

# The Fundamental of Corporate Governance Is Entrepreneur's Logic Instead of Agent's Will

—Based on Case Study of Shanghai Jahwa

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## Abstract

Restructuring of state-owned enterprises (SOEs) introduces diversified investment to change the situation in which state-owned shares play a dominant role. However, this process is full of complexity. The key of restructuring is to follow the fundamental logic of corporate governance, that is, to give full play of entrepreneurship instead of the agent's will. This case analyzes the gain and loss of Shanghai Jahwa (hereinafter referred to as Jahwa) and finds out that the agent's will plays a leading role in corporate governance, making the development of Jahwa deviate from the entrepreneur's logic and resulting in much uncertainty of the future development. This case enlightens us that the key to judging the rightness of the direction of restructuring of SOEs is to see if the restructured corporate follows the entrepreneur's logic.

## Keywords

Corporate Governance, Restructure of State-Owned Enterprise (SOE), Agent's Will, Entrepreneur's Logic

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## 1. Introduction

The reform of the state-owned enterprises has been the key in the reform of China's economic system since the reform and opening up. Under the backdrop of economic globalization, analyzing and summarizing the experience and lessons of the SOE's reform and mastering the fundamentals of corporate governance in the SOE's reform will help enhance the international competitiveness of China's SOEs. As a leading company in the daily-use cosmetics industry, the entrepreneurs and agents of Shanghai Jahwa have conflicts in its restructuring

process. This essay conducts a case study of this conflict and analyzes the gains and losses of its reform from the perspective of corporate governance. Meanwhile, it offers a way for the restructuring of the SOEs in China.

## 2. Theory

The enterprise's management right and ownership are highly unified at the beginning of its development. The capital owner uses his or her own asset as the "stake" for self-management and self-sufficiency financially. The competition among enterprises is the competition among entrepreneurs and complete market competition for this business model [1]. The entrepreneur has the absolute ownership of the enterprise. The entrepreneurship is constrained to the minimum level and the entrepreneurs conform to self-discipline in market competitions. Entrepreneurs are self-disciplined under the condition of market competitions [2]. In short, the market tests and differentiates the entrepreneurs who lead the enterprise to capture the market share. The logic of the development of an enterprise, industry or even the whole market is the entrepreneur's logic.

These two rights separate when the enterprise develops to a certain degree. As the agent, the professional manager has the right to control the operation of the enterprise. Due to the self-interest motivation and information asymmetry, it can hardly avoid the actions such as "moral risk" and "adverse selection" which damage the interest of the asset owners [3]. The key to balancing the conflicts and confrontations between capital ownership and operational control for corporate governance is to design an internal management system with supervision and motivation functions and to cultivate and select managers with entrepreneurship. Certainly, the effectiveness of corporate governance is influenced by the national external environment. For example, America has an improved manager's market and a sound legal system, which constrains the self-interest actions of the managers to some extent and safeguards the effective corporate governance.

In China, a large majority of enterprises which grow up through restructuring are SOEs. Compared with the private company and foreign-owned company, the major characteristic of China's SOEs is the lack of the capital owner. Capital ownership is used by State-owned Assets Supervision and Administration Commission (SASAC) on behalf of the country. In fact, SASAC is the agent instead of the capital owner and it does not have enough time, information and motivation to supervise the enterprises and select excellent managers for the enterprises so its capital ownership entrusted by the government becomes a kind of "cheap voting right" in real sense [4]. Under the backdrop of China's administrative management system, managers of SOEs are appointed by SASAC. In fact, these seemingly selected managers are usually bureaucratic. Agent's will is usually embodied in the administrative appointment process. The agent usually favors those who obey the orders. However, those with entrepreneurship are usually more innovative and adventurous. Therefore, the managers appointed are not entrepreneurs but the officials representing the will of SASAC and having a close relationship with SASAC. Unfortunately, the low efficiency of the majority of SOEs is the result of the managers' lack of entrepreneurship in this administrative appointment system [2].

The majority of the SOEs in China have the low operational efficiency because of these reasons and only a small number of SOEs have developed with specialty and by chance to some degree. Some SOEs which face bankruptcy due to the mismanagement at the beginning stage become the burden impeding the economic development for the local government. For example, the continual financial loss of Haier Group and Hongta Group results in the serious depreciation of state-owned assets. Other enterprises with small-scale national investment such as Lenovo Group with only 200,000 yuan of national investment, because of small scale and low value, are always neglected without government's attention. These two kinds of enterprises enable those with entrepreneurship stand out due to less government control and slack government policy. They have the remaining control of the enterprise to the largest extent and become the internal ones referred to by the economists [5]. "Internal control" structure motivates the entrepreneurs who have great dreams and ambitions and improves the company's situation in risks to promote its development. Therefore, the development process of these enterprises conforms to the entrepreneur's logic instead of the agent's will.

