Chapter 46
Optimal Corporate Bankruptcy System Design: From the Perspective of the Contingent Governance

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Abstract Taking the traditional theory of corporate governance as a logical starting point, this paper builds and interprets the theoretical models of the corporate contingent governance, on the basis of the results of some scholars' researches on the corporate contingent governance theories. Then under this theoretical framework, the optimal bankruptcy system under the conditions of the perfect market economy and the sub-optimal bankruptcy system under the conditions of imperfect market economy are conceptualized, built and designed.

Keywords Corporate governance · The contingent governance · Corporate bankruptcy system · Design

46.1 The Origin of the Problem: The Corporate Governance Theories

Corporate governance, first of all, is a kind of mutual checks and balances, i.e., checks and balances between stakeholders with the interests of shareholders as the core It should be said that corporate governance includes both the corporate governance structure and corporate governance mechanisms. Its core is a set of rights arrangements, the division of responsibility and restraint mechanisms in the framework of the laws, regulations and practices, to ensure that the interests of the stakeholders [1]. In China, how to improve their corporate governance has been an important part of enterprise reform, the society is very concerned about this with heated discussions, and the government has taken measures from all aspects to foster the foundation of modern corporate governance system. However, China's state-owned enterprises have many problems in corporate governance for a long time, and the

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rapidly emerging private enterprises have more difficult problems in corporate governance (one of the important reasons is their lack of internal corporate governance motivation). Therefore, to improve the corporate governance practices of Chinese enterprises will be a complex, long-term and arduous task.

In fact, the traditional corporate governance theories can more accurately be defined as an internal governance theory, with its emphasis on the set of the company's internal institutions and personnel powers configuration problems, and focus on the checks and balances of the various internal powers of the company. However, the issue of corporate governance is a complex system engineering. It not only involves internal governance issues, but also involves external governance issues. Simply put, the company's external governance refers to such a governance mechanism in which the company's external market stakeholders, in a timely manner under certain circumstances, can exert pressure on the company, acquire or take over the company, resulting in the launching of company management replacement or the insolvency proceedings. This can effectively avoid the "moral hazard" and "adverse selection" of the company management, and force the management to operate the company well. Such governance mechanisms include company acquisitions (Take over) and the contingent governance of stakeholders. The former happens when other organization or individuals, based on some considerations, acquire the shares of the target company to a certain percentage, and thus control the company. For the managers of the acquired company, the result is their loss of the control of the company, so it has a huge deterrent on the lazy behavior of company managers; The latter refers to the corporate governance mechanisms in which the company's stakeholders, based on the company's operating condition and in accordance with the law, take over in a timely manner and deprive the company's original managers of management rights Its essence is the contingent supervision and control of the company It ha a far-reaching significance in improving the corporate governance structure. Since in this paper the optimal bankruptcy system design problem is discussed from the perspective of the contingent governance, here we only focus on the second method, i.e., the contingent governance mechanism.

46.2 Theoretical Model of the Corporate Contingent Governance and Basic Interpretation

The Contingent Governance theory[1] was first proposed by Japanese scholar Aoki [2]. He believes that in order to effectively prevent the "moral hazard" and "adverse selection" problem in the production, operation and management process, an effective way is like thiswhen the enterprise is in a normal operating state, the company should be controlled by corporate insiders; when the enterprise is in non-normal operating state (such as bankruptcy proceedings), the control should be transferred from insiders to shareholders, creditors, employees and other stakeholders of interests [2]. Aoki [2] in 1994 and in later articles [3] called such transfer of control over the operating state of business "the contingent governance". Zhang [4] on the basis of state-contingent model, further elaborates the contingent governance theory According to his model, when the enterprise's total revenue is sufficient to pay the workers' wages, the contract revenue of creditor and the minimum expected return of shareholder, the company should be controlled by the management; when total income is greater than the wages and the contract revenue of creditors, but less than the sum of the workers' wages, the contract revenue of creditor and the minimum expected return of shareholder, the company should be controlled by the shareholders; when the total income is greater than the wages, but less than the sum of the workers' wages, the contract revenue of creditor, the creditor should take control;when the total revenue can not pay the workers; wages, the enterprise control rights should be transferred to the workers. However, Yang and Zhou [5] think that the state dependence of corporate control does not mean the automatic transfer of control. For example, when the total revenue is less than the workers' wages and the principal and interest of creditors, will the shareholders take the initiative to transfer the control to the creditors? The answer is uncertain. Therefore, they believe that a system or contract should be set in advance (such as the corresponding provisions in the Bankruptcy Act or debt covenants) to ensure the smooth transfer of control. Based on the researches of these scholars and other scholars [6–9], this article designs the corporate contingent governance model as follows (Fig. 46.1).

