

Analysis of the Current Situation of the Development of Independent Directors in China - Taking the Bao Wan Dispute as an Example

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Abstract: Recently, the case of financial fraud by Kangmei Pharmaceuticals has triggered dramatic changes in independent directors of Chinese listed companies and set off a wave of departures of independent directors, thus causing us to think about the role of independent directors in the Bao Wan dispute in 2016. This article reviews the Bao-Wan dispute and analyses various aspects, including a comparison of the basic personal profiles of independent directors and the current development status of independent directors in China, to reveal the main existing problems of independent directors in China and put forward constructive suggestions. As an important part of corporate governance, independent directors should perform their duties independently and impartially, and effectively shoulder the obligation to supervise corporate governance.

1. Introduction

On 12 November 2021, the Guangzhou Intermediate People's Court handed down a first-instance verdict in the financial fraud case against Kangmei Pharmaceutical Co. It can be said that the independent directors of Kangmei Pharmaceuticals were subjected to the heaviest joint and several liability sentences in the history of the company, which also triggered a wave of resignations of independent directors before their term expired. It is no coincidence that the 11th meeting of the 17th session of the Board of Directors of Vanke held on 17 June 2016 was also the subject of in-depth discussions in various sectors of the community, concerning whether the resolution of the Board meeting was lawful and valid, whether the application for recusal by the independent directors was valid, how the votes should be counted, whether the independent directors were qualified to be elected in terms of "independence". Many issues have not yet been agreed upon, including whether the resolution of the Board meeting was legally valid, whether the application for recusal by the independent directors was valid, how the votes should be counted, whether the independent directors were qualified for election in terms of "independence", and whether the independent directors could continue to perform their duties normally in Vanke.

The mainstream of the domestic academic community believes that an independent director is a director who does not hold any position other than a director in the company and does not have any relationship with the listed company and its major shareholders that may prevent him/her from making an independent and objective judgment. [1] The independent director system refers to a system of establishing independent directors on the board of directors of a company to safeguard the rights and interests of shareholders and to protect the normal operation of the company. Independent directors often have a strong level of expertise, and they are responsible for listed companies and all shareholders. Since the introduction of the independent director system in China, a series of supporting documents have been issued to speed up the process of localization, but the controversy over the performance of independent directors has never ceased in academic circles and public opinion. One view is that independent directors have no say in the enterprise and are "vase directors"[2]; another view is that independent directors play a positive role in corporate governance [3].

This paper analyses and compares the Kangmei Pharmaceuticals incident with the "Bao Wan dispute", summarises the current situation of independent directors' supervision in China by analyzing the basic information and performance reports of independent directors of the two companies, reflects on the crux of the frequent failure of the independent director system, and explores the responsibilities and obligations of independent directors in performing their duties and future development after the wave of independent directors' resignations. It also explores the responsibilities and obligations of independent directors and the future development of the system after the resignation of independent directors.

2. Case Study

2.1. Review of the "Bao Wan dispute".

Founded in 1997, Kangmei Pharmaceutical Co., Ltd. was listed on the SSE in 2001. It is a national high-tech enterprise, mainly engaged in the production, operation, wholesale sales, and trading of Chinese herbal medicines and medical devices. It is a leading real estate company in China. Both companies can be said to be regional benchmark companies in their industries before the events related to the sole director.

In 2015, Qianhai Life, a subsidiary of Baoneng, and its concerted action partner, Jushenghua, bought a large number of Vanke shares on the secondary market through various financing means, leapfrogging China Resources to become its largest shareholder. On 17 June 2016, Vanke held a board meeting to vote on the issue of whether to introduce Shenzhen Metro to restructure the company through the issuance of additional shares. Once the vote is passed, Shenzhen Metro will become the largest shareholder of Vanke, and the shareholding ratio of the original shareholder's Bao Neng, China Resources, and Anbang will be diluted. According to Article 137 of Vanke's Articles of Association, "When formulating plans for major acquisitions, acquisition of the Company's shares, or mergers, demergers, dissolutions and changes in the Company's form; or deciding on matters such as the Company's foreign investments, acquisition, and sale of assets, pledging of assets, or entrustment of financial management, at least two-thirds of the directors of the Board of Directors shall vote in favor of such plans"[4]. 4], and there are 11 seats on the board of directors of Vanke, of which three are held by CRH. During the voting process, the matter was passed despite the opposition of all the CRRC directors, who held three seats on the board, due to the recusal of independent director Zhang Liping.