The above enterprises will be restructured in a large scale under the governance of the enterprise logic after they develop to a certain stage. In the restructuring process, the government pursues for diversification of asset rights blindly without conforming to the entrepreneur's logic due to different reasons and introduces in new investors and agents continuously to baffle the enterprise's development because of violating the entrepreneur's logic. The founder of Jianlibao Group, Jingwei Li made the cooperative plan of employees sharing the stocks of the Group. The management team raised 450 million yuan to purchase the government's stock. However, the government of Sanshui city insisted on transferring the 75% of the stock equaling 338 million yuan to Hai

Zhang. Unexpectedly, Hai Zhang who carelessly operated the business pocketed all the money of Jianlibao Group without his own investment. In the critical moment of restructuring process of Foshan Electrical and Lighting Co., Ltd., Xincai Zhong, the founder wished to use Management Buy-Out (MBO) plan to increase control over the company by the entrepreneurs' team. However, SASAC of Foshan city insisted on transferring the stock to two foreign-owned companies called OSRAM and SITECO, resulting in the conflict between big shareholders and entrepreneurs and great sufferings for the enterprise's development. The failures of the restructuring of the enterprises lie in the violation against the entrepreneur's logic. On the contrary, the success of restructuring of GREE Group is in that it conforms to the entrepreneur's logic. Mingzhu Dong, whom the entrepreneur Jianghong Zhu thought highly of, instead of Shaoqiang Zhou, appointed by SASAC took over as the president. Therefore, only the enterprises in accordance with the entrepreneur logic can enjoy sustainable development no matter whether it is the private one or SOE.

As a pioneer of restructuring of SOEs in Shanghai, the restructuring process of Shanghai Jahwa involves the conflict between the agent's will and the entrepreneurship. This case demonstrates the importance of conforming to the entrepreneur's logic in corporate governance by analyzing the gains and losses during the restructuring process of Jahwa and meanwhile provides an alternative for the restructuring of SOEs in China.

### 3. Case Study

#### 3.1. Brief Introduction to Shanghai Jahwa

Shanghai Jahwa (stock code: 600315) was founded in 1898 and covers a business scope of developing and producing cosmetics and daily chemical products, etc. Listed in Shanghai Stock Exchange in 2001, Jahwa is the first listed company in cosmetics industry in China and one of the few local companies which can compete with the multinational companies in an all-round way. The company finished the equity division reform in July, 2006 and became the only large stakeholder of the joint stock company. Meanwhile, Shanghai Jahwa Group is the wholly-owned subsidiary of Shanghai Guosheng Group authorized by SASAC in the jurisdiction of SASAC of Shanghai. On Nov 15, 2011, Shanghai Pingpu Investment accepted 100% stock of Jahwa held by SASAC of Shanghai. The real controller of the company changed from SASAC of Shanghai to Ping An Insurance (Group) Company.

#### 3.2. Analysis of the Restructuring Process of Shanghai Jahwa

In order to adapt to the development of the market economic system, Jahwa launched the reform of SASAC in 2011. Shanghai SASAC still implemented the policy of "Deregulation" and transferred the right of reform to the entrepreneur Wenyao Ge. At that time, the offer of Hainan Airline Group was 700 million yuan higher than Ping An Trust but Ping An Trust finally succeeded because it promised publicly that it would not change the incumbent members of board of directors or senior managers of Jahwa and would put an additional investment of 7 billion yuan for expanding Jahwa's fashion industry, supporting Wenyao Ge's business strategy. More importantly, Mingzhe Ma, leader of Ping An, sincerely supporting Wenyao Ge to "make a big plan". Gang Chen, leader of the investment management department, had much interest in Wenyao Ge's plan to acquire Tianjin Haiou and supported his strategy to extend the fashion industry. Fortunately, Wenyao Ge planned to build a dream of a fashion empire with reform as well as the global vision and capital of Ping An. The decision logic is totally the entrepreneur's logic. In this process, the entrepreneurs choose partners and find the strategic investors.

