel, perhaps the most prominent advocates of market utility in the legal academy, themselves admitted that market discipline is ineffective so far as ‘one shot’ managerial misconduct is concerned.⁹⁹ But for them, such misconduct seemed only a minor exception to their arguments for the superiority of market mechanisms over legal liability. Why did they ignore that type of managerial misbehaviour, despite its

⁹⁷ See Donald E Schwartz, *supra* n 45.

⁹⁸ See Benjamin Klein and Keith B. Leffler, *supra* n 70; Harold Demsetz, *supra* n 45.

⁹⁹ Frank H. Easterbrook & Daniel R. Fischel, *supra* n 53, Chapter 4.

seriousness? Why did they not recognize that sufficient legal deterrence is fundamental for market mechanisms to work? We may have an answer, if we can appreciate that their studies focused on the experience of the US, where they considered that ‘the widespread assumption that corporate managers systematically act in ways contrary to investors’ best interests is without foundation’¹⁰⁰ and ‘the opportunity cost of excess leisure and not working hard is probably the single largest source of agency costs’.¹⁰¹ If their assertion is true, sufficient legal deterrence may have already been secured in the US and the critical issue of corporate governance is no longer misappropriation and fraud but that of duty-of-care violations.

For duty-of-care violations, market mechanisms may be a better cure than legal liability.¹⁰² Indeed, where lack of legal deterrence is no longer a problem, it may be desirable to emphasize the utility of market mechanisms rather than to promote legal sanctions, because of the concern about ‘over-deterrence’. If emphasis is still put on legal sanctions where adequate deterrence has already been secured, the net benefits may be negative in that gains from increased deterrence may be outweighed by the costs of ‘over-deterrence’. Furthermore, even if the concern about over-deterrence is unfounded, making use of market forces to improve corporate governance may be more cost-effective than expending effort to increase legal deterrence where legal deterrence has already been substantial. In view of this, it is understandable that legal liability for duty-of-care violations is only nominal and the business judgement rule is firmly accepted in the US.¹⁰³ So, if we are able to appreciate that the advocates of market utility have focused their study on the US where they assumed that managerial misappropriation and fraud may no longer be ‘systematic’, their preference for markets over legal liability is understandable. Criticisms of their market primacy submission may not be valid if what they assumed is true.¹⁰⁴

¹⁰⁰ See Daniel R. Fischel & Michael Bradley, *supra* n 45 at 262.

¹⁰¹ *Ibid.*, at 291.

¹⁰² *Ibid.*, at 263.

¹⁰³ See Bernard S. Black & Brian R. Cheffins, ‘Outside Director Liability across Countries’, Stanford Law and Economics Olin Working Paper No. 266 (December 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=438321. A more radical suggestion is to abolish the liability for duty-of-care violations. See Kenneth E Scott, *supra* note 44.

¹⁰⁴ However, after Enron and WorldCom, there are views that stress the significance of duty of care. See Lisa M. Fairfax, ‘Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty through Legal Liability’, 42 *Houston Law Review* (2005), 393-456.

This, however, does not mean that, as general theories, the market efficacy and in particular the market primacy proposition are logically sound and universally applicable. Not all countries are in the same position as is the US. At least in China, currently illegal managerial self-enrichment is widespread, fraud is rampant, and corporate scandals are recurring realities. For a country like this, the propositions that market mechanisms are effective and preferable over legal liability in ensuring good corporate governance is plainly wrong. We should understand that the market efficacy and market primacy theories are America-specific, and that there are fundamental differences in the practice of corporate governance between China and the US. Otherwise, those theories will be misread and the urgent need to enhance legal deterrence to battle managerial misappropriation and fraud will be missed.

(3) Limits of Legal Liability?

Whether law is significant or insignificant in maintaining social order is an old debate. A thorough examination of the general proposition that law has limits is beyond the scope of this paper. Nevertheless, a brief comment about the effectiveness of legal liability in preventing managerial misappropriation can be made. Managerial misappropriation is a type of white-collar crime and the attributes of white-collar crimes are very different from conventional crimes.¹⁰⁵ White-collar criminals act on careful calculation rather than out of instant impulsive emotion or under the influence of drugs. The claim that offenders may be ignorant of the existence of the law is also not applicable to the highly intelligent company managers. Furthermore, company managers are unlikely to be impoverished so as to be resilient to the threat of legal liability. Thus the findings from research on traditional crimes that legal sanctions are ineffective to deter may not be applicable to white-collar crimes.¹⁰⁶ To the contrary, it has long been recognized that white-collar offences, as a type of 'instrumental acts (those that are presumably rational)', are most affected by threats of punishments.¹⁰⁷ Thus the effectiveness of legal liability to deter managerial misappropriation should not be questioned. It is argued that crimes have deep social roots and to address the

¹⁰⁵ See generally Gilbert Geis, Robert F. Meier & Lawrence M. Salinger (eds.) *White-collar Crime: Classic & Contemporary Views*, (NY: Free Press, 1995).

¹⁰⁶ *Ibid.*

¹⁰⁷ See William J. Chambliss, 'The Deterrent Influence of Punishment', *Crime and Delinquency*, 12 (1966), 70-75; Charles R. Tittle, 'Crime Rates and Legal Sanctions', *Social Problems*, 16 (1969), 409-423. See also Albert DiChiara & John F. Galliher, 'Thirty Years of Deterrence Research: Characteristics, Causes, and Consequences', [Crime, Law and Social Change](#), Vol. 8, No. 3 (July 1984), 243-263.

root causes are as important as legal sanctions. This indeed may be similarly true as with white-collar crimes. But the validity of this proposition does not mean that legal sanctions are insignificant. Whatever the social causes are and however well they are tackled, white-collar crimes would not be substantially reduced if legal deterrence were exceedingly weak.

Some philosophers also raise questions concerning legislation and the enforcement of law in support of their objection of governmental intervention of social and economic life.¹⁰⁸ Because of the existence of problems in legislation and enforcement, doubt is hence cast on the significance of law as an institution for social control. True and relevant they may be, the existence of these problems does not necessarily imply that legal sanctions are trivial in combating managerial misappropriation. Because, as has already been demonstrated, legal liability is the only effective way to tackle one-off managerial misappropriation, we cannot afford to ignore legal liability, notwithstanding the existence of difficulties in legislation and enforcement. The right approach is to find out how to solve the legislative and enforcement problems in order to make legal liability more effective. Of course these problems cannot be completely eliminated, legal sanctions are not perfectly effective and managerial misappropriation will always be a component of our economic life. But in different countries the job has been done with different degrees of success. In some countries both legislation and enforcement are more satisfactory. Accordingly, legal sanctions are more effective and in turn managerial misappropriation and fraud are less severe. In others the case is different. It is actually the difference in tackling the legislative and enforcement problems that distinguishes well and poorly performing countries. To enhance corporate governance, we have no choice but to improve legislation and enforcement to strengthen legal sanctions against managerial misappropriation and fraud. If we disregard legal liability because of existence of difficulties in legislation and enforcement, the goal to improve corporate governance will never be achieved.