2.2. Comparative analysis of the basic situation of sole directors.

This paper obtains the annual reports and independent directors' performance reports of Kangmei Pharmaceutical and Vanke Group for 2016-2020 from the Juchao Information Website and quantifies the similarities and differences in the independent directors' system and performance of the two companies based on two aspects, namely the heterogeneity of independent directors themselves [5] and the performance of the group of independent directors, as extracted from existing studies.

2.2.1. Heterogeneity in the background of sole directors.

Both companies have both academic and practical independent directors, with a mix of audit and political affiliations, but with a clear gender bias and an age range of 50-60. The majority of Vanke's independent directors are residents of Hong Kong, China, and have served as independent directors in both domestic and international companies, with more experience as independent directors and higher social influence.

Table 1 Comparison of basic information on sole directors

Comet Pharmaceuticals			Vanke Group		
Name of sole director	Gender	Age	Name of sole director	Gender	Age
Lee Ting On	Male	77	Condé Nast	Male	74
Jiang Zhenping	Male	65	Wu Jianing	Male	62
Zhang Hong	Male	52	Zhang Yi Chen	Male	59
Chonghui Guo	Male	49	Wei Bin	Male	53
Zhang Ping	Male	47	Wang Shih	Male	71
Lai Xiaoping	Male	62	Yu Liang	Male	57
Xu Mu town	Male	64	Liu Shuwei	Female	70

Table 2 Comparison of academic, audit, political and professional backgrounds of sole directors

	Comet Pharmaceuticals	Vanke Group
Academic Background	Dingan Li: Professor	Kang Dian: Master
	Jiang Zhenping: Tertiary	Liu Shuwei: Professor
	Zhang Hong: Postdoctoral Fellow	Ng Ka Ning: Master
	Chonghui Guo: Ph.D.	Zhang Yichen: Bachelor
	Zhang Ping: Ph.D.	
	Lai Xiaoping: Ph.D.	
	Xu Mu Zhen: Bachelor	
Audit Background	Jiang Zhenping: Deputy Chief Accountant of Shantou Zhongrui Accounting Firm Co., Ltd.; accountant of the Nan'ao County Agricultural Machinery Bureau of Guangdong Province and the director of Puning Accounting Firm of Guangdong Province.	Katherine Ng: Joined KPMG in Hong Kong in 1984, a partner since 1996, then Vice-Chairman of KPMG China
Political affiliations	Li Ding'an: Member of the 8th CPPCC of Wuhan, Member of the 7th CPPCC of Hubei Province, Member of the 8th, 9th, and 10th Standing Committees of the CPPCC of Guangdong Province	Zhang Yichen: Member of the 11th, 12th, and 13th National Committee of the Chinese People's Political Consultative Conference
	Xu Muzhen: clerk in the Criminal Police Department of Puning County Public Security Bureau	
Part-time appointments	Li Dingan: Wuhan Liyuan Information Technology Company Limited (300184), Jiadu Xintai Technology Company Limited (600728), Shenzhen Zhongheng Huafa Company Limited (000020)	Kang Dian: Chairman of Xinhua Asset Management Co.
		Liu Shuwei: Independent Director of Zhuhai Gree Electric Appliance Company Limited, China Optical Group Company Limited, Shenzhen Zhaoyu Technology Co.
		Wu Jianing: independent director of China Petroleum & Chemical Corporation; Fandor Network Group Limited; China Metallurgical Corporation

2.2.2. The extent to which sole directors perform their duties.

According to Quan Yi et al.'s study, the exercise of functions by independent directors is measured by their annual in-person attendance at meetings, and the degree of commitment of independent directors to corporate affairs is reflected in the number of attendances considering the availability and timeliness of the data.^{6]} Taking Kangmei Pharmaceuticals as an example, the attendance of meetings by independent directors during 2016-2020 was summarised, from which the participation of independent directors in major corporate affairs was initially judged. In particular, the more independent directors attended in person, indicating a better possible performance of their duties.