Assume the enterprise's operating status (such as normal operation and non-normal operation) is represented by the income I[2], and assume that I is distributed continuously between 0 to $I_{\max}$, where $I_{\max}$ is the maximum possible revenue. Sup-

[1] According to Jin Bei and Huang Qunhui, both incorporated state-owned enterprises and unincorporated state-owned enterprises can be called a "new type of state-owned enterprises", that is, both incorporated enterprises and unincorporated enterprises are called "enterprise", According to this logic, since the "corporate enterprises" after the restructuring is a type of enterprise and they face the problem of "governance ", then the enterprises before restructuring (such as the former state-owned enterprises) or unincorporated enterprises are also a type of enterprise and they too face the problem of "governance". Based on this consideration, we use the broader concept of "enterprise contingent governance" rather than "the corporate contingent governance" for this research [11].

[2] Of course, other financial indicators such as asset-liability ratio, overall labor productivity or return on equity can also reflect the state of business. To simplify our analysis of the problem, we only use the corporate revenue as an indicator to show the business situation of enterprises.

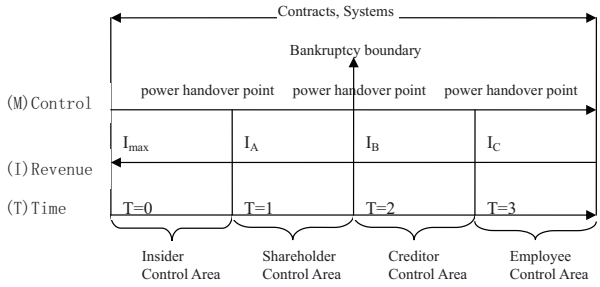

Fig. 46.1 The Theoretical Model of Enterprise Contingent Governance

pose the enterprise employees' contract wages is X, contract revenue of creditors is Y, and the minimum expected revenue of shareholders is Z, then:

When the enterprise is in a normal operating state $(I_{\max} - I_A,\ I_A - I_B)$[3], there are two scenarios: The first scenario is $I_{\max} - I_A$ Stage, when $I > X + Y + Z$, in which the corporate total revenue can pay workers' wages, the contract income of creditors and the minimum expected income of shareholders, can also pay managers incentive compensation in addition to their fixed income (such as bonuses, social prestige, working consumption). The control of the company lies in the hands of managers, this stage is defined as the insider control area; the second scenario is $I_A - I_B$ Stage, when $X + Y < I < X + Y + Z$, in which the corporate total revenue can pay workers' wages and the contract income of creditors but cannot pay the minimum expected income of shareholders. So, shareholders have most incentive to control enterprises and practice contingent governance and the corporate control will be transferred from the managers to the shareholders. The transfer time is the power handover point when $T = 1$, and this stage is defined as shareholders' control area.

When the enterprise is in a non-normal operating state $(I_B - I_C, I_C - 0)$, there are also two scenarios: The first scenario is the $I_B - I_C$ Stage, when $X < I < X + Y$. In this case, the enterprises' revenue are reduced to be able to pay the workers' wages, but unable to pay the contract revenue of creditors, nor the minimum expected return of shareholders. The shareholders have lost the motivation to control the enterprise[4], but creditors may, at this time, take actions (for example, to apply for corporate bankruptcy or take over the business for a reorganization) to minimize their lossIf no actions are taken, they will have losses that are otherwise reparable. Therefore, the creditors have the greatest willingness to control enterprises and practice contingent

[3] In fact, when the corporate revenue is reduced to the $I_A - I_B$ Stage, the minimum expected return of shareholders cannot be met and the enterprise actually has entered the non-normal operating state, but here in order to emphasize the enterprises enter the non-normal operating state only after its entry into bankruptcy proceedings $(T = 2)$, the $I_A - I_B$ Stage is defined as the normal operating state.