¹⁰⁸ For example, see Friedrich A. Hayek, *Law, Legislation, and Liberty, volume 1, Rules and Order* (Chicago: University of Chicago Press, 1973); Antony Allott, *The Limits of Law*, (London, Butterworths, 1980).

Since 1990s there has been an upsurge of scholarly interest in the study of social norms in the legal academy.¹⁰⁹ Such strong interest in the social norm study seems to imply the importance of social norms in guiding human behaviour. Indeed it was openly claimed by ‘law and norms’ scholars that the role of law in the overall system of social control had been exaggerated and the importance of socialization and the informal enforcement of social norms had been underestimated.¹¹⁰ Thus it is worth and necessary to have a brief discussion about the role of social norms in ensuring good corporate governance.

Social norms are non-legal rules adopted by the majority of members of a social group or the whole society. It is generally agreed that norms are ‘informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both’.¹¹¹ Specifically, norms are enforced through three mechanisms. First is the sense of guilt, shaming, etc resulting from violation of personal ethics internalized by the first party. This actually is about the role of morality in maintaining social order. Second is the withdrawal by the second party from a contractual relationship which he has or may have with the violator. Third is the disapproval of and shunning from the violator by third parties, which can be termed ‘ostracism’.¹¹² It can be seen that the last two mechanisms are identical to shareholder voting and market discipline in the scenario of corporate governance.

Can social norms play a significant role in ensuring good corporate governance without the support of legal liability? Again we need to answer the critical question whether social norms alone can discourage corporate management from engaging in

¹⁰⁹ See Robert C. Ellickson, ‘Law and Economics Discovers Social Norms’, *The Journal of Legal Studies*, Vol. 27 No. 2 (June 1998), 537-552.

¹¹⁰ Ibid.

¹¹¹ See Richard H. McAdams, ‘The Origin, Development, and Regulation of Norms’, *Michigan Law Review*, Vol. 96 No. 2 (November 1997), 338-433; Edward B. Rock & Michael L. Wachter, ‘Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation’, *University of Pennsylvania Law Review*, vol. 149 Issue 6 (2000-2001), 1619-1700.

¹¹² Ibid; Robert C. Ellickson, *Order without Law: How Neighbours Settle Disputes*, (Harvard University Press 1991), Chapter 7; [Richard A. Posner](#) & Eric Bennett Rasmusen, ‘Creating and Enforcing Norms, With Special Reference to Sanctions’, [International Review of Law and Economics, Vol. 19, Issue 3 \(September 1999\)](#), 371-382.

one-off misappropriation and fraud. The answer is quite dubious.¹¹³ First of all, we cannot take the social norms which favour shareholders' interests over the personal interests of management for granted. For social welfare maximizing norms to take roots, 'a pattern of sanctions' is the prerequisite.¹¹⁴ However, as has been previously demonstrated, market discipline and other market-related governing mechanisms do not pose an effective sanction against managerial misappropriation. How about the role of the first party's self-discipline, or morality? Where misappropriation in a society is widespread and rarely punished by law, it is doubtful that the ethics favouring shareholders' interests over their own would be naturally assimilated by managers. Even if such personal ethics is in place, moral condemnation and sense of guilt may be easily dwarfed where financial stakes are substantial to the personal well-being of managers. The same can be said for other non-financial utilities such as psychological satisfaction out of reputation, success etc. Thus we can conclude that social norms alone are not effective to discourage one-off managerial misappropriation and this in turn implies that it is doubtful that social norms can play a significant role in corporate governance without the support of legal sanctions.¹¹⁵ The establishment of social norms that encourage honest work has to rely on regular legal sanctions. Without effective legal sanctions, such productive norms would be illusory. As a matter of fact, when misappropriation is widespread but enforcement is sporadic, it is dangerous that norms encouraging embezzlement rather than honesty may take hold. This is likely where consumerism is deep in the culture of the society, personal wealth is excessively worshipped, but law is fundamentally weak, as is the case currently of China. In a society like this, 'Robber Barons' may be the role model for many company managers. Thus we can see that the effectiveness of social norms in ensuring good corporate governance is similarly conditioned upon effective legal deterrence against one-off managerial misappropriation.

¹¹³ The whole of Issue 6 of the *University of Pennsylvania Law Review* vol. 149, No. 6 (June 2001) is devoted to the debate of whether social norms can play a significant role in corporate governance. See also Robert E. Scott, 'The Limits of Behavioural Theories of Law and Social Norms', 86 *Virginia Law Review* 1603, 1643-44 (2000); Melvin A. Eisenberg, 'Corporate Law and Social Norms' 99 *Columbia Law Review* 1253 (1999); Edward Rock, 'Saints and Sinners: How Does Delaware Corporate Law Work?' 44 *University of California Los Angeles Law Review* 1004 (1997)

¹¹⁴ See John Finley Scott, *The Internalization of Norms* (1971), at 72, cited in Robert C. Ellickson, *Supra* note 111, footnote 17.

¹¹⁵ See Robert E. Scott, *supra* note 103; Marcel Kahan, 'The Limited Significance of Norms for Corporate Governance', *University of Pennsylvania Law Review*, Vol. 149, No. 6, (June 2001).

There have also been calls recently to use the so-called ‘social sanctions’ like ‘shaming’ as alternatives to legal sanctions.¹¹⁶ It is possible that ‘shaming’ may increase the negative publicity of misbehaviour and thus facilitate the working of market discipline on the one hand, and on the other it may reinforce moral condemnation and personal guilt. But, as has been discussed above, market competition as well as morality is not so effective in discouraging one-off managerial misbehaviour. More problematic about the ‘shaming’ proposal is that ‘shaming’ cannot be independent of legal sanctions in the scenario of misappropriation and fraud. Without prosecution and conviction or civil judgement, it is difficult to imagine how ‘shaming’ can be achieved.¹¹⁷

E. Under-Deterrence: Evidence from China

So far it has been demonstrated in theory that it is vitally important to deter fraudulent managerial self-enrichment and that legal sanctions play a unique role in doing so. In this section concrete evidence from China is presented to show that ‘systematic’ misappropriation and fraud are not imaginary where legal deterrence is exceedingly weak. This evidence clearly demonstrates that market mechanisms are in themselves not effective to discipline fraudulent misappropriation, and the prevalence and persistence of fraud and misappropriation are better explained by the lack of adequate legal deterrence. The evidence concerns misappropriation of listed companies’ funds. Other scandals, such as fabricating accounting figures, manipulating share prices through trading, making up stories about the business prospects of companies etc, are not discussed here.