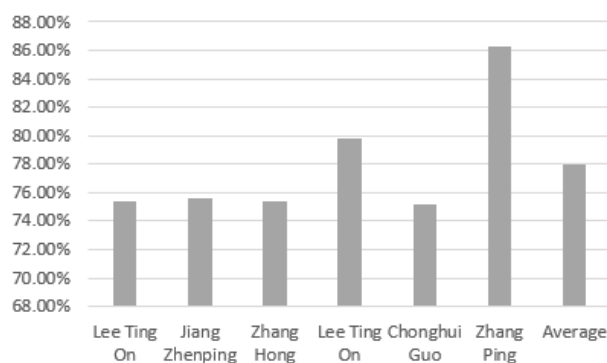


Figure 1. Proportion of Comerica's sole directors attending by correspondence, 2016-2020

Table 3. Summary of Board performance

Year	Name of Director	Participation in the Board of Directors				Participation in General Meetings
		Number of board meetings to be attended during the year	Number of personal appearances	Number of participants by correspondence	Proportion	Number of general meetings attended
2016	Lee Ting On	12	12	8	66.67%	2
	Jiang Zhenping	12	12	8	66.67%	2
	Zhang Hong	12	12	8	66.67%	2
2017	Lee Ting On	13	13	11	84.62%	2
	Jiang Zhenping	13	13	11	84.62%	2
	Zhang Hong	13	13	11	84.62%	2
2018	Lee Ting On	4	4	3	75.00%	2
	Jiang Zhenping	14	14	10	71.43%	2
	Zhang Hong	4	4	3	75.00%	2
	Chonghui Guo	10	10	7	70.00%	1

	Zhang Ping	10	10	7	70.00%	1
2019	Jiang Zhenping	9	1	8	88.89%	1
	Chonghui Guo	9	1	8	88.89%	0
	Zhang Ping	9	1	8	88.89%	1
2020	Jiang Zhenping	15	5	10	66.67%	5
	Chonghui Guo	15	5	10	66.67%	4
	Lai Xiaoping	1	1	0	0.00%	0
	Zhang Ping	4	0	4	100.00%	1
	Xu Mu town	5	2	3	60.00%	4

2.2.3. Analysis of the effectiveness of independent directors in performing their duties.

Firstly, from the overall performance of Vanke's independent directors, it can be seen that the independent directors made decisions that were beneficial to the development of the company in this incident for the benefit of both shareholders and the company, and a large extent improved the company's decision-making level. At the same time, from Watson's public statements and disclosures, this article believes that he did not favor either the management or the major shareholders, but provided favorable opinions for both the company's management and the relevant shareholders with his independence, and actively performed his supervisory and advisory function as an independent director. Of course, Vanke's independent directors can be called an excellent example of independent directors' practice in Shenzhen, although there are still many flaws. Vanke's independent directors are recommended by the management and major shareholders, and this selection process is extremely flawed. In addition, the boundaries of independent directorship are also blurred, subjective and emotional, especially when the independent directors themselves are socially influential and have closely intertwined interests with the company's management.

3. Status quo and major issues in the development of independent directors in China

3.1. Current situation of independent directors in China

Since the development of the independent director system, even though there have been incidents of financial fraud caused by the inaction of sole directors, such as Kangmei Pharmaceutical and the Bao Wan dispute, it has to a certain extent given proper supervision to listed companies and helped them to develop better. Over the past two decades, with the increase in the number of listed companies, the number of independent directors in China has grown and the number of independent directors employed by domestic A-share listed companies has reached 13,517.

The current trend is for independent directors in China to be small in proportion, highly specialized and highly educated. As of December 31, 2020, about 80% of the board of directors had only three independent directors. Some banks or state-owned modeling enterprises with larger operations have five or more independent directors, which is a slightly higher percentage. At the same time, the currently listed companies pay more attention to the selection of independent directors in terms of their professional ability, and the selection of independent directors in recent years has mostly focused on experts with financial, legal, and various related industries. In terms of the educational composition of independent directors, with the increase in per capita education, China's independent directors are

highly educated, with 77.96% of independent directors holding a doctorate or master's degree by the end of 2020.