[4] When the shareholders now participate in the contingent governance, their marginal cost is greater than marginal revenue. No matter how much effort the shareholders put, they cannot make ends meet.

governance, and the corporate control should be transferred from the stockholders to the creditor. The transfer time is the power handover point when $T = 2$, and this stage is defined as creditors control area. the second scenario is the $I_C - 0$ Stage when $I < X$, in which the corporate income has been unable to pay the workers' wages. Creditors, even if through bankruptcy liquidation procedure, can not guarantee their contract revenue. If creditors pay other prices (such as the consumption of time, restructuring capital reinvestment, etc.) to practice the contingent governance on the indebted enterprises, the result would be that the marginal cost is greater than marginal revenue, so the creditors lose the motivation to control the corporate. At this point, since I can pay part of the workers' wages, and if workers take the initiative to control and govern the enterprises (such as self-help production), their actual income may be far greater than when they are not involved in enterprises contingent governance, so in this case workers have the greatest incentive to participate in the contingent governance of indebted enterprises. the corporate control should be transferred from creditors to workers. The transfer time is the power handover point when $T = 3$ and this stage is defined as worker control areas.

In particular, the time $T = 2$ is the critical point when the enterprise shifts from the normal operating state to a non-normal operating state. The corporate revenue I is in a critical state when it just can not pay creditors contract revenue, control at this time should be transferred from the shareholders to creditors. Since he creditors exercise control mainly through the bankruptcy reorganization and bankruptcy liquidation, so the corporate revenue when $T = 2$ is defined as the bankruptcy boundary.

During the whole processes when the corporate revenue I is reduced from $I_{\max}$ to 0, the time T from $T = 0$ to $T = 3$ (even after $T = 3$), the control is transferred from the insiders to the shareholders, creditors, employees and other contingent governance subjects, there is a set of comprehensive contracts (such as debt contracts) or system arrangement (such as bankruptcy law) to regulate each steps, in order to ensure smooth handover of control.

For the special case of China's state-owned enterprises bankruptcy in the transition period, when the enterprises reach bankruptcy boundary, the control is actually first transferred to the government, so the $T = 2$ stage and subsequent stages are defined as the government control area (applicable only to policy bankruptcy of state-owned enterprises in the transition period,).

The above analysis is somewhat abstract, so we make a summary of the theoretical model of the enterprises contingent governance and its implications.

The corporate contingent governance refers to the orderly transfer of corporate control to different subjects in accordance with the changes in business performance, financial condition or operating state correspondingly[5]. It is a dynamic corporate

[5] The essence of the changes in "enterprise performance, financial condition or operating state" is the changes in business conditions or performance or the adverse selection and moral hazard behavior of a party that have made damage to the interests of other parties, for instance the poor management of managers leads to the decline in corporate profits or dividends and damages the interests of the owners (shareholders); deterioration of the financial situation of enterprises hurt the corporate solvency and increase the financial risk of the creditorsimproper decisions of business managers harm the interests of the employees. Of course, the improvement of the operating con-

governance, the core of which is, during the whole processes from the normal operating state to the non-normal operating state and withdrawal from the market after bankruptcy, the various subjects can take control in a timely and contingent manner and participate in corporate governance. It is to effectively solve such a problem: when changes in corporate performance, financial condition or operating state affect the interests of the stakeholders (managers, owners, creditors and employees) directly or indirectly, some kinds of mechanisms (such as the "Bankruptcy Law" or debt covenants, provisions or arrangements) will be triggered automatically to make re-arrangements between the various stakeholders in order to achieve the readjustment of the corporate governance structure.

We find that an important tool to realize the contingent governance is the effective transfer of control (corporatization and reorganization of demutualization, mergers and acquisitions, proxy rights competition discrete merger, liquidation, etc.). The basic premise of this effective transfer of control is to the corporatization of enterprises, because there is no obvious contingent governance to take control in unincorporated enterprise. The best function of corporatization, in view of corporate governance, is to define the corporate property rights, and the clear property rights serve as the basis for a timely and orderly contingent governance among the various stakeholders. Obviously, it is difficult for unincorporated enterprises to implement contingent governance mechanisms. In general, the corporate contingent models in different economic systems are not exactly the same, but in a mature market economy system there are striking similarities in implementing the corporate continent governance, this is, as the business conditions deteriorate, the corporate control is always moving along the direction of managers (insider control) to shareholder, creditor and workers.

After an abstract analysis and a popular generalization of the theoretical model of the corporate contingent governance and its implications, a more simplified description of the corporate contingent governance is as follows (Fig. 46.2).