(1) Misappropriations in Listed Companies

¹¹⁶ See Dan M. Kahan, ‘What Do Alternative Sanctions Mean’, 63 *University of Chicago Law Review* 591 (1996). In relation to the role of ‘shaming’ in corporate governance, see David A. Skeel, Jr., ‘Shaming in Corporate Law’, 149 *University of Pennsylvania Law Review* 1811 (2001).

¹¹⁷ See Dan M. Kahan, ‘What’s Really Wrong with Shaming Sanctions’, working paper available at <http://www.ssrn.com>, for a self-criticism.

Generally, corporate governance in listed companies in China is pitiful.¹¹⁸ One acute problem is that funds are routinely channelled out of listed companies to their controlling shareholders or other related parties not for business purpose. According to a survey conducted by the CSRC at the end of 2002, of the total 1175 listed companies, 676 had experienced fund tunnelling by their majority shareholders, with misappropriated funds amounting to 96.7 billion Chinese Yuan.¹¹⁹ Up to the end of 2003, the balance of misappropriated funds of 623 listed companies was 57.7 billion Yuan.¹²⁰ As of 30th June 2005, the majority shareholders of 480 listed companies expropriated corporate funds and the balance of about 48 billion Yuan accounted for more than half of the profits of all listed companies made in the first half of the year. At the same time, more than 1000 listed companies had illegally guaranteed loans of about 42.5 billion Yuan borrowed by their majority shareholders.¹²¹

In a substantial number of cases where funds were tunnelled or guarantees offered to majority shareholders, no board decisions were made or resolutions passed by shareholders' meetings, even though these are required by articles of association of companies, administrative regulations¹²² or primary legislation.¹²³ Such tunnelling or guarantees are simply executed by some executives and concealed from both other directors (usually independent directors) and the public shareholders who should have the right to make decisions. More often than not, such tunnelling and guarantees are not authentic business transactions. They are misappropriation, or to use plain language, stealing. In 2005 about 180 directors were publicly censured by the two

118 See Stoyan Tenev & Chunlin Zhang with Loup Brefort, *supra* note 11; Donald C. Clarke, 'Corporate Governance in China: An Overview', *China Economic Review*, Vol. 14 Issue 4 (December 2003) 494; William A. Fischer, 'Will China face up to its governance problem?' *Financial Times* (Sponsored reports/Mastering Corporate Governance, June 2nd 2005); Cindy A. Schipani & Liu Junhai, 'Corporate Governance in China: Then and Now', *Columbia Business Law Review*, Vol. 2002, 1-69 (2002). The International Institute for Management Development in Switzerland surveyed the corporate governance of 60 economies in the world in 2004 and China ranked 25th on board effectiveness, 40th on shareholder value, 57th on insider trading and 44th on shareholder rights. Another survey by the World Economic Forum in 2003 ranked China 44th among the 49 economies surveyed. See Qiao Liu, 'Corporate governance in China: current practices, economic effects, and institutional determinants', *CEifo Economic Studies*, Vol. 52, No. 2 (2006), 415-453.

119 See Ou Guofeng, Li Hongwei & Shun Tingyang, 'The Obstinate Disease of Misappropriation of Funds by Majority Shareholders', *Securities Market Weekly* (Issue 17, 2005), 19-21, available at <http://zhoukan.hexun.com/Magazine/ShowArticle.aspx?ArticleId=8571> (in Chinese).

120 *Ibid.*

121 *Ibid.*

122 See the CSRC, Guiding Rules on the Article of Association of Listed Companies (16th December 1997), Article 94; the CSRC, Notice Regarding Guarantees Offered to Others by Listed Companies (6th June 2000), Article 5.

123 See the NPCSC, Company Law 1993 (2005), Article 105 & 122.

stock exchanges for misbehaviour and more than half involved in fund misappropriation.¹²⁴ At the same time, the requirements of mandatory disclosure stipulated by securities law are taken extremely lightly and misappropriation is routinely covered up to the last minute. In 2004 and 2005, there were respectively 49 and 43 cases of violations of securities law which were penalized by the CSRC. Among these, about 55% involved misrepresentation by listed companies.¹²⁵ It should be remembered that violations which have been revealed and punished are only a tip of iceberg of all violations. In a study of CSRC penalties and public censures by the two stock exchanges, it is estimated that for every one case of penalty or public censure there are as many as four cases of violation that have not been revealed or pursued.¹²⁶ It is no exaggeration to say that misappropriation is widespread and negative information is routinely concealed by listed companies in China.

Several high profile cases have been widely reported:

- Kelon (000921): A company whose shares are quoted on both Shenzhen and Hong Kong Stock Exchanges. The company was originally controlled by a local government in Guangdong Province. In 2001 a private company owned by an entrepreneur bought control of the company and the same person had thereafter acquired control of four more listed companies. After the control of the company was handed over to the private person, there were extensive reports suggesting that accounting figures were manipulated and funds of the company were misappropriated by the controller. In 2005 the CSRC announced to conduct an investigation and, shortly after that, six managers including the controller were arrested by the local police. The local government regained control of the company and appointed KPMG to conduct an investigation. After it had examined the occurrences of money transfer above 10 million Chinese Yuan, KPMG reported that during 2001 to 2005 about 7.5 billion Yuan had been transferred in and out of the bank accounts of

¹²⁴ Documents of public censure are publicized by the two stock exchanges (in Chinese) and available on their websites (<http://www.sse.com.cn> and <http://www.szse.cn>).

¹²⁵ Documents of penalty are publicized by the CSRC (in Chinese), available on its website <http://www.csrc.gov.cn>.