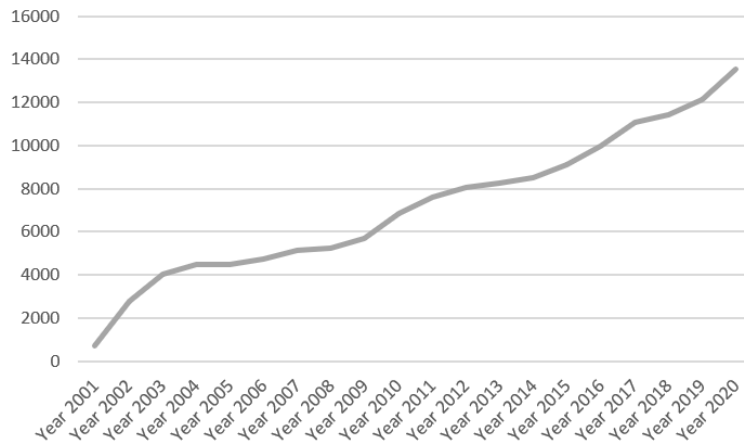


Figure 2 Trend in the number of independent directors (times) serving in listed companies in China, 2001-2020

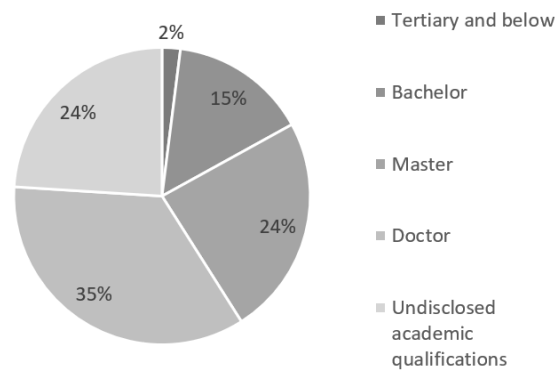


Figure 3 Educational composition of independent directors of listed companies in China in 2020

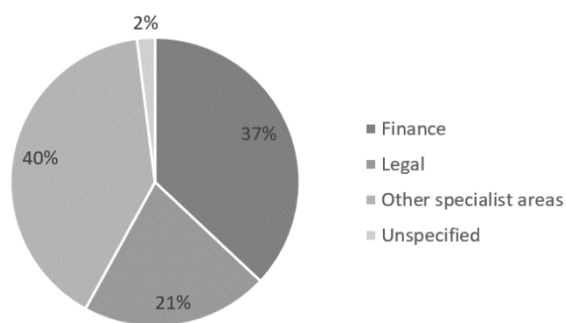


Figure 4 Professional composition of independent directors of listed companies in China in 2020

The independent director system first originated in the United States in the 1930s when the SEC proposed the idea of establishing "non-employee directors". The law stipulates that the number of independent directors must account for more than 40% of the board of directors and that an audit committee composed entirely of outside directors must be established. In contrast, the localization of independent directors in China is not yet complete and needs to be further improved.

3.2. Existing major problems of independent directors

3.2.1. Insufficient independence.

Independence is an important prerequisite for independent directors to carry out their work effectively. At present, the performance of the duties of independent directors in China is mostly

superficial, and it is difficult to have a practical impact on corporate governance. In China's listed companies, there are many instances where independent directors remain silent and do not raise objections when they know that there are problems in the company's operation and the major shareholder's decisions are unreasonable (Yao Yan, 2021). The main reason for this is that there are major problems with the composition of independent directors, the nomination mechanism, and the payout system. Although many companies currently have independent director positions, the number of independent directors is relatively small and their opinions cannot have a significant impact on the company's decision-making. Most independent directors are appointed by the majority shareholder, which means that the majority shareholder has substantial control over the retention of independent directors and the setting of their remuneration. As a result, independent directors are unable to play their role independently based on factors such as voice and human interest. At the same time, most of the independent directors in China are paid by way of fixed allowances, which are paid directly by the companies they work for. As a result, independent directors tend to side with the major shareholders and management and forgo expressing their views to reduce the risk of leaving the company. The examples of the recent disputes between Kangmei Pharmaceutical and Bao Wan have also made us realize that currently independent directors tend to adopt a non-opposition attitude when faced with inappropriate corporate decisions.

