

ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

▶ **Making sense of
thought leadership**

by Mignon van Halderen and Kym Kettler-Paddock

▶ **Soft information matters
in SME lending**

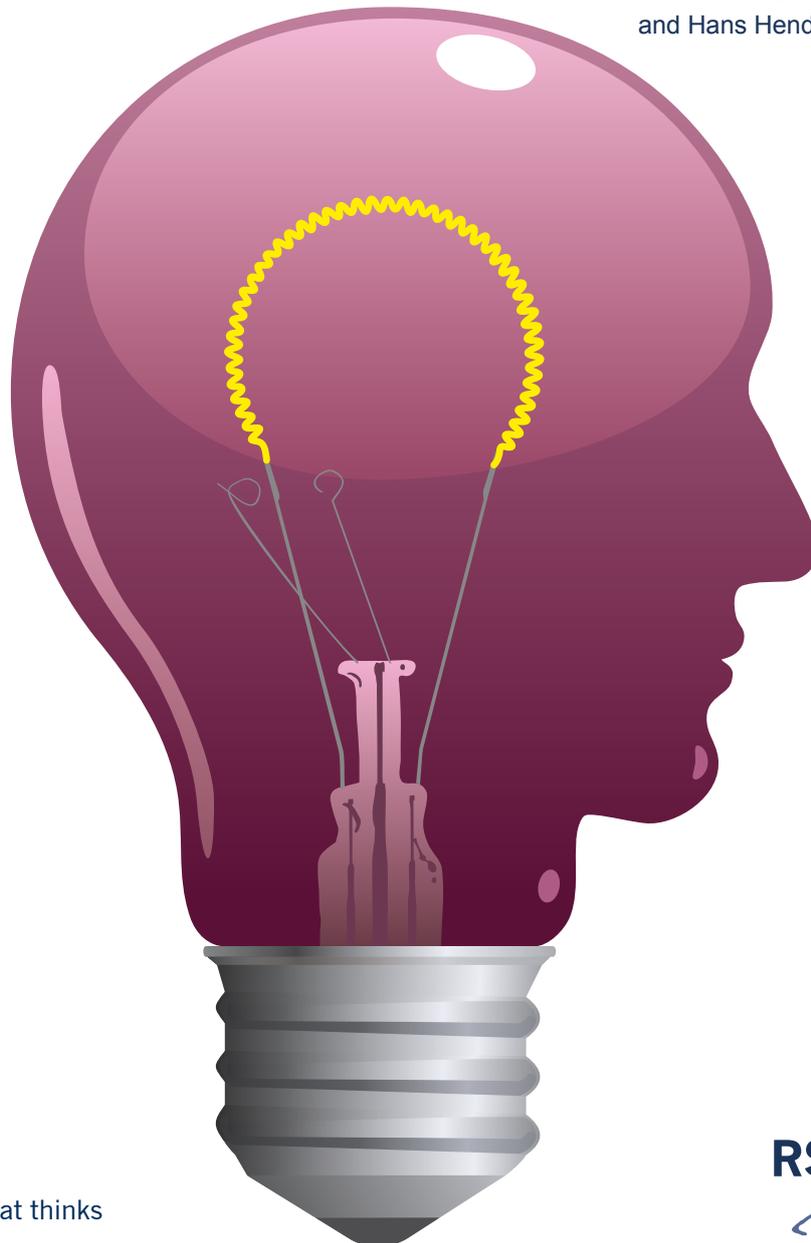
by Jens Grunert and Lars Norden

▶ **Identity management key
to successful mergers**

by Steffen Giessner

▶ **Chinese insolvency
law lacks teeth**

by Barbara Krug, Nathan Betancourt
and Hans Hendrischke



The business school that thinks
and lives in the future

Introduction



As a business school, RSM leads the way in educating managers on the key issues and challenges that organisations must face if they are to be leaders, not just within their own fields, but on the global stage. As an academic centre, RSM is very much at the cutting edge of management science and here too, with its interdisciplinary approach and world class faculty, it leads the way in creating new knowledge and ideas through research that is developed with practical, real-world application in mind.

It is through consistently providing innovative and inspired management solutions that RSM can claim its position as a thought leader in the interconnected worlds of business and management research. We are rightly proud of our abilities and achievements and to help us spread the word, *RSM Insight* serves as a platform from which this expertise can be shared.

Typically, the very nature of thought leadership and its value to organisations is explored in this sixth issue. Also featured is valuable research into: the factors influencing lending to small and medium sized enterprises; the critical importance of identity management in corporate mergers and acquisitions, and why China's insolvency laws, heralded as 'state of the art', are in reality toothless.

I am sure that you will find these articles both informative and enlightening.