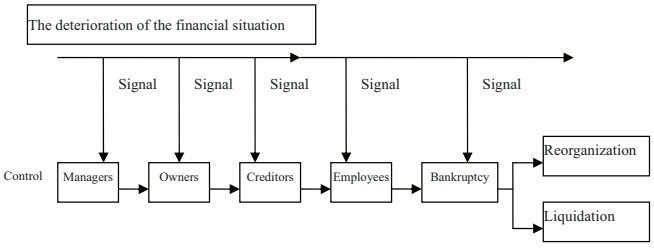

Fig. 46.2 The Simplified Model of Enterprise Contingent Governance

ditions can benefit certain parties, which also can cause changes in the governance structure. For example, the increase in company's profitability will make owners tend to give greater control to managers, which can undermine the control rights of the creditors. More discussions are in [12].

We note that the contingent governance emphasizes the word "contingent", i.e., corporate stakeholders, as the contingent governance subjects, can have a timely, dynamic and contingent governance in accordance with the operating conditions of enterprises, which coincides the Contingency Management Theory in management. The core idea of the Contingency Management Theory is that there is no hard and fixed management model and that managers should constantly adjust themselves to seize the opportunity to adapt to external changes [10]. From this perspective, the contingent governance theory itself enjoys a corresponding theoretical support, which also highlights the necessity and strong vitality of the contingent governance theory. As the focus of the paper is the optimal corporate bankruptcy system design from the perspective of the contingent governance, we do not intend to analyze the contingent governance theory itself too much. Now we will discuss the corporate bankruptcy system design problems from the perspective of the contingent governance.

46.3 Optimal Bankruptcy System Design from the Perspective of Contingent Governance

46.3.1 Optimal Bankruptcy System Design under the Perfect Market Economy Conditions

In the previous section, we have analyzed the corporate contingent governance theories. Now we take them as supports to design the optimal bankruptcy system[6]. It's worth emphasizing that irrespective of our discussion of bankruptcy system design under the perfect market economy conditions here or bankruptcy system design under the imperfect market economy conditions in next section, we have a basic premise: the analyses are made from the perspective of the corporate contingent governance. First of all, let's take a look at the scenario under the perfect market economy conditions.

To do this, we first assume that there is such a simple economic society and that this society is composed by the following categories of people: first, business managers (in order to simplify the analyses of the problem, the managers and business owners are regarded as the same category of people); second, the outside investors[7]; third, the government, whose job is to design the bankruptcy system and whose main consideration is how to maximize the overall welfare of the society when designing the bankruptcy systemfourth, the court, which is responsible for the implementation of the Bankruptcy Lawfifth, in order to further simplify the problem, we assume that

[6] The perfect market economy condition is an ideal state. In this scenario, there is no any uncertainty or information asymmetry.

[7] Since the focus of the paper is to examine the bankruptcy problems when the enterprise go into a financial crisis, outside investors will be here particularly defined as creditors.

creditors are the only contingent governance subjects. Meanwhile, we also assume that the enterprises operate under the perfect market economy conditions.

Based on these assumptions and the aforementioned Contingent Governance Model, we can describe the optimal bankruptcy system with this objective function:

$$Y = \int_i (M+U)dF(X) + \int_i \left[\int_{r_1(x,s)} (Q+U)dH(S) + \int_{r_2(x,s)} (X+aS+U)dH(S) \right] dF(X).$$

In this objective function, Y represents the expected welfare of the society, M represents the debt financing scale of the enterprise, U represents the private benefits the enterprise managers enjoy when they control the enterprise, Q represents the liquidation value that creditors get when the control is transferred to creditors. "i", "j", "$r_1(x,s)$", "$r_2(x,s)$" represent different sets, in which $i = \{x|$creditors agree to renegotiate debt covenants after taking control$\}$, $j = \{x|$creditors do not agree to renegotiate debt covenants after taking control$\}$, $r_1(x,s) = \{(x,s)|$creditor requires enterprises to be liquidated$\}$, $r_2(x,s) = \{(x,s)|$ creditors accept the debt contract re-negotiations and allows businesses to continue to operate after negotiations$\}$.

When $T = 0$, external investors (creditors) sign debt covenants with the enterprise. Assumes that both creditors and managers are risk-neutral. After signing the covenants, the managers choose their effort level s, Because of the "moral hazard", managers may become "lazy", so we assume that the level of their work efforts is in a continuous distribution in a certain range, i.e., $s \in [s_{\min}, s_{\max}]$, The managers try to improve the output of enterprises in a First-order stochastic dominance sense. The more efforts the managers put, the more returns they get, yet higher cost they pay. In other words, when manager work hard to earn high returns, there is a negative utility $H'(s), H'(s) > 0, H''(S) > 0$.