However, the cracks between Ping An and Wenyao Ge occurred within less than one year after the honeymoon. At first, the acquisition plan of Tianjin Haiou made by Wenyao Ge was opposed by Ping An. Acquiring Haiou watches to complete the "Dream Team" of national brands was Wenyao Ge's dream. Gang Chen, the leader of the investment management department once admitted he would assist this acquisition. However, he was sent away from Shanghai because he was sidelined in March 2012. The managers of Ping An thought that investing in Haiou watches was entering another field which may have certain risks without benefits to the current main business. They refused this acquisition in November this year. The agent's will of Jahwa can be seen by this point. Wenyao Ge, founder of Jahwa cannot succeed over the agent.

The management teams between Ping An and Jahwa had the divergence in investment after the conflict of Haiou watch acquisition, which caused insecurity for Ping An psychologically. Therefore, entering the board of directors and board of supervisors to have the voice was an inevitable choice. In March 2012, Yijiang Zhu was

elected as leader of board of supervisors of Shanghai Jahwa. In December of the same year, Kai Tong of Ping An Trust became the first member of the board of directors representing Ping An. As the first large stakeholder, it was understandable that Ping An had a seat in the board of director. However, for the management team, the original ecological system was broken [6]. The fast offensive tactics of Ping An relied on capital power and embodied the agent's will.

Under the forced control of management will of Ping An, Wenyao Ge committed to career was forced to resign and succeeded by Chun Zhang, the independent director, in September 2013. With the continuous occupation of Jahwa's board of directors by Ping An, the will of the agent was increasingly exposed. They believed in their own control and the management ability of pushing forward the rapid development of Jahwa. Promoting the professionalization of management and modernization, the future high-speed development of Jahwa had great possibilities. Wenyao Ge represented a backward system and the wishes, concept and actions mode were incompatible with modern professional managers. Therefore, reform was inevitable. As expected, soon after resignation of Wenyao Ge, the board of director forced away Zhuo Wang, the successor of Wenyao Ge, in May 2013.

After Wenyao Ge left Jahwa, Ping An Trust needed to elect a new chairman of the director for Shanghai Jahwa. The one was neither from the management team of Jahwa nor from Ping An. Instead, he was the professional manager, Wenjian Xie, working in Johnson & Johnson Medical. Although we are not sure whether Wenjian Xie has the entrepreneurship or quality and has the ability to promote the sustainable development of Jahwa, we have two points for sure. First, forcing away the founder Wenyao Ge with ability and willingness to work does not conform to the entrepreneur's logic and is totally the agent's will. Second, compared with Wenjian Xie, Zhuo Wang was working in Jahwa from an early time and had a 24-year long close cooperation relationship with Wenyao Ge so Zhuo Wang was qualified with the entrepreneurship also seen in Wenyao Ge. Selecting Zhuo Wang to take over Jahwa was carrying forward entrepreneurship in accordance with the entrepreneur's logic.

Zhuo Wang did not leave after the board of directors of Jahwa dismissed him from the general manager by "internal control was issued with negative advice". He submitted Application for Labor Dispute Arbitration to the arbitration committee on 4 June 2014 and requested for arbitration to resume the labor relationship with Jahwa. After labor dispute arbitration and lawsuit lasting about one and a half years, Zhuo Wang came back to Jahwa on 25 September 2015 but only held the empty post of "researcher of Chinese culture application".

## 4. Conclusion and Enlightenment

### 4.1. Conclusion

The reform of SOE will definitely face the problem of separation of the two rights in the framework of the modern enterprise system. Obeying the governance logic of giving play to entrepreneurship is the key to decide the success of restructuring of the SOE. The corporate governance of Shanghai Jahwa in its restructuring process is not in accordance with the entrepreneur's logic but the will of the agents to a large extent. Therefore, the future development of Jahwa will face great uncertainties.

### 4.2. Enlightenment

Peter F. Drucker, master of management once pointed out "The enterprise can only develop in accordance with the entrepreneur's logic. The development of the enterprise is limited by the thinking space of the operators". Therefore, the enterprise belongs to the entrepreneur who is the axis of the development of the enterprise bearing all the burdens of business activities of the enterprise [7]. The development of the enterprise should conform to the entrepreneur's logic in order to achieve sustainable development no matter whether it is in the development stage of the enterprise or in the restructuring process and whether it is private company or SOE. The most important criterion to evaluate the success of SOE is to see if it is in accordance with the entrepreneur's logic.

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