Henk W. Volberda

Professor of Strategic Management and Business Policy
Director of Knowledge Transfer

Rotterdam School of Management, Erasmus University
Email: hvolberda@rsm.nl **Tel:** +31 (0)10 408 2761

Contents

Page 04 ▶ Making sense of thought leadership
by Mignon van Halderen and Kym Kettler-Paddock

Page 07 ▶ Identity management key to successful mergers
by Steffen Giessner

Page 10 ▶ Soft information matters in SME lending
by Jens Grunert and Lars Norden

Page 12 ▶ Chinese insolvency law lacks teeth
by Barbara Krug, Nathan Betancourt and Hans Hendrichske

Making sense of thought leadership

by Mignon van Halderen and Kym Kettler-Paddock

Many corporations feel that they should be developing a thought leadership strategy. However, when asked what thought leadership actually means or entails, most managers immediately falter in providing an explanation. So, what is thought leadership, why is it important, and how can companies pursue it?

To understand the origins and relevance of thought leadership, it is first essential to recognise that tremendous changes have affected business and society in recent years. Whilst globalisation spurs business, it has at the same time made it increasingly competitive. Through the ubiquity of technology, and other factors, business is also much more knowledge driven. One consequence is that stakeholders desire to know more about the companies with which they interact. Across society there have been significant shifts in priorities. Many of the major issues affecting society today – climate change, water management, renewable energy, aging, health and well-being, for example – have gained great ground in their importance. Now, rather than merely acknowledging that these concerns exist

in general terms, society places greater emphasis on determining the ways in which they can be tackled.

This presents companies with the opportunity to proactively step in to the discussions about these issues and position themselves as organisations that not only care, but as ones that may have innovative perspectives and ideas that can contribute or help push forward the debate.

It is by tapping into societal trends – and being perceived as having taken up the gauntlet to address society’s concerns – that thought leaders can emerge. By developing novel points of view (NPOVs) that catch not only the attention of society, but which break with or challenge conventional thinking, companies are able to create a platform from which they can differentiate themselves from competitors and be seen by stakeholders as intellectual leaders in the fight against society’s worries.

It is from this perspective that we propose a definition of thought leadership as: *the action of introducing*

and promoting convention-breaking ideas that cause people to change how they think about marketplace or societal issues.

Companies as diverse as Philips, Apple, IBM and General Electric all pursue thought leadership strategies. Unilever’s personal care brand Dove is frequently cited as having implemented a successful thought leadership strategy.

In 2003, Unilever’s Global Brand Team for Dove was charged with reinvigorating the fifty-year old brand. They commissioned research on the perception of beauty in ten countries and received some startling results indicating that low self-esteem was rife among women. Only 2 per cent of women described themselves as beautiful and only 12 per cent were satisfied with their physical attractiveness. Women also indicated that they felt pressured by the beauty industry to do something about their appearance.

The Dove Brand Team used this research to create a NPOV for the convention-breaking ‘Real Beauty Campaign’, which included the use of average-looking women instead of professional models to promote their products. Unilever used their NPOV of the definition of beauty to give them social relevance. Dove became an authority – a thought leader – on



the social issue of beauty and our preconceptions of it.

In positioning themselves as thought leaders within their sector, Dove moved beyond standard marketing and branding techniques. They developed platforms that their target audience could get involved with – Mother and Daughter days, for example, and the Dove Self-Esteem Fund, the purpose of which, according to their website, is “to help free the next generation from self-limiting beauty stereotypes.”

Philips also serves as a good example of a company with a thought leadership vision based on the breaking down of conventional societal thinking. It wants, by 2015, to become global leader and trusted voice around the issues of aging and city living. To do so, Philips seeks to challenge the accepted notion of aging as a sedate process concerned with infirmity, and by changing society’s conception of cities as being largely unsafe and unhealthy.

Here it is worth pointing out that one can only be a leader of anything if people are prepared to be followers. This is also true of thought leadership and companies need to encourage thought followers among stakeholders. Thought followership can be defined as: *those members of a thought leading corporation’s targeted stakeholders*

who have changed, to a greater or lesser degree, the way they think about a market or societal issue as a result of the convention-breaking idea to which they have been exposed.

Creating thought leadership

Thought leadership is comprised of two pillars. The first is novelty (the NPOV), and the second is trust. Without trust stakeholders will not endorse the NPOV. Nor will they perceive the organisation as being the preferred partner to work or associate with.

Tied in to the two pillars is a four-step process. The first step is to articulate a novel point of view. This doesn’t have to be an amazingly earth-shattering one. Sometimes it is enough to be the first to bring an idea or perspective to the attention of stakeholders and to propel societal discussion about it. The important factor here is that the NPOV needs to be something that changes the way we think or perceive the subject matter.