¹²⁶ See Wu Xiaoliang, 'Research on Punishments of Securities Violations', *Caijing Magazine*, Issue 136 (27th June 2005), available at <http://caijing.hexun.com/text.aspx?sl=2304&id=1219558> (in Chinese).

the company not for business purpose, resulting in a net loss to the company of 592 million Yuan. The CSRC's investigation finally uncovered that from 2002 to 2004 477.18 million Yuan profits were fabricated. The transfers of funds had never been disclosed by the company and its auditor, Deloitte and Touche, neither revealed the transfers of funds nor the fabricated profits.¹²⁷

- Sanjiu Yiyao (000999): Following the company's IPO, from July 1999 to December 2000 more than 2.5 billion Yuan were channelled to its controlling shareholder in fund movements that were not true business transactions, representing about 96% of the company's total net assets. In the same period, more than 1.1 billion Yuan was lent to one of its sister companies at interest rates of between 2.25% and 2.925%, while it borrowed nearly 1.5 billion Yuan from others at interest rates of between 3.504% and 9.504%. In July 2002 the CSRC made a decree demanding that the controlling shareholder repay the misappropriated funds. At the end of November 2003, about 1.6 billion Yuan had still not been paid back and most of the repayments were in non-cash assets.¹²⁸ The tunnelling had never been disclosed before the CSRC took action. Ironically, after the CSRC's decree, misappropriated funds increased further. To the end of 2005, the balance was more than 3.7 billion Yuan.¹²⁹
- Hou Wang Gufeng (000535): By the end of 1999, while the company's gross assets were only 934 million Yuan, about 890 million Yuan had been misappropriated by its controlling shareholder. The misappropriation took in different forms, including borrowings, receivables, and bank loans borrowed by the controlling shareholder but recorded in the company's account and so on. The company also guaranteed more than 300 million-Yuan loans borrowed by its controlling shareholder. In February 2001 its controlling shareholder was declared bankrupt. The company not only got nothing back; it also had to meet its obligations under the guarantee.¹³⁰

¹²⁷ See the reports by *China Securities Journal* on 21st January and 17th July 2006, available at <http://www.cs.com.cn/> (in Chinese).

¹²⁸ See CSRC Penalty Decision No. 12 (2002), available at its website <http://www.csrc.gov.cn> (in Chinese)

¹²⁹ Statistics available on the website of Shenzhen Stock Exchange, <http://www.szse.cn/> (in Chinese).

¹³⁰ See the reports by the *Research Centre of Corporate Governance of Nankai University*, available at <http://www.cg.org.cn/index.asp> (in Chinese).

- Pi Jiu Ha (600090): On 30th December 2003 the company made an announcement that its Chairman had disappeared. It was also disclosed that the company had guaranteed loans to different companies amounting to 1.787 billion Yuan, of which about 1 billion had not been disclosed before. After the announcement, the price of its shares dropped from 16.51 to 3.66 Yuan on 11th July 2004.¹³¹
- Tuo Pu Software (000583): In 1998 a company owned by an individual acquired a listed company and renamed it Tuo Pu Software. In 2000 the listed company issued new shares and raised about 1 billion Yuan with the approval of the CSRC. In the same year, the same individual acquired another listed company and renamed it Yan Huang Online. In 2001 Tuo Pu Software reported huge profits (0.78 Yuan per share). But two years later in 2003 it reported huge losses (1.64 Yuan per share). An investigation by the CSRC revealed that between October 2003 and April 2004 about 1.4 billion Yuan (100.56% of its net assets) were transferred out of Tuo Pu Software to companies controlled by that same individual. In 2003 Tuo Pu Software also guaranteed about 886 million Yuan of loans (63.81% of its net assets). Yan Huang Online also guaranteed loans to related parties amounting to 286 million Yuan (280% of its net assets). Both companies were censured by the Shenzhen Stock Exchange in June 2004 for non-disclosure. But by this time the controller had already absconded to the US. The local regulatory authority ‘invited’ him to come back to China to assist investigation, but he refused on the grounds of illness. The share price of Tuo Pu Software plummeted from 48 Yuan in July 2000 to 4.43 Yuan on 30th June 2004.¹³²
- De Long Group: A conglomerate owned by four brothers, De Long Group was the largest shareholder of three listed companies and the 2nd largest of several other listed companies. It also controlled dozens of securities companies, local banks and trust companies. The Group first acquired one listed company and

¹³¹ See CSRC Penalty Decision No. 19 (2004), available at its website <http://www.csrc.gov.cn> (in Chinese).

¹³² See CSRC Penalty Decision No. 30 (2005), available at its website <http://www.csrc.gov.cn> (in Chinese).

then misappropriated its funds and caused it to guarantee loans. With the misappropriated and borrowed money, the Group bought a number of other listed companies and financial institutions. Every time when a company was acquired, the Group played the same game. Furthermore, securities companies controlled by it manipulated the share prices of these listed companies to a ridiculously high level with funds from different sources. By offering the inflated shares it owned as collaterals, the Group borrowed even more from banks. In this way the Group expanded dramatically in a few years and in 2003 the brothers ranked 25th on Euromoney's list of China's richest men. But in April 2004 the game was all over after national banks were commanded by the central government to cut lending in order to cool down the overheated economy. The Group collapsed spectacularly. The tunnelling of astronomical amounts of money was thus finally officially disclosed. There is little hope that these funds can ever be recovered, because the greater part may have been used to prop up the inflated share prices of the companies and now the value of those shares is negligible.¹³³

From a general description and these concrete cases, we can gain an insight into the reality of corporate governance in China. It is clear that currently corporate governance in China is essentially in a state of lawlessness. Misappropriation is widespread; frauds are outrageous. A basic level of 'law and order' has not yet been established in 'corporate China'.

(2) Under-Deterrence and Misappropriations

What is the state of legal deterrence in the face of these blatant criminalities? The reality is that legal deterrence is extremely soft. Despite the fact that theft and frauds are pervasive, both criminal prosecutions and administrative penalties are sporadic. It is difficult to estimate how many culprits have escaped punishment, but, as mentioned above, violations which have been penalized by the CSRC or publicly censured by the

¹³³ See Lin Huawei, Cao Haili & Zhou Fan, 'Finale in Sight for Delong Saga', *Caijing Magazine*, Issue 165 (January 09 2006), available at <http://caijing.hexun.com/english/detail.aspx?issue=165&id=1488152>.

stock exchanges may be only one quarter of the total number.¹³⁴ Even this figure may overestimate the rate of penalization. There are many suspected violations, many of which are obvious and have been widely reported by the media, but the government has done nothing about them. There are many situations where suspected violations had been reported by the media for years, but the government intervened only when the companies involved eventually collapsed. It was reported that from January 2003 to June 2004, 10 top managers of listed companies absconded from the country, with it being subsequently revealed that their companies had been looted of funds or caused to guarantee bank loans amounting to billions.¹³⁵ Surprisingly, there are no criminal actions against these absconders. A few of them have been penalized by the CSRC. The severest case of penalty was a 300 thousand Yuan regulatory fine against a Chairman and CEO of a listed company on the grounds that he was responsible for the cover-up of the tunnelling of funds out of and guarantees offered by the company.¹³⁶ Compared to the nearly 1 billion Yuan of funds of which the company was looted or caused to guarantee, that amount of fine is laughable. Even this trivial amount of fine will not be collected, as the Chairman has disappeared and nobody knows his whereabouts. Yet even a fine of this size is actually unusual. Many violations are settled with private admonishments, letters from the regulator or stock exchanges demanding redress, or public censure by stock exchanges. It is doubtful whether these soft measures have any deterrent effect. For example, among the 477 company directors who were censured by the Shanghai Stock Exchange between April 2001 and November 2004, more than 10% were censured repeatedly.¹³⁷

As far as private litigation is concerned, deterrence is non-existent. On the one hand, the old Company Law did not clearly confer on shareholders the standing to sue derivatively¹³⁸ and several attempts to take on derivative actions by minority shareholders had all failed as a result of the courts' refusal to accept their cases.¹³⁹ On the other hand, shareholders' right to take on private securities actions is substantially

¹³⁴ See Wu Xiaolian, *supra* n 111.