When $T = 1$, the decline in corporate revenue has made the control transferred to the shareholders, between $T = 1$ and $T = 2$, creditors and business managers can observe x, a signal representing financial situation of enterprises, $x \in [s_{\min}, s_{\max}]$, $s_{\min}$ represents the most incomplete information, $s_{\max}$ represents the most complete information, $F(x)$ is its probability distribution function.

When $T = 2$, the control has been transferred to the creditors when creditors observe an accurate but unverifiable signal that the enterprise is in a financial predicament. This is signal is represented by $f(s) = as + b$, in which $f(s)$ represents company's cash flow, s is the manager's effort level, a is a parameters, b is a random variable, $b \in [b_{\min}, b_{\max}]$, the distribution function is $K(s)$, and the density function is $k(s)$. Under perfect market economy conditions, $b = 0$. At this point, the creditors will, according to the financial situation of enterprises, make the decisions whether to liquidate the enterprises, to let managers continue to operate the business or to renegotiate existing debt covenants.

Thus, based on our analysis of the Contingent Governance Model and the objective function of the optimal bankruptcy system, we can list the basic characteristics of an optimal bankruptcy system as follow.

First, in an optimal bankruptcy system, the government can directly define the appropriate sets ["i","j","$r_1(x,s)$","$r_2(x,s)$"] to make the overall social welfare optimal when the enterprise goes bankrupt.

Second, an optimal bankruptcy system should ensure a smooth transferring of control to such contingent governance subjects as creditors when the enterprise is in financial difficulties.

Third, from the perspective of the overall social welfare, when the liquidation value of the enterprise is less than the value of its continuing operations, the optimal bankruptcy system should prevent creditors from excessive liquidation of the enterprise to ensure the continued operation of the enterprise; when the corporate liquidation value is greater than its continuing operations, the optimal bankruptcy system should ensure such contingent governance subjects as creditors have enough power to implement corporate bankruptcy liquidation.

Fourth, when such contingent governance subjects as creditors, due to the "transaction costs" or "information rent" and other reasons, fail to get accurate information as to whether they should continue to operate or liquidate bankruptcy, the manager should have enough incentive to liquidate the worthless insolvent enterprise even if the continued operation is more beneficial to their own utility; the manager also should have sufficient constraints not to liquidate the enterprise that is worthy of continued operation even if the bankruptcy liquidation is more beneficial to their own utility.

46.3.2 Optimal Bankruptcy System Design under the Imperfect Market Economy Conditions

The above analysis of the optimal bankruptcy system is based on the strict assumptions of perfect market economy. However, in the economic and social reality, this optimal bankruptcy system is difficult to achieve (due to the limit of constraints). Unlike the conditions of perfect market economy, in the economic and social reality the decisions of corporate bankruptcy liquidation and the investor's investment decisions are made by corporate managers and investors (such as creditors) respectively, and the government can not directly choose the ranges of the sets "i","j","$r_1(x,s)$", "$r_2(x,s)$", but only has an indirect impact. Meanwhile, due to the presence of agency problems, such contingent governance subjects as creditors, government, and even shareholders have a worse access to the relevant information about the enterprise than the managers. There is a serious problem of information asymmetry between them. In other words, the market is not "perfect". So, we need to revise the optimal bankruptcy system under the conditions of perfect market economy[8].

To this end, we introduce the following constraints into the objective function of the optimal bankruptcy system:

[8] Under the imperfect market economic conditions, there is widespread uncertainty and information asymmetry.

$$I \geq U + \int_{s_{\min}}^{s_{\max}} \int_{\omega}^{b_{\max}} (x + as + b - \omega) dk(b) dh(s), \tag{46.1}$$

where $\omega = F - x - as$, F is the book value of debt financing.

$$\int_{r_1} J_2 dH(S) + \int_{r_2} J_4 dH(S) \geq \beta, \tag{46.2}$$

where β is the actual benefits that creditors may get when liquidating the debt enterprises.

$$J_1 + J_2 \leq L, \tag{46.3}$$

$$J_3 + J_4 \leq dX + aS + b + U. \tag{46.4}$$

In the above constraints, I represents the possible gains of corporate managers when they file for bankruptcy; J_1 represents the gains of corporate managers when the enterprise is liquidated; J_2 represents the gains that such contingent governance subjects as creditors can get when the enterprise is liquidated; J_3 represents the gains of enterprise managers when the enterprise continue to operate, J_4 represents the gains that such contingent governance subjects as creditors can get when the enterprise continue to operate. In these constraint formulas, Equation (46.1) represents the incentive compatible constraints of managers, which means that when managers file for bankruptcy their gains should not be less than what they can get if the companies continue to operate. Equation (46.2) represents of the participation constraint of creditors, which means that such contingent governance subjects as creditors allow the debt enterprises be liquidated only when they expect that their gains from corporate bankruptcy will be higher than their gains from its continued operation. Equation (46.3) and Equation (46.4) represent the social feasibility constraints, which mean that for such contingent governance subjects as managers and creditors the sum of their possible benefits should be economically achievable when the enterprise is liquidated or continues to operate.