Thought leadership is not necessarily articulated explicitly. Apple, for example, is seen as a thought leader, yet they do not express their ideas vocally. Apple’s iTunes stands as a very good example of this. How we use and think about buying and playing music is completely different today when compared to a decade ago.

A critical question often asked is whether thought leadership is nothing more than radical innovation dressed up. There is, however, a huge difference. Innovation is the process by which an idea or invention is translated into a product or service that the markets will pay for. Thought leadership, on the other hand, is about a company leveraging a specific vision, connecting it to societal issues, and becoming the trusted voice in the market and the owner of a NPOV.

The second step is made through sharing the expertise and information the company has accumulated around the NPOV. As noted earlier, it is important for thought leaders to build trust-based relationships with stakeholders. One way for companies to do so is by openly sharing information about their novel point of view. The open sharing of information can show that the organisation has the best interests and welfare of its stakeholders at heart, and this perception can create or enhance trust.

Creating strong interactive networks with stakeholders is the third step. Thought leaders not only share information with their stakeholders, they also seek to create a dense community or network with them. The deeper organisations can become embedded in these social networks, the more central they are to those with

Making sense of thought leadership (continued)

by Mignon van Halderen and Kym Kettler-Paddock

influence in the sphere of their NPOV.

Additionally, thought leaders continually need information from the market in order to maintain their position as the trusted advisor. As well as offering a means to be aligned with stakeholders who share the company's vision, the reciprocal sharing of information is an excellent way to develop trust and enhance reputation.

The fourth step requires the company to act in line with the desired positioning. In some respects, this is the most obvious as well as the most important step. Organisations cannot create a thought leadership position based on hollow principles, ideas or visions. A strong sense of strategic alignment is essential so that all elements of the organisation are committed to and entirely supportive of the NPOV.

demonstrate to stakeholders that it is truly acting in line with its NPOV, the greater the likelihood that they will trust the thought leader.

Before looking to develop a thought leadership position, companies need to assess whether there is potential within it to do so. In making this assessment there are three questions, which we identify as decision drivers, that managers must address.

1. To what extent does the company see dynamic forces within society that have the potential to reshape or change the lives of its stakeholders?
2. Does the company have a unique vision relative to societal concerns or the dynamic market forces that affect it?
3. To what extent does the organisation have the ability to demonstrate its intellectual capacity?

companies to commit to a long-term strategy. A company cannot become a thought leader in just a year or two. Rather, it requires a leap of faith and a deep commitment over a period of many years.

When looking to develop a thought leadership position, companies must fully comprehend that as a commitment it is akin to picking up and bearing a flaming torch. As such it needs to be held aloft at all times so that its carrier clearly illuminates the way for the benefit of all. ■

Mignon van Halderen is Assistant Professor of Corporate Communication, Department of Business Society Management, Rotterdam School of Management, Erasmus University.
Email: mhalderen@rsm.nl

Kym Kettler-Paddock is a graduate of RSM's International Executive Master of Science in Corporate Communication and in 2010 wrote her thesis on thought leadership. She works with Mignon van Halderen in further developing the concept of thought leadership and advising corporate communication managers in pursuing it.
Email: Kym.Kettler@tiscali.nl

“A company cannot become a thought leader in just a year or two.”

Indeed, companies should actively elucidate around the NPOV upon which they wish to be seen as thought leader. Such efforts encourage stakeholders and others to perceive the organisation as having achieved the position it seeks to attain. Our findings indicate that the more the thought leader can

Thought leadership is not appropriate for every company as not every company has the type of product, service or operation that will allow it to connect to a societal issue from which a novel or thought leadership position can be developed. A determining factor is that thought leadership requires



Identity management key to successful mergers

by Steffen Giessner

Alienated employees who feel a loss of identity could place financial and strategic objectives of a merger at risk through lack of drive, reduced performance, and even sabotage. Identifying and managing these issues from the start could therefore be critical to the success of such undertakings.



Mergers and acquisitions (M&As) can bring about extreme and drastic changes. This can, in turn, create a sense of uncertainty and insecurity with some employees in the smaller of the two companies involved. This largely affects employees at the grassroots who typically have concerns about their job security, career and work situation. Will they be laid-off? What are their career prospects? Will they continue to work with their current colleagues and report to the same line manager? Will they be assigned other duties? And will their job description change?

Based on a theoretical and practical framework of identity management during M&As, this article describes the research we have undertaken in determining the crucial role social identity and the human element play in M&As, the obstacles they can raise, and effective ways of controlling or eliminating them. In particular, we describe how underlying employee motives and organisational changes can create tensions and conflicts between organisations involved in an M&A, and their employees. Furthermore, we look at how managing identification continuity in an appropriate fashion, addressing fairness perceptions, and good leadership can all enhance social identification in the newly formed company.