¹³⁵ See the report by *Beijing Business Today* on 21st June 2004, available at <http://www.bjbusiness.com.cn/20040621/touzi476.htm> (in Chinese).

¹³⁶ See CSRC Penalty Decision No. 19 (2004), *supra* n 116.

¹³⁷ See the report by *South Daily* on 30th November 2004, available at <http://finance.news.tom.com/1008/1009/20041130-118787.html> (in Chinese).

¹³⁸ See The NPCSC, Company Law (1993), Article 111.

¹³⁹ See Deng Jiong, 'Building an Investor-Friendly Shareholder Derivative Lawsuit System in China', *Harvard International Law Journal*, Vol.46, No.2 (2005), 347.

restricted by a judicial interpretation adopted by the Supreme People's Court. According to the interpretation, only securities actions against misrepresentation are permissible.¹⁴⁰ Actions can be taken only after criminal conviction or administrative penalty decisions have been entered into.¹⁴¹ Furthermore, both American-style class actions and English-style group litigation are not allowable and actions can only be taken individually or jointly.¹⁴² As a result of these restrictions, there have been only a few private securities lawsuits, all of which are against flagrant frauds.¹⁴³ Damages awarded are insignificant and it is not clear whether culpable managers have been made personally accountable. In short, legal deterrence on misappropriation and fraud is inconsequential in China. Most violations are not revealed or pursued, and both criminal prosecutions and administrative actions are infrequent. Where actions are taken, penalties are phenomenally light-handed. Finally, deterrence via private lawsuits is non-existent.

From the above discussion, we may have a better understanding of why misappropriation are so widespread and fraud flagrant in listed companies in China. It is true that reasons are complex and systemic. No single factor is wholly responsible for this unpleasant situation. The stock market is basically devoid of any disciplinary function because of the dominance of state ownership. There have been virtually no hostile takeovers since the stock exchanges were opened. Control is transferred by way of private transactions, mostly because the governments are forced to give up their stakes in listed companies after the companies run into financial difficulties. Share prices in the main have no connection with the performance of companies and artificial manipulation of share prices is rampant. Similarly, the voting by minority shareholders as a disciplinary mechanism is negligible because of the dominance of state ownership. Yet the governments, notwithstanding their majority ownership, have not been able to exercise the kind of effective monitoring of the running of these

¹⁴⁰ See the Supreme People's Court of China, Notice on Temporary Suspension of Acceptance of Civil Securities Compensation Cases (21st September 2001); the Supreme People's Court of China, Notice on Relevant Issues Concerning the Acceptance of Civil Tort Cases Resulting from Misrepresentation Occurred in Securities Markets (15th February 2002).

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ See Walter Hutchens, 'Private Securities Litigation in the People's Republic of China: Material Disclosure about China's Legal System?' *University of Pennsylvania Journal of International Economic Law*, vol. 24 No.3, 599-689 (Fall 2003).

state-controlled companies that in principle private owners should be able to achieve. Further, state ownership very possibly has a psychological impact upon managers. The paradigms of neo-classical economics have now been firmly established in China and state ownership is widely perceived as illegitimate and regarded as ‘nobody’ ownership. Managers feel no moral stigma with misappropriation of the assets of listed companies that are to all intents and purposes under state ownership. Misappropriation is further exacerbated by the growth of excessive consumerism and individualism. So, state ownership is truly responsible for the prevalence of misappropriation in state-controlled listed companies, not just because state ownership deprives the stock market and shareholder voting of any disciplinary function.

Nevertheless, if legal deterrence remains weak, it would be naïve to expect that corporate governance could be significantly enhanced by divesting the state of its controlling stakes in listed companies in an effort to restore the legitimacy of ownership and the disciplinary function of market competition. As a matter of fact, plenty of companies suffering from misappropriation and fraud are privately-controlled and the crooks are the private controllers. Of the 6 cases reported above, 3 involved listed companies which were controlled by private persons. Recently, the Shanghai and Shenzhen Stock Exchanges publicized the names of 189 listed companies whose funds have been channelled out of the companies not for business purposes. Among them, 69 are privately controlled companies, a figure which is exceedingly out of portion to the share of private companies in the total number of listed companies.¹⁴⁴ It is clear that in too many cases the presence of private controllers has not resulted in good corporate governance. This demonstrates again that private ownership is not a panacea.¹⁴⁵ Actually it would be dangerous to

¹⁴⁴ It is estimated that among the 1300 plus listed companies there are about 200 whose controlling ownership has been transferred to private persons after IPO. See Stephen Green, “‘Two-thirds privatisation’: How China’s listed companies are - finally - privatising?” Briefing Note (The Royal Institute of International Affairs, December 2003), available at <http://www.chathamhouse.org.uk/pdf/research/asia/BNLPSalesPt11.pdf>.

¹⁴⁵ Dispersed ownership pattern is incompatible with a weak legal system and ownership tends to concentrate where legal deterrence is soft in a country. Whilst concentrated ownership may solve the agency problem between shareholders and managers, it creates a new one between majority and minority shareholders. To tackle this varied agency problem, law (especially legal deterrence) is also vital. See Kenneth E Scott, ‘Corporate Governance and East Asia: Korea, Indonesia, Malaysia, and Thailand’, in A. Harwood *et al* (eds.) *Financial Markets and Development*, (Brookings Institutional Press, 1999).

commence mass privatization where legal deterrence is weak. The consequence of mass privatization is quite predictable where legal deterrence is weak: the country becomes immersed in a state of chaos where dirty wars of asset grabbing and ownership battling ensue, a scenario occurred during and after the mass privatization in some Central and Eastern European countries.¹⁴⁶ The result would be catastrophic for China and the effect of illegitimate and corrupt privatization will run for a long time to haunt the country.¹⁴⁷ This indicates that strong legal deterrence is even critical to the success of privatization. The experience from those Central and Eastern European countries also tells that dispersed ownership created by privatization is not sustainable where legal deterrence remains weak.¹⁴⁸ This confirms that market-based mechanisms have a limited role to play in corporate governance where legal deterrence is not strong.