Thus, under the conditions of information asymmetry, we can get a revised, constraints-dependent and suboptimal objective function of bankruptcy system:

$$Y = \int_i (M + U) dF(X) + \int_i \left[\int_{r_1(x,s)} (Q + U) dH(S) + \int_{r_2(x,s)} (X + aS + U) dH(S) \right] dF(X), \tag{46.5}$$

$$I \geq U + \int_{s_{\min}}^{s_{\max}} \int_{\omega}^{b_{\max}} (x + as + b - \omega) dk(b) dh(s), \tag{46.6}$$

$$\int_{r_1} J_2 dH(S) + \int_{r_2} J_4 dH(S) \geq \beta, \tag{46.7}$$

$$J_1 + J_2 \leq L, \tag{46.8}$$

$$J_3 + J_4 \leq dX + aS + b + U. \tag{46.9}$$

In the above formulas, Equation (46.5) represents the objective function when the government formulate in the bankruptcy system, and Equations (46.6) to (46.9) are the constraints. In this way, we can list the basic characteristics of a sub-optimal bankruptcy system under the imperfect market economy conditions as follow:

First, under the imperfect market economy conditions, due to the presence of widespread information asymmetry, the government can not directly define the sets "i", "j", "$r_1(x,s)$" and "$r_2(x,s)$" to optimize the bankruptcy system.

Second, under the imperfect market economy conditions, a set of suboptimal bankruptcy institutional arrangements should ensure the orderly transfer of control to such contingent governance subjects as creditors when the enterprise is in financial crisis.

Third, due to the information asymmetry, when the enterprise is in financial crisis the managers have better access to the information as to the economical and financial viability of the enterprise than such contingent governance subjects as creditors. So, the suboptimal bankruptcy system must ensure these contingent governance subjects have certain powers (normally this power refers to the corporate control, but can also refer to other powers). With these powers, such contingent governance subjects as creditors can reject managers' bankruptcy filing thereby preventing a valuable enterprise from bankruptcy; they can also file for bankruptcy so that the worthless debt enterprises can be liquidated.

Fourth, when such contingent governance subjects as creditors, due to the "transaction costs" or "information rent" and other reasons, fail to get accurate information as to whether the enterprises should continue to operate or be liquidate a set of suboptimal bankruptcy institutional arrangements should ensure that managers sufficient incentive to voluntarily liquidate the worthless debt enterprise, even if the continued operation has utility greater to themselves; the arrangements should ensure that managers have sufficient constraints not to liquidate a debt enterprise that is worth continuing to operate, even if the bankruptcy and liquidation bring utility greater to themselves.

46.4 Conclusion

Taking the traditional theories of corporate governance as the logical starting point, and on the basis of the results of some scholars' researches on contingent governance theory, we build a theoretical model of the enterprise contingent governance and give its basic interpretations. Then, within this theoretical framework, we conceptualize, build and design the optimal bankruptcy system under the perfect market economy conditions and the sub-optimal bankruptcy system under the imperfect market economy conditions. It's worth noting that, by the completion of this paper in late 2012, almost all the literature and documents that can be retrieved were published before 2006. In other words, the literature on the corporate bankruptcy system from the perspective of contingent governance in the past five years (2006-2012) is basically in a blank state. As a matter of fact, a lot of problems on the enterprise

bankruptcy are also worthy of our in-depth study, such as the games after the enterprise go into bankruptcy proceedings (even before the bankruptcy proceedings), contingent governance models of different contingent governance subjects, the review of China's Enterprise Bankruptcy System and reassessment if its efficiency, and the specific reform approaches to China's Enterprise Bankruptcy System. In this sense, we hope this study will make more experts and scholars pay more attention to the problems of corporate bankruptcy, and, of course, the validity of the conclusions of this study is subject to future tests and the criticism from peer experts.

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