We would like to point out that, although there are legal and other differences between the terms acquisitions and mergers, they are not relevant in the context of our research and this article. We will therefore use both terms interchangeably.

The question of identity

Corporate mergers have received a bad press and are largely held in a negative light by lower-level employees affected (unlike their line managers who see potential career advancement in them). In fact, just a hint in the media of a possible merger can create anxiety among personnel.

That is why mergers require proper human resource management to ensure they reach their financial and strategic objectives, and minimise negative consequences for employee well being. Understanding the history behind employees' identification with the merged organisation during the corporate merger is crucial, because stronger post-merger identification results in less conflict and higher levels of motivation.

Unfortunately, employees often identify more strongly with their previous company than with the merged one. One effective way to understand the processes that underlie organisational identification is through the social identity approach. Applying it to organisational mergers shows that levels of identification with the merged organisation are partly explained by status and dominance differences of the organisations involved, through motivational threats and uncertainties during the merger, and by the representation of the post-merger identity. ▶

Identity management key to successful mergers (continued)

by Steffen Giessner

But what is identity? As humans, the starting point to understanding the world around us is to understand ourselves, and the way we understand ourselves is through the context of our surroundings. In many ways, we see ourselves as individuals with our own defining personality and characteristics: this is our personal identity. But being social animals, we also see ourselves as belonging to different social groups and identifying with their norms and characteristics. For example, Dutch football spectators watching their national team play Germany suddenly find themselves looking at German fans as opponents: spectators on both sides lose their personal identity during the match and take on a national one.

Now, considering we spend eight hours a day at work (the rest of the day is divided into eight hours of sleep and eight hours of personal time), it is not surprising that work and our working environment – the people and the company – determine an important part of who we are and what we identify with (our organisational identity). Importantly, the longer we spend in this environment, the more we become attached to it and the more emotionally involved with it.

Our research has shown that loss or reduction of social identity lies at the core of these problems. Misunderstanding and miscommunication can result

as anxious employees (unwittingly) misinterpret or distort the truth. For example, they may overlook or downplay negative aspects of their current department. If employees feel that they may lose their job, they may protest openly, or silently by underperforming. Others may even sabotage the merger project in anyway they see fit just to demonstrate their fear, anger or disappointment.

Not surprisingly, three out of four mergers result in financial failure. This has less to do with bad financial advice and strategy, and more to do with the human element. Merger managers would therefore be wise to anticipate these problems and prepare for them.

Aim at integration

Good identity management is the obvious answer and the operative word here is permeability. In the context of this article, permeability refers to the ability of a company or personnel to integrate or be integrated into another organisation. It usually applies to a smaller, acquired company being integrated into a larger acquiring one.

Merger managers need to first determine how these identities work, and why they are threatened. Our findings also underscore open, balanced, honest and rapid communication as being the most effective tool in resolving such merger issues. Displaying total

openness and honesty from the start in explaining possible organisational changes – however disruptive they are to the current work situation – but also prospects for career advancement.

Crucially, this communication process should be well structured. All employees should be informed as soon as possible of such changes – a new company name, for example, the restructuring of their department or a reassignment of duties and responsibilities. For employees not likely to experience an identity crisis caused by these changes, the communication process should then focus on identity continuity. In contrast, for employees who will experience a discontinuity of identity, communication efforts should subsequently focus on explaining the underlying motives of the merger in order to increase a perception of necessity for this undertaking.

Such a structured and strategic communication approach increases the perception of permeability among personnel from the acquired firm because it creates a favourable climate for them to evaluate the new organisation and their role in it (increased permeability). Of course, there may be subsequent lay-offs, but at least these employees feel that they stand an honest chance and are therefore prepared to give the merger their best efforts.



The most critical period of insecurity and uncertainty is shortly after a merger has been announced, but before employees can be told of the real implications of the merger. Considering that negotiations have not started at this point, such problematic issues cannot be addressed or resolved. This means that merger managers will have to find ways to deflect or alleviate insecurity and uncertainty issues in the meantime because these require an explanation. In this scenario, if merger managers are not forthcoming with one, concerned employees will devise or find their own.

One thing to bear in mind is that managing the human side of a merger involves both individual and organisational identities, and strengthening one will not necessarily boost the other. For example, offering individuals a bonus may not necessarily reduce or eliminate the threat to their organisational identity. We also discovered in our research that employees, who sense a continuity of their pre-merger identity in the post-merger organisation (in other words, their identity has not changed), will adapt to and accept the merger more easily.

However, there is an added complication. There is always a stronger and a weaker party in a merger (any so-called merger of equals is a misnomer and does not exist), usually

the acquiring and acquired company respectively. Employees of the stronger company are less accepting of equal conditions for all because they feel they are better than their smaller rival, and therefore more deserving of better terms and career prospects. They are therefore threatened by any attempts at integration.

