

Implications of the Huge Compensation Case of Kangmei Pharmaceutical Co., Ltd on the Responsibility of Independent Directors

Ziyi Peng

Business School, Hunan Normal University, Changsha, Hunan 410011, China

ziyi2019@hunnu.edu.cn

Abstract

The judgment of first instance for the Kangmei Pharmaceutical Co., Ltd case has for the first time found joint and several liability for independent directors who failed to discharge their duty of diligence, which strengthened the accountability of independent directors and drew the attention of all walks of life. This paper explores the problems in the process of independent directors' performance of their supervisory functions from three perspectives: the selection and appointment system, the communication system and the incentive system. This paper also believes that against the background of "one single-large shareholder", elected independent directors are unable to safeguard their independence and access to sufficient information to effectively fulfill their supervisory duty. At the same time, the immaturity of China's reputation mechanism has prevented the reputation incentive system from working effectively, and the independent directors lack sufficient incentive to participate in corporate governance.

Keywords

Independent Directors; Fulfill Duty; Kangmei Pharmaceutical Co., Ltd; Financial Fraud.

1. Introduction

The purpose of establishing an independent director system in China is to allow independent directors to supervise the operation of the company in accordance with the law, improve the ability of corporate governance and promote the maximization of corporate interests. The foundation of independent directors is their status as "outsiders", free from the "internal control" of the company interest groups and management layer, and their independent supervision of the company's business activities.

Since March 2020, China's new *Securities Law* has been formally implemented, which marks the formal establishment of the shareholder litigation system in China and improves the Investor protection mechanisms in listed companies. On 12 November 2021, the judgment of first instance for the Kangmei Pharmaceutical Co., Ltd case has found joint and several liability for independent directors who failed to discharge their duty of diligence, and their compensation amounting to hundreds of millions of dollars. This case was the first practice of the new *Securities Law*, so to a certain extent, it also reflected the improvement of the accountability system of criminal liability and civil recoveries for independent directors, which has attracted the attention of all sectors of society.

2. Analysis of the Reasons for the Restricted Performance of Independent Directors of Kangmei

(1) Lack of independence of independent directors

Table 1. Top 10 shareholder's holding ratio of Kangmei 2016-2018

Shareholder	2018	2017	2016
Kangmei Industrial Investment Holding Co., Ltd.	31.91%	32.98%	31.27%
Minmetals International Trust Co., Ltd.	4.66%	4.66%	4.64%
Shenzhen Qianhai Chongming Wanfang Equity Investment Co., Ltd	3.29%	3.97%	3.31%
China Securities Finance Co., Ltd.	2.99%	3.29%	1.92%
Changzhou Yanze Yong Hui Investment Centre	2.69%	3.28%	1.58%
Tianjin Kumpeng Sunac Enterprise Management Consulting Co., Ltd.	1.97%	1.97%	1.98%
Xu Dongjin	1.97%	1.97%	1.93%
Puning Jinxin Pawnshop	1.87%	1.87%	1.88%
Puning Guojin Information Consulting Service Co., Ltd.	1.87%	1.87%	1.88%
Chen Shuxiong	1.59%	1.68%	1.41%
Total	54.81%	57.54%	51.80%

According to Table 1 Top 10 shareholder holding ratio of Kangmei 2016-2018, "one single-large shareholder" and "insider control" has developed within Kangmei Co., Ltd, where right of supervision and right of check and balance are not effective. The largest shareholder of Kangmei Co., Ltd has always been Kangmei Industrial Investment Holdings Co., Ltd (the de facto controller is Ma Xingtian), whose shareholding has always been above 30%. Meanwhile, Ma Xingtian's wife Xu Dongjin is the seventh largest shareholder, holding approximately 2% of the shares of the company. The shareholding of the couple is over 30%, much higher than other investment institutions and shareholders, so they have absolute control and say over Kangmei Co., Ltd. In this case, it is difficult for small and medium shareholders to interfere with the decisions of the Board of Directors and to protect their rights and interests.

At the same time, Ma Xingtian was the Chairman and General Manager of Kangmei Co., Ltd, and his wife Xu Dongjin was the Vice Chairman and Deputy General Manager of Finance Department, creating a situation of "insider control". Therefore, the serious deficiencies in corporate governance provided opportunities for Ma Xingtian and his wife to commit financial fraud and seek private selfish gain, seriously undermining the rights and interests of other shareholders.

Table 2. Shareholding ratio of Ma Xingtian and his wife

Name	Shareholding ratio of 2018	Shareholding ratio of 2017	Shareholding ratio of 2016	Position
Ma Xingtian	35.38%	35.45%	33.73%	Chairman, General Manager
Xu Dongjin	1.97%	1.97%	1.93%	Vice Chairman and Deputy General Manager
Total	37.35%	37.42%	35.66%	

According to the "Guidance on the Establishment of an Independent Director System in Listed Companies", the board of directors, the supervisory committee and shareholders who individually or collectively hold more than 1% of the issued shares of a listed company may nominate candidates for independent directors and have them elected at a general meeting of shareholders. In a situation where "one single-large shareholder", according to Table 2, Ma Xingtian couple have absolute control and the ability to influence the nomination of independent directors. They are very likely to elect independent directors who can help earn private selfish interests, while small and medium shareholders are unable to take effective

measures to restrict their actions. Under these conditions, independent directors lose their “independence” from the moment they are elected. Therefore, in the case of anomalies in financial index, the independent directors, who have extensive management experience and excellent professional knowledge of accounting, have never objected at the fourteen board meetings. Moreover, in October 2018, the media publicly questioned the falsification of Kangmei Co., Ltd, claiming that the falsification methods were easily identifiable and that financial professionals could easily spot the anomalies. Therefore, there is every reason to suspect that the “independence” of the independent directors of Kangmei Co., Ltd has been compromised, and that they have not played their role in monitoring the quality of accounting information.