3.2.2. Low willingness of independent directors to perform on their own.

In 2001, the China Securities Regulatory Commission issued the "Guidance on the Establishment of Independent Director System in Listed Companies", which stated that the board of directors of listed companies should include at least two independent directors or at least 1/3 of independent directors. At present, the setting of independent directors in China only meets the minimum restrictions of laws and regulations, which also makes independent directors in a disadvantaged position of enterprises and do not have the right to speak. In addition, independent directors, as external governors, are not involved in the day-to-day operations of the company and are unable to obtain and analyze relevant information promptly. Most independent directors have a wealth of expertise, but they are unable to make accurate and appropriate judgments about the business situation based on their little understanding of the company's daily operations and the little time and energy they devote to them (Lu, 2018). And most listed companies will prevent or delay independent directors from accessing true inside information. The unequal access to information prevents independent directors from effectively monitoring the company's operations. In addition, another key reason for the lack of willingness of independent directors to perform is the inadequate protection mechanism of their rights and interests. Independent directors' opinions may lead to a reduction in their salary or even dismissal, which has a significant impact on their interests.

3.2.3. Inadequate restraint mechanisms.

At present, the number of laws and regulations relating to independent directors in China is relatively small. The Company Law of China only provides indicative documents on the existence of the independent director system and has not yet clarified the specific requirements for the establishment of independent directors in listed companies. Neither the national government nor the company level has clearly defined the duties of independent directors, and the disciplinary mechanism is less than perfect. Before the Kangmei Pharmaceuticals incident, independent directors were mostly not required to take greater responsibility for operational problems that arose in the company. There were few mandatory constraints on independent directors, and they were mainly self-regulatory and self-aware. At the same time, due to the limitations of the nomination system and the selection of independent directors, there were often problems of nepotism and lack of professionalism of independent directors. When selecting independent directors, listed companies may directly select directors who are familiar with major shareholders and management, without conducting a complete investigation into their actual abilities. Independent directors with a lower level of competence themselves often find it difficult to perform their supervisory responsibilities over the company, while those with a higher level of professionalism may choose to devote less energy to the company's existing

problems based on a series of reasons, such as human relations, and refrain from offering opinions that are contrary to the major shareholders' decisions. Thus, in the current state of China's market, the independent director system has not yet reached its establishment intention and is not effective in safeguarding the interests of the company and its investors, and needs to be further improved.

4. Responses and recommendations

4.1. Emphasis on the system of appointment and training of independent directors.

Listed companies should actively improve the appointment and selection system of independent directors and strengthen the relevant training work for independent directors after their appointment. Change the current industry practice of selecting independent directors based on external criteria such as reputation, change the current independent director selection mechanism, improve the pool of independent directors and broaden the scope of choice of independent directors for the management and shareholders of listed companies. Establish an independent directors association to provide comprehensive management of independent directors in the current market and provide advice on the selection of independent directors from a third-party perspective to help companies select more appropriate and suitable independent directors. At the same time, the ability of independent directors to serve will be tested and evaluated regularly, and training will be provided to strengthen the ability of independent directors in all aspects promptly so that they can more effectively monitor the current state of affairs of listed companies.

4.2. Improving the accountability system and laws and regulations relating to independent directors.

The current boiling over of Kangmei Pharmaceuticals' independent directors has triggered a large number of resignations of independent directors. The reason for this is that the system related to independent directors in China is unclear and imperfect, and government and social supervision are weak. To improve the current situation of independent directors in China, we should strengthen the punishment and accountability of directors who fail to effectively perform their duties. The current situation should be improved through both governmental and legal compulsory requirements and social market self-regulation, to establish a market environment in which independent directors perform their respective duties and are dutifully supervised by listed companies. We can also set up a third-party independent director monitoring committee to evaluate and test the performance of independent directors' duties from a completely objective perspective and to propose adjustments when appropriate. At the same time, government regulations and social supervision will further promote the self-restraint of independent directors, which in turn will better enhance the effectiveness of independent directors' performance.

4.3. Improving access to information and strengthening mechanisms for safeguarding rights and interests.

At present, independent directors in China are not given more rights but are expected to have a greater role, and there is a serious discrepancy between responsibilities and powers. Efforts should be made to increase the rights of independent directors in listed companies and to increase the proportion of their staff in the board of directors to increase their voice. Improve the system of protecting the rights and interests of independent directors and reduce the risk of performance of independent directors so that they are willing to speak out and dare to do so. In addition, broadening the access of independent directors to the company can also effectively increase the motivation of independent directors to perform their duties and reduce the risk of financial fraud by major shareholders and management. In terms of the specific setup of the independent director system, the willingness of independent directors to perform their duties will be increased, and their degree of influence on corporate decision-making will be increased, assist companies to make more accurate decisions and safeguard the interests of small and medium-sized shareholders and investors.

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