The challenge is to navigate between the two organisations without upsetting either one, focusing all the time on a unified organisational identity that reflects the new company's mission and vision, and which all employees will adopt eventually.

Our experience also shows that upper management is often in an excellent position to influence and convince, especially in establishing a new organisational identity or reinforcing the pre-merger one. Take the case of the merger between two London hospitals. Realising the importance of getting the physicians – the most influential group – on his side, the CEO of the acquiring hospital made the effort to speak personally to every physician at the acquired hospital, explaining the merger and its benefits and consequences in detail. This gesture was not only effective in convincing and reassuring the physicians of the value, appreciation and respect placed in them by the acquiring hospital, it also gave them

a feeling of belonging and a new organisation identity.

The process goes on

Having detailed the issues raised by identity and the deployment of identity management to dispel or contain them, it is important to point out that identity management does not end once the contract is signed and the merger takes effect. According to new research, the human-related action plan in a merger is in fact an ongoing process. In analysing the effects of a merger, it has been discovered that different things matter at different points in time, which is why it is important to continue to manage and monitor this psychological process.

In the first months after the merger, for example, identity continuity is critical, but six months or a year later, the issue of fairness (for instance, were the merger procedures and the distribution of resources fair?) takes precedence. This means that a merger manager's work is not done as long as there are related outstanding issues to be dealt with. ■

Steffen Giessner is Associate Professor, Department of Organisation and Personnel Management, Rotterdam School of Management, Erasmus University.
Email: sguessner@rsm.nl

Soft information matters in SME lending

by Jens Grunert & Lars Norden

Loan data from small and medium-sized enterprises (SMEs) has shown that such positive attributes as good management skills and character – so-called ‘soft’ facts – can improve a borrower’s bargaining power with their bank and thus loan terms.

Small and medium-sized enterprises (SMEs) in the United States of America and many European countries are limited in the ways they can finance their operations. While larger enterprises have access to capital markets for their funding, SMEs have to rely heavily on banks for their borrowing needs. This is because SMEs, unlike their larger counterparts, are not covered by the large credit rating agencies and do not have to publish quarterly or annual financial statements. And with few or no ‘hard’ facts available, SMEs are viewed by banks as being informationally opaque and difficult to evaluate financially. Consequently, these financial institutions have to resort to *qualitative* information (‘soft’ facts) about an SME and its manager or owner to assess creditworthiness.

Through our recent research, we have sought to determine if there is a relationship between the quality of the available information (mainly ‘soft’ facts) banks have on their SME borrowers and the resulting bargaining power of these borrowers. Our research

was based on a representative sample of SME loan data from both the USA and Germany.

Credit information

Let us first define what we mean by ‘hard’ and ‘soft’ information or facts in the context of bank relationships. Hard information refers to the usual quantitative details found in financial statements, such as sales, profit, cash flows and leverage. Soft information, as the term suggests, is more qualitative and refers to such intangibles as management skills, company strategy and market share. It also includes the credibility and reliability of the company director or owner. It has been known in banking circles for a very long time that the character of a borrower plays an important role in deciding on a loan.

It is not only a question of whether borrowers are able to repay a loan; it is whether they feel duty-bound to do so. In fact, the American banker’s handbook goes as far as to say that “there is no substitute for character - it is a vital factor”.

Another important soft fact has to do with continuity and governance, especially important in privately owned family businesses, which SMEs tend to be. What happens, for example, if the current manager or owner dies? Is there an established line of succession in place to ensure business continuity and good governance?

While hard and soft information is important in assessing the creditworthiness of all firms, soft information is particularly important for SMEs, due to the absence or unreliability of hard facts, and the reason why banks place significantly more weight on it. Crucially, a good assessment based on soft information means that borrowers could get a better deal on their loan.

As part of our study we analysed SMEs in the United States and Germany with the *same* credit rating to see whether some of them had better bargaining power. Bargaining power is determined by examining loan contracts in a particular credit-rating category for the interest rate charged and the collateral pledged, and then comparing them against the average interest rate and average collateral requirement respectively within that category. Firms that managed to negotiate a below-average interest rate and a below-average collateral requirement have bargaining power

in our investigation. We then look to see if these two measures of bargaining power are related to a good hard- and soft-facts assessment. We are able to extract this information from the banks' credit-rating assessment details.

Bargaining power

Our results are quite revealing and have consequences for entrepreneurs, SMEs and banks. We find evidence to support the hypothesis that bargaining power is directly related to good soft facts. What is more, we can show

in this capability. We also find that entrepreneurs with a good educational background tend to have more sophisticated communication skills, and are consequently more proficient at negotiating with their banks and in using their soft facts to their advantage.