(2) Independent directors are incompetent

During the trial of the Kangmei Pharmaceutical Co., Ltd case, its independent directors argued that “as independent directors, we carefully reviewed the company’s reports during the performance of my duties and independently formed and clearly expressed our opinions based on our individual expertise. Although failing to identify and discover the falsity in the annual report involved in the Kangmei Co., Ltd case in an objective level, they have exercised their duty of diligence and the duty of prudent attention to the reasonable concerns of investors in listed companies.” It is clear from the defence that several independent directors of Kangmei Co., Ltd tacitly agreed that their due diligence requirement was to review the company’s reports, and they did not consider that other concerns of day-to-day operational information were also extremely important. In particular, under the conditions of deceptive information in the company’s report, independent directors who merely based on the consideration of the written report, the simple enquiries, and who normally did not pay continuous, adequate and proper attention to the process of occurrence of the relevant matters in the report, and the existence of risks. Under this condition, the inferences and conclusions drawn in the absence of information are bound to deviate from the facts, which is one of the important reasons why the independent directors of Kangmei Pharmaceutical Co., Ltd did not detect financial fraud. The requirement for independent directors to do, on the other hand, should be to give reasonable attention to the day-to-day matters of the business, not just to show up at the general meetings of shareholders to simply vote and sign off. The appearance of this phenomenon to a large extent is because the system of independent directors of listed companies in China lacking a systematic and effective incentive mechanism. Whether it is the exercise of rights or the fulfilment of obligations, the inadequacy and single form of incentive leads to a lack of sufficient motivation for independent directors, who thus choose to abstain from exercising their rights in most cases.

(3) Independent director-related incentive mechanism is defective

Nowadays, independent directors are mainly motivated by salary incentive mechanism and reputation incentive mechanism. As there is a conflict between the salary mechanism and the “independence” of independent directors, and as independent directors may get a high salary that undermines their independence. Therefore, reputation incentive mechanism may become an important incentive for independent directors to perform their duties. Reputation incentives, as non-profit incentives, not only permit the independence of independent directors, but also provide effective constraints on the performance of independent directors. Reputation incentives allow independent directors to receive offers from other companies beyond their current term of office and to earn new income on an ongoing basis. They can also assist independent directors in obtaining more social resources, study opportunities and motivate independent directors to perform their duties. Conversely, if independent directors fail to do their jobs, the loss of reputation will make them falling into a passive position in the labour market and make it difficult for them to secure employment with other companies. The loss of wealth gained by independent directors from the loss of additional directorships is much

greater than the directors' remuneration currently given for the seat. All of these reveal that reputation incentives act as a stronger incentive and constraint on the behaviors of independent directors than salary incentives. As a result, in a good reputation market, independent board of directors actively perform their duties in order to avoid damage to reputation capital that could affect their pricing in the labour market. The current immature environment of China's reputation mechanism, the failure to truly establish a professional market for independent directors and the imperfect penalties for malpractice of independent directors prevent the reputation incentive system from playing its proper role effectively. Furthermore, the motivation of independent directors is not effectively enhanced or constrained.

3. Conclusion and Suggestions

This paper has found that the huge compensation case of Kangmei Pharmaceutical Co., Ltd has revealed problems with the system of independent directors. Firstly, there are some cases of "one single-large shareholder" and "insider control" in the companies, and the current selection system weakens the independence of independent directors and deprives them of the prerequisite to play their supervisory role. Second, independent directors are generally multi-tasking and lack time and energy to pay attention to daily operations, so they are unable to effectively supervise the whole company. Finally, the imperfection of the reputation incentive system makes independent directors lack incentives and constraints, so most of them choose not to act.

Therefore, this paper recommends that scientific selection and appointment procedures should be standardized to restrict the emergence of situations where major shareholders have complete control over the selection and appointment of independent directors and to enhance the position and influence of small and medium shareholders in decision-making. The controlling shareholders and the directors and senior executives sent by it should not be a candidate, so that the majority of small and medium shareholders can participate in the selection who will have full influence and decision-making power. Secondly, the reputation incentive mechanism for independent directors should be improved to enhance the motivation of independent directors. It should also ensure that independent directors devote sufficient energy and time to pay full attention to the daily operation of the company and to detect any abnormalities in the operation of the company in a timely manner. Finally, it is important to strengthen the discipline of independent directors, increase the cost of dereliction of duty and accurately record the behaviors of independent directors in the company's credit file. In the event of illegal benefit or serious misconduct, independent directors will leave themselves with a poor reputation record that will affect their subsequent careers.

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