Actually, some market-based mechanisms are available in China, but they have nevertheless proven to be inconsequential. Since 2001, it has been compulsory for listed companies to install independent directors on their boards and by now at least one third of directors should be independent.¹⁴⁹ However, there are too many cases where the presence of independent directors did not prevent misappropriation and fraud. Two notorious cases reported above illustrate perfectly the limited value of independent directors in China.¹⁵⁰ Both involve privately controlled listed companies which were looted of hundreds of millions of Yuan by the controlling shareholders. In one case, three independent directors, one of whom is a prominent economist from a prestigious university in China, resigned just before the company was about to bust. In the other, independent directors resigned after the CSRC announced to conduct an investigation into the company's business and accounts. One of the independent

¹⁴⁶ See Bernard Black, Reinier Kraakman & Anna Tarassova, *supra* note 39; Joseph R. Blasi, Maya Kroumova & Douglas Kruse, *Kremlin Capitalism—Privatizing the Russian Economy* (Cornell University Press, 1997); Maxim Boycko, Andrei Shleifer & Robert Vishny, *Privatizing Russia* (MIT Press, 1995).

¹⁴⁷ See Joseph Stiglitz & Karla Hoff, 'The Creation of the Rule of Law and the Legitimacy of Property Rights: The Political and Economic Consequences of a Corrupt Privatization', NBER Working Paper 11772, November 2005.

¹⁴⁸ See Christof Ruehl, 'From Transition to Development: A Country Economic Memorandum for the Russian Federation', World Bank report, available at <http://www.worldbank.org/>; Erik Berglof & Anete Pajuste, 'Emerging Owners, Eclipsing Markets? Corporate Governance in Central and Eastern Europe', in P.K. Cornelius and B. Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press, 2003).

¹⁴⁹ See the CSRC, *supra* n 31.

¹⁵⁰ The first and last case reported above.

directors is a former executive of the Hong Kong Stock Exchange. It is not clear why the independent directors were not able to prevent the misappropriations and reveal the frauds. But in both cases, the resigning directors cited as the reason for resignation ‘not being able to access the information needed to perform their duty’.¹⁵¹ The reason provided seems vague. Why were they not able to access information? Very possibly the independent directors themselves were defrauded by the executives of the companies and misappropriations were concealed from them. This conforms to the common finding that transactions which are required to be deliberated upon and decided by board meetings are nevertheless executed secretly by executives. These two cases prove that, where managers are determined to misappropriate and are amenable to fraud, the presence of independent directors matters nothing.

The same can be said about performance-based remuneration. Again this can be proven by a real case.¹⁵² Although the CSRC only recently adopted a rule regulating the performance-based remuneration such as stocks and stock options for managers of listed companies,¹⁵³ the company concerned, which is controlled by a local government, granted its management stock options long before this. It was reported that the annual income of the Chairman and CEO, including salary, bonus and stock options, was worth more than 7 million Yuan, an amount that was very generous for a manager in China. But this huge reward could not dissuade him from misappropriation. In December 2005, he was sentenced to six years in prison for misappropriating tens of millions of funds from the company, which is a rare case of criminal sanction against top managers of listed companies who perpetrate misappropriation. In an environment where legal deterrence is insubstantial, the utility of performance-based remuneration is predictable.

In summary, ‘systematic’ misappropriation and fraud are not theoretical imagination. They seem inevitable where legal deterrence is inconsequential. To a large degree, extremely weak legal sanction has to be blamed for the scale of misappropriation and fraud currently occurring in China. While the stock market is dysfunctional and

¹⁵¹ See the report by *People’s Daily* on 13th July 2005, available at <http://finance.people.com.cn/GB/1045/3537808.html> (in Chinese).

¹⁵² See the report by *China Securities News* on 24th December 2004, available at http://www.cs.com.cn/ssgs/02/t20041224_561733.htm (in Chinese).

¹⁵³ See the CSRC, *supra* n 37.

shareholders do not play a role to ensure good corporate governance in China at present, some market-based governance mechanisms do exist, which nevertheless have proven to be ineffective. It is unrealistic to expect that reforming the markets and introducing more market-based initiatives can significantly improve corporate governance. The urgent need is to battle misappropriation and fraud. This cannot be done without legal sanctions being strengthened.

(3) The Reasons for Under-Deterrence

Why are legal sanctions infrequent and so lenient in China? Again the reasons are complex and systemic. There are both practical obstacles and problems in legislation which prevent criminals from being called to account.¹⁵⁴ In practical terms, law enforcement agencies are fragmented in that the CSRC is not responsible for criminal investigation. The responsibility for criminal investigation rests with ‘Public Security Bureaus’ or ‘Anti-Corruption Bureaus’¹⁵⁵ which, on the one hand, are struggling to deal with conventional crimes and, on the other, are controlled by the Communist Party and the governments which are in sympathy with corrupt managers whom they appoint. The courts are also tightly controlled by the party and governments. Corrupt managers enjoy support from party and government officials. Traditionally top company managers come from the party and governments and thus it is quite possible that government officials and managers are former colleagues and close friends. Moreover, corruption by managers means failure to perform their duties, if not complication in the corruption, on the part of persons who are entrusted the power to appoint and monitor managers. As a result, party and government officials who have the authority to control law enforcement activities are disincentivized to reveal corruption by managers and call them to account. For the CSRC who is entrusted to take administrative actions to enforce the securities law, the amount of resources

¹⁵⁴ See Wenhui Cai, ‘Private Securities Litigation in China: Of Prominence and Problems’, 13 *Columbia Journal of Asian Law* 135 (1999).