Our study also has implications for banks. Considering bargaining power and soft information relate to the strength of the bank–borrower relationship, loan officer turnover is recommended as an effective device to maintain incentives inside the bank

“The character of a borrower plays an important role in deciding on a loan.”

that soft information has not only first-order effects on the credit rating of the borrowing firms, but also second-order effects on borrower bargaining power. This of course is excellent news for entrepreneurs and SMEs. After all, with the exception of the credit offered by their suppliers, SMEs rely mainly on banks for external funding and this can reduce their loan costs significantly.

However, SMEs have to ensure that banks are fully aware of this soft information; something savvy managers with good communicating and negotiating skills are capable of doing. This may require SMEs to invest

and to avoid collusion between loan officers and borrowers. Furthermore, since the evaluation of soft information depends, among other factors, on the loan officer's experience with the borrower, it could be reasonable to assume that new loan officers tend to make an 'average assessment' in order to trade-off the risk assessment and lending volume. Consequently, loan officer rotation helps to avoid a systematic drift towards increasing borrower bargaining power over time, arising either from gradually increasing accuracy of the loan officer's assessment, or from collusion.



A related implication is that loan officers might have to personally bear the negative consequences arising from high borrower bargaining power. If they were paid according to the contracted loan rate margins, however, lower spreads would reduce their variable compensation. Finally, there is the question of bank competition. For example, the number and structure of bank relationships as well as switching costs of borrowers might relate to the interaction between bargaining power and soft information in banking.

To summarise the key findings, our study suggests that soft information represents an important and direct determinant of borrower bargaining power, with strong implications for banks and SMEs in the way they operate in the loan contracting process. ■

Jens Grunert is Assistant Professor, Department of Banking and Finance, University of Tuebingen, Germany. E-mail: jens.grunert@uni-tuebingen.de

Lars Norden is Associate Professor of Finance, Department of Finance, Rotterdam School of Management, Erasmus University. Email: lnorden@rsm.nl

Chinese insolvency law lacks teeth

By Barbara Krug, Nathan Betancourt & Hans Hendrischke

The speed by which China has moved towards a market economy has not been accompanied by a similar development of its judiciary system. Since the early 1990s, foundational national legislation with a direct effect on firms, such as laws dealing with contract, investment, liability and insolvency have been introduced, sometimes reluctantly.

This recent legislation should have established court-rulings as a legitimate alternative form of dispute resolution to the often arbitrary bureaucratic intervention inherited from the socialist past. Yet this switch-over from administrative interference to court rulings did not materialise and firms question the usefulness of taking business disputes to court.

Complaints regarding the court system are corroborated by empirical studies. One survey of 89 arbitral awards enforcements cases in 2001 found that only 47 per cent of rulings issued in disputes involving foreign firms have been enforced (as opposed to 53 per cent for Chinese firms). In addition, enforcement remains weak: on average, only 30 per cent of the stipulated compensation payment was actually secured. Since arbitration is usually regarded as superior to more formal dispute resolution venues, such as courts, it cannot come as a surprise that the law appears underused and is considered toothless.

China's recent Insolvency Law serves as a prime example. After 12 years of legislative wrangling the 2006 PRC Enterprise Bankruptcy Law (EBL) is viewed by the Chinese press and by international law firms as 'state of the art' since it follows the UNCITRAL (United Nation Commission on International Trade Law) 'Model Law on Cross Border Insolvency'.

The EBL replaced a patchwork of insolvency legislation that had existed since 1986. Three changes in the EBL were intended to bring Chinese insolvency practices closer to international standards. First, the new EBL gives priority to restructuring over liquidation. Second, an administrator is put in charge of the daily operation of the firms during the insolvency procedure. The administrator, who needs to be a qualified lawyer or have proven corresponding competence, is authorised to design a restructuring plan and coordinate the different claims of creditors. Third, the new EBL revised a remnant from the socialist past

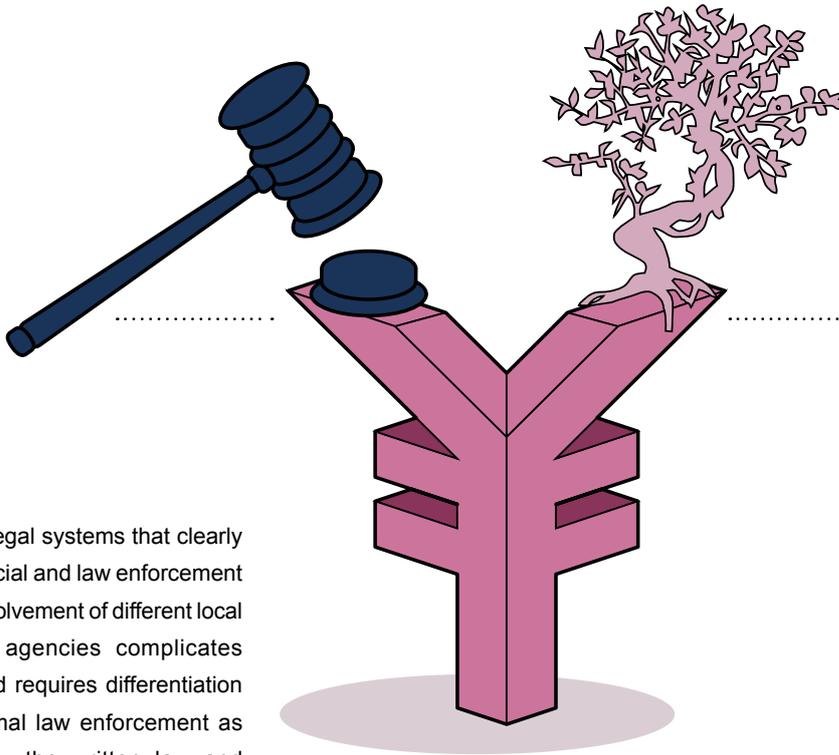
that had given primacy to the claims of employees. Under the new law secured claims are prioritised ahead of employees' claims and non-secured claims are in last position.

And yet just three years after the introduction of the EBL, the general uptake is discouraging:

- The use of litigation in insolvency cases in the Chinese legal system has declined. Instead, courts often stipulate out-of-court settlement.
- Out of court settlement – taking the form of mediation at the local community level – is regarded as a superior forum for dispute settlement. Local communities even pride themselves as being 'zero litigation' districts.
- By transferring cases to administrative rulings, or 'grassroots mediation', the law no longer functions as an external coordination/enforcement agency but rather succumbs to intra-administrative informal negotiations. In the end, dispute settlement rarely depends on formal rules and procedures.

The role of local government agencies

One factor that helps to explain the under-usage of the law is the peculiar role of local government in the insolvency process, something



unknown in legal systems that clearly separate judicial and law enforcement agencies. Involvement of different local government agencies complicates decisions and requires differentiation between formal law enforcement as suggested by the written law and informal practices that characterise the handling of specific cases often through arbitration.

As in conventional legal systems, the advantage of arbitration lies in the perceived fairness and the speed by which a settlement can be reached. In reality, however, informal procedures and reliance on uncodified practices by various actors tend to make outcomes unpredictable.

Legal design flaws

Another set of factors explaining the under-usage of the EBL derives from the design of the written law, which sets incentives for parties to seek out-of-court settlements. The first problem is *ambiguity*. In particular, the creation of a bifurcated insolvency system for State-owned Enterprises (SOEs) and non-SOEs between 1986 and 2006 generated massive confusion over the employment of the legal process. The state responded to this

complicated situation with a series of legal clarifications and amendments, which, in fact, added to the confusion.

To clear up this confusion, the new EBL equally applies to SOEs and enterprises of any other ownership form, including joint venture and private enterprises. However, the EBL makes exceptions for firms in certain strategic industries identified by the State Council, such as chemical and pharmaceutical industry or mining.

The second problem is *verifiability*. The usage of courts depends crucially on the verifiability of claims; otherwise courts will dismiss the case. In China, the problems of verifiability take two forms. The first is the identification of the plaintiff and defendant. The second relates to the identification of creditors and debtors.

For example, in the late 1980s, local government agencies forced local banks to convert their non-performing

loans into shares. The effect was that banks were no longer creditors but became owners of bankrupt firms. Studies also reveal the difficulties of distinguishing the following items on a firm's balance sheet: cash management by banks and bank loans; the buying of shares or private credit in family run businesses where family members or friends can be either silent partners, and offer informal loans.

Similarly, cross share-holding and unrecorded bank loans by private investors make the identification of claimants in a bankruptcy case difficult and time-consuming.

As the law differentiates in procedures for plaintiffs (who are often creditors) and defendants (who are often debtors) when pursuing insolvency, the murky situation of ownership, loopholes in corporate law, and poor auditing procedures do not allow for easy calculation of the balance sheet or for the determination of a party's rights under the law. Litigation is often used simply as a mechanism to verify claims. For example, creditors and the firm in question may use formal court procedures to establish the net debt position of the firm and withdraw the case from the court as soon as they have received an official statement about the net assets.

The problem of verifying claimants and the value of their claims or the net

Chinese insolvency law lacks teeth (continued)

By Barbara Krug, Nathan Betancourt & Hans Hendrischke

debt position of a firm is connected with the missing ranking scheme for claims stipulating which debts will be served first. One peculiarity of the EBL is that before the net debt position of a firm is calculated, all housing estates

pressure to privately settle the case prior to any court order create a kind of unravelling effect. As has been shown in other sectors, this contributes to the 'thinness' of the market, i.e. to an insufficient number of parties making

and theoretically ease court mediation processes when compared to the old laws. However, legal practice is more complicated as it involves additional actors and justice is typically served through extrajudicial conciliation.