¹⁵⁵ It was reported in December 2003 that a bureau under the Ministry of Public Security was established which is monopolistically responsible for the investigation of securities crimes in the country. See the report by the Xinhua News Agency on 24th December 2003, available at http://news.xinhuanet.com/stock/2003-12/24/content_1245775.htm (in Chinese). But here come the confusion and conflict. Technically, misappropriation is not a securities crime, but misappropriation is necessarily accompanied by cover-up, which violates securities law. In this situation, it is not clear which agency- the designated bureau or local public security bureau-is responsible.

allocated for the pursuit of violations is laughable. In particular, the CSRC lacks investigatory powers. It is doubtful whether the CSRC has the power of subpoena as the Securities and Exchange Commission in the US does. Until recently, it had to apply for a court order before it could seize evidence or freeze bank accounts.¹⁵⁶ Last but not least, dismally, corruption also happens within the CSRC.¹⁵⁷

So far as obstacles resulting from legislation are concerned, firstly, criminal legislation against misappropriation is full of loopholes, differential treatment and conflicts. The applicable provisions are different with regard to managers from different companies, depending on whether a company is controlled by the state or by private persons. This makes the legislation tremendously complex and uncertain, leaving law enforcers with huge room to manoeuvre. More deplorably, there are no explicit provisions against tunnelling of funds from which managers do not receive the funds personally or make profits with the funds for themselves. For example, if a company is controlled by the state, managers who tunnel funds out of the company may not violate criminal law if they cannot be proven to have received the funds or made profits for themselves. Thus, if funds of a state-controlled company are tunnelled to its controlling company or subsidiaries and the responsible managers have not received the funds personally, no crimes are committed. This is one reason why there are so many misappropriations but prosecutions are sporadic. Secondly, criminal intention of misappropriation is required to be proved for conviction, which is not easy to do. Similarly, criminal legislation against violations of securities law is also porous and clement. It is indeed a crime to provide IPO prospectus with falsified information or material information being concealed and to fabricate accounting records, but punishment is amazingly moderate with the maximum sentence being imprisonment for 5 and 3 years respectively.¹⁵⁸ Even these extraordinarily lenient provisions have virtually not been enforced and there are only a few incidences of prosecution to date. For violations of other disclosure requirements stipulated by securities law, they are not criminally punishable. As long as they do not intend to manipulate share prices, corrupt managers do not have to concern that they may spend

¹⁵⁶ The new Securities Law provides the CSRC such a right without seeking an order from the courts, but with conditions. See the NPCSC, Securities Law (2005), Article 180.

¹⁵⁷ Recently an officer from the CSRC was sentenced to 13 years in prison for taking bribes. See the report by *Shanghai Securities Daily* on 14th December 2005, available at http://www.cnstock.com/cjzg/hgjj/2005-12/14/content_951634.htm (in Chinese).

¹⁵⁸ See the NPCSC, Criminal Law (2005), Article 160 & 161.

some time in prison for violating those disclosure requirements, even if they deliberately make up information about the performance of their companies, let alone conceal information that is required to be disclosed. The most severe punishment for those violations is a 300 thousand Yuan regulatory fine against individuals.¹⁵⁹ In view of the lamentable state of legislation and enforcement against misrepresentation, it is not surprising to see that the tunnelling of funds out of listed companies is routinely covered up until the last minute.

As far as private lawsuits are concerned, the restrictions for private shareholders to bring both derivative and securities actions have been discussed above.¹⁶⁰ The new Company Law has clarified the confusion of the old law concerning derivative actions and provided shareholders the *locus standi* to sue on behalf of their companies. However, onerous conditions are imposed. First, only shareholders who individually or jointly hold more than one percent of the shares are qualified. Second, these shares should have been held for at least 180 days by those shareholders before an action can be taken. Thirdly, shareholders should first serve a demand on the supervisory board (if a suit is against managerial directors) or managerial board (if against supervisory directors). These conditions are both unreasonable,¹⁶¹ and unnecessarily restrictive. The arbitrary threshold requirement of shareholdings would virtually exclude individual shareholders from being able to bring derivative actions and only institutional shareholders would be qualified. As a result, there is no positive prospect that derivative actions would be actually brought up, according to the experience of Continental Europe.¹⁶² Considering that supervisory and managerial directors are in the main associates and both controlled by the majority shareholder, the demanding requirement makes no sense. It cannot be ruled out that supervisory and managerial directors may conspire to frustrate a lawsuit. Furthermore, the law says nothing about the issue of funding which is critical for derivative actions to be actually taken.

¹⁵⁹ See the NPCSC, Securities Law (2005), Article 193.

¹⁶⁰ See text on page 39 & 40

¹⁶¹ The 1% threshold is arbitrary. It is unreasonable that shareholders with shareholdings above the threshold are qualified but those under the threshold are not. Such a provision is discriminatory. As for the 180 days threshold, it is difficult to understand why such a condition should be in place. It means that a shareholder may not be able to take on an action immediately after he finds a violation. He should wait until the 180 days threshold is met.

¹⁶² See Kristoffel Grechenig & Michael Sekyra, 'No Derivative Shareholder Suits in Europe - A Model of Percentage Limits, Collusion and Residual Owners', Working Paper (September 2006), available at SSRN: <http://ssrn.com/abstract=933105>.

Without a proper rule of funding to address the disincentive inherent with derivative action on the part of minority shareholders, derivative actions would in all likelihood be illusory and not be actually brought.¹⁶³

The obstacles discussed above are only the superficial reasons. To answer the question why legal sanctions are infrequent and lenient, we should look beneath the surface. But a thorough examination of the issue is beyond the scope of this paper. Here only a brief observation can be made. One important reason that lies deeper is that the government lacks strong will and determination to strengthen legal sanctions against misappropriation and fraud occurring in listed companies. It is a common wisdom that the weak legal system in China is attributable to the nature of political system there and the absence of 'rule of law'. But we should admit that the control of conventional crimes in China is relatively satisfactory. In this respect, the governments might be said heavy-handed, and will and determination are not a problem. If the governments had the determination to battle misappropriation and fraud just as it attacks conventional crimes, the situation would be much better. Why do the governments not have the will and determination to tackle corporate and securities crimes? It has to be said that a misreading of the theories from the West that market mechanism are favourable over law made some contribution. Since the early 1990s when the Communist Party of China announced its intention to establish a 'socialist market' economy, the term 'market mechanisms' have become fashionable in China. Many government officials, including those from the CSRC, show a strong interest in 'market mechanisms'. Thus, when they talk about reform policy in public, phrases such as 'market competition' and 'market mechanisms' are heavily featured. Many academics are also obsessed with 'market mechanisms'. However, as far as corporate governance is concerned, they may have misread 'market mechanisms'. They may have overlooked the limitations of 'market mechanisms' and the crucial point that sufficient legal deterrence is the precondition for 'market mechanisms' to work. Because of this misguided learning, the urgent need to attack misappropriation and fraud through enhanced legal deterrence has not fully been recognized, and hence the lack of strong will and determination to do so.

¹⁶³ See Arad Reisberg, 'Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commence Litigation', *Journal of Corporate Law Studies* Vol. 4 Issue 2 (October 2004)

F. A Brief Comment on the Debate of Whether Law Matters in Corporate Governance

There has been a heated debate as to whether law matters in corporate governance since the seminal works of LLSV concerning the relationship between law and finance were published.¹⁶⁴ Their empirical studies demonstrate that noticeably the degree of ownership dispersion in publicly traded firms and the depth and breadth of capital markets in a country correlates positively with the protection afforded to shareholders by law. The implication is that law does matter in corporate governance. On the contrary, studies by some other academics show that law plays a limited role in the evolution of corporate ownership structure in a country. Here, other factors such as markets,¹⁶⁵ self-regulation¹⁶⁶ or politics¹⁶⁷ are suggested to be more important in determining the degree of corporate ownership dispersion and the growth of capital markets. Thus they conclude that law may not be as critical as is alleged in corporate governance.

LLSV largely did not take legal liability into consideration in their measurement of the protection afforded to shareholders by law. They compiled an 'anti-director' index containing six sub-indices as the measurement of the degree of shareholder protection in a country. These six sub-indices include shareholder rights that are not related to legal liability, such as voting through mail, cumulative voting, the minimum percentage of share capital to call an extraordinary shareholders' meeting, preemptive rights, and so on. These rights, whether shareholder voting rights or any of

¹⁶⁴ See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny (LLSV), 'Law and Finance', *Journal of Political Economy* (1998) Vol.106, No. 6; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Corporate Ownership Around the World', (1999) *Journal of Finance* Vol. 54, No. 2; LLSV, 'Legal Determinants of External Finance', *Journal of Finance* Vol. 52, no. 3 (1997): 1131-1150.

¹⁶⁵ Frank Easterbrook, 'International Corporate Differences: Markets or Law?' *Journal of Applied Corporate Finance*, Vol. 9, Issue 4 (Winter 1997), 23.

¹⁶⁶ Brian Cheffins, 'Does Law Matter?: The Separation of Ownership and Control in the United Kingdom', *The Journal of Legal Studies* 30 (2001), 459-84; Brian Cheffins, 'Law, Economics and the UK's System of Corporate Governance: Lessons from History', *Journal of Corporate Law Studies* 1 (2001), 71-89; John C. Coffee, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control', *Yale Law Journal* 111 (1) (2001), 1-80.

¹⁶⁷ Mark J. Roe, supra n 51; Mark J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact*, (Oxford University Press, 2003); Mark J. Roe, 'Corporate Law's Limits', 31 *The Journal of Legal Studies* 233 (2002); Lucian Arye Bebchuk & Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', 52 *Stanford Law Review* 127, 139-66 (1999).

others, are market-related but are not rights in connection with legal liability. As discussed above, however, legal liability is far more important than market competition and other market-based mechanisms in corporate governance. Thus it is doubtful that the ‘anti-director’ index can correctly reflect the degree of shareholder protection in a country. As a result, their argument that law matters based upon the ‘anti-director’ index they compiled is not convincing and the wide criticisms over their studies are thus understandable. While the general conclusion of this paper conforms to LLSV’s proposition that law matters in corporate governance, the importance of legal liability demonstrated by this paper nevertheless suggests that their studies should not be taken at face value.

The limitation of LLSV’s studies was not avoided by those who argued that law may matter less. Similarly, in developing their argument they largely did not take into account legal liability, especially criminal sanctions. For example, in reaching his conclusion, Professor Cheffins admitted a caveat that his study focused on corporate law and did not consider other types of legal regulation.¹⁶⁸ Because of the limitation that legal liability was neglected, the argument that law matters little should also not be taken too seriously. Furthermore, those who based their studies on the examination of history and argued that financial intermediaries and stock markets’ self-regulation may play an important role in the evolution of dispersed corporate ownership structure in the US and UK had only examined a period of history when dispersed ownership first emerged but not afterwards.¹⁶⁹ Dispersed corporate ownership structure may first come into existence in a country even where legal protection is weak. For example, dispersed ownership can be created by mass privatization, or manic stock markets may lead to the creation of many dispersed public companies, although the legal system is weak. However, it is unimaginable that dispersed ownership could last for long and public investors would not move away from the markets if the legal system remains weak. This has been proven by the experience of many transition economies where the method of mass privatization was employed.¹⁷⁰ On the contrary, although legal protection for shareholders may have been weak when dispersed companies first emerged in the US and UK, we should admit that both

¹⁶⁸ Brian Cheffins, ‘Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies’, working paper (August 2001), available at <http://ssrn.com/abstract=279350>.

¹⁶⁹ See Brian Cheffins, supra n 148; John C. Coffee, supra n 148.

¹⁷⁰ See supra note 148.

countries in the end had developed a relatively solid legal system with strong legal protection for investors. It is in this way that dispersed ownership survived. If a strong legal system had not been developed, it is doubtful that the corporate ownership structure and capital markets in the US and UK would be as it is at present. From this, we can see that the validity of the argument that law does not matter is further compromised.

If we understand that legal liability is fundamental, it is not difficult to reach a judgement as to whether law matters or not in corporate governance. On the other hand, when we accept that law matters, we should not take LLSV's studies literally. We should appreciate that investor protection is not just limited to the shareholders' rights contained in the 'anti-director' index compiled by them, and that legal liability is far more important than those rights.

G. Conclusion

To evaluate the Chinese government's policies and efforts to promote good corporate governance in China, this paper has gone some way to re-examine the working mechanics of market competition and market-based governance mechanisms to ensure good corporate governance. The essential finding is that to rein in serious managerial misbehaviour such as misappropriation and fraud is fundamental to good corporate governance and deterrence by way of legal liability is vital to achieving that end. Market competition and other market-based governance mechanisms are not effective to discourage this serious misbehaviour. Even their limited value to discipline managerial shirking is also based on a successful curb on this serious misbehaviour by legal deterrence. In this sense, effective legal deterrence is the foundation of corporate governance upon which the whole system stands.

Currently corporate governance in China is essentially in a state of lawlessness. Misappropriation is widespread and fraud is outrageous. This being so, the top priority is to establish 'law and order' in 'corporate China' and to strengthen legal sanctions is the only effective way to battle the excessive misappropriation and

flagrant fraud. Only once this has been done will the efforts to implement market-orientated reforms yield the envisaged results. The Chinese government should appreciate that the market efficacy and market primacy theses are based on the American experience, where misappropriation and fraud may no longer be excessive. While these theses may be plausible, and indeed desirable, for America or other developed countries, they are not for China, where a basic level of 'law and order' has yet to be established in corporate sector.

While the study of this paper focuses on corporate governance in China, the conclusion is similarly valid as with other transition and developing countries where legal deterrence is intrinsically weak. The fundamental difference in corporate governance between developed countries on the one hand and developing and transition countries on the other may lie in the distinctive degrees of success of bringing serious managerial misbehaviour under control. This highly significant contextual difference should not escape from our attention when we consider accepting theories and introducing corporate governance practice from the West. Otherwise, policies adopted to improve corporate governance would be misguided and efforts would be misapplied. If this happened to a country, the benevolent goal to catch up developed countries in the performance of corporate governance would never be achieved.