“One factor that helps to explain the under-usage of the law is the peculiar role of local government in the insolvency process.”

owned by the firm are set aside and transferred to the local government agency in charge of the 'resettlement' of the retrenched workforce.

Unsurprisingly, the value of land and the allocation of decision making rights, over the distribution of returns from land sales or from the disposal of other industrial assets, often unleashes a 'race for assets' between competing courts and local government agencies rushing to execute confiscation orders, even before court orders are issued. This asset scrapping can lead to a situation where firms that otherwise would have had a chance to restructure are left without the means to serve their debts.

There is also evidence that the courts know enforcement lacks power due to 'out of court' settlements. Both the confiscation of assets and the

full use of the EBL, which leaves those parties that insist on using the EBL with fewer courts and weaker enforcement agencies at their disposal than is required for market clearing.

In short, courts cannot offer safe participation as there are coordination failures in the proceedings that force all parties concerned to wait for court orders and court mediated ranking of debts and claims. Instead, outcomes are inconsistent and locally determined. Local government agencies use their discretionary power to manipulate procedures in favour of firms under their jurisdiction even if they are not immediate players in insolvency cases.

Foreign companies therefore need to beware that the written law in China is not the only indicator of judicial practice. On paper, the EBL may conform to international standards

and theoretically ease court mediation processes when compared to the old laws. However, legal practice is more complicated as it involves additional actors and justice is typically served through extrajudicial conciliation. To reach the best possible outcome, it is necessary for parties to take into account both the formal legal process and extra-judicial practices, and forms of enforcement. To outsiders, legal action through the court system by itself is likely to be unpredictable and to hinge more on local economic and political interests than on straightforward adherence to the letter of the law. ■

Barbara Krug is Professor of Economics of Governance, Department of Organisation and Personnel Management, Rotterdam School of Management, Erasmus University. Email: bkrug@rsm.nl

Nathan Betancourt is a PhD Candidate, Department of Organisation and Personnel Management, Rotterdam School of Management, Erasmus University. Email: nbetancourt@rsm.nl

Hans Hendrischke is Professor of Political Economy and Director of the Confucius Institute, University of Sydney. Email: hans.hendrischke@sydney.edu.au



RSM Insight – live links to authors and departments

Mignon van Halderen

Assistant Professor of Corporate Communication

▶ Email: mhalderen@rsm.nl

▶ Personal home page

▶ Department of Business Society Management

Steffen Giessner

Associate Professor of Finance

▶ Email: sguessner@rsm.nl

▶ Personal homepage

▶ Department of Organisation and Personnel Management

Lars Norden

Associate Professor of Finance

▶ Email: lnorden@rsm.nl

▶ Personal home page

▶ Department of Finance

Barbara Krug

Professor of Economics of Governance

▶ Email: bkrug@rsm.nl

▶ Personal home page

▶ Department of Organisation and Personnel Management

Nathan Betancourt

PhD candidate

▶ Email: nbetancourt@rsm.nl

▶ Personal home page

▶ Department of Organisation and Personnel Management

RSM INSIGHT

2nd Quarter 2011

RSM Insight is published by
Rotterdam School of Management,
Erasmus University

DIRECTOR – KNOWLEDGE TRANSFER

Prof. Henk W. Volberda

MARKETING DIRECTOR

Willem Koolhaas
(wkoolhaas@rsm.nl)

EDITOR

Russell Gilbert
(rgilbert@rsm.nl)

MEDIA & PUBLIC RELATIONS MANAGER

Marianne Schouten
(mschouten@rsm.nl)

DESIGNERS

UNIT20.

© 2011 Rotterdam School of Management,
Erasmus University. All rights reserved



Rotterdam School of Management, Erasmus University **The business school that thinks and lives in the future**

A top-ranked international business school renowned for its ground-breaking research in sustainable business practice and for the development of leaders in global business. Offering an array of bachelor, master, doctoral, MBA and executive education programmes, RSM is consistently ranked amongst the top 10 business schools in Europe.

www.rsm.nl

Erasmus Research Institute of Management

ERIM is the joint research institute of Rotterdam School of Management, Erasmus University and Erasmus School of Economics (ESE) at Erasmus University Rotterdam. Within ERIM, over three hundred senior researchers and doctoral students are active in a diverse range of research programmes. From a variety of academic backgrounds and expertise, the ERIM community is united in striving for excellence and works at the forefront of creating new business knowledge.

www.irim.nl

