When American Firms Misbehave, Chinese Companies Pay the Price

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“Guilt by association” in US financial markets appears to be driven by investors’ prejudice against Chinese firms.

One of the ways through which human beings make sense of the world is generalisation, a cognitive shortcut that assumes members of the same group have similar characteristics. Generalisation can be helpful when it is used to size up novel situations, enabling us to anticipate and prepare for the unknown. But it can do serious harm if taken too far. Racism, religious persecution and conflict are but some of the more extreme consequences. In business, too, companies can bear the cost of prejudice.

Volkswagen’s admission in 2015 that it had for years cheated in emissions testing to make its diesel cars look environmentally friendly damaged not only its own brand and sales **but also that of other German automakers**. Scandalised consumers were quick to tar the likes of BMW, Mercedes-Benz and Smart with the same brush, although there was nothing to suggest that these German firms also engaged in fraud. They were simply guilty by association.

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Existing research suggests that a “guilt by association” effect is the result of evaluators projecting a firm’s misconduct onto innocent firms in the same industry (i.e. generalisation). However, the specific underlying cognitive mechanism(s) remain ambiguous.

In a **paper** in *Organization Science*, **Edward Zajac** of the Kellogg School of Management and I show that two processes are likely at play. One is inductive generalisation, whereby evaluators extrapolate from the facts of the given case to innocent organisations with similar characteristics (e.g. industry and country of origin). The other is deductive generalisation, when evaluators’ *pre-existing* beliefs fuel generalisation.

The latter type of generalisation, as we show, is particularly damaging for innocent firms that fall under negative stereotypes. Left unchecked, it can leave everyone else – consumers, investors and financial markets – worse off.

The Chinese penalty

Our study examined firms that used reverse mergers (RMs) to publicly trade in US financial markets from 2001 to 2016, focusing on the spillover impact experienced by innocent Chinese firms as a result of misconduct allegations against a fellow RM company. We showed the spillovers were shaped by anti-Chinese sentiment. Such negative sentiment has recently spiked in the US; assaults, harassment and even shootings targeting Asian-Americans have festered as Covid-19, first discovered in China, swept the country.

RMs are controversial in themselves because they are seen as shortcuts to public listings, whereby private company merges with a listed empty shell, thus going public quickly and inexpensively. To study the guilt by association phenomenon in corporate misconduct, we used the US Securities and Exchange Commission (SEC) database to identify all RM firms that were subject to enforcement actions between 2006 (after the SEC imposed new RM-related regulations) and 2016.

We identified 491 firms that faced at least one SEC enforcement action. Of these, 282 were from the US, 126 were from China, and 83 were from other countries. We calculated a three-day cumulative abnormal return (CAR) – around the date the alleged misconduct was announced – for all non-accused RM firms to examine how an accusation against an RM firm affected innocent peers’ stock market valuations.

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The results show that innocent RM firms experienced, on average, a significant negative CAR of -0.175 percent. This suggests the spillover effect of inductive generalisation, where one bad apple spoils the entire barrel in the eyes of investors.

What’s more disturbing is the finding that innocent Chinese RM firms experienced a significantly greater devaluation (-0.272 percent) compared to non-Chinese RM firms (-0.149 percent), irrespective of the offending firm’s country of origin. We term this the recipient effect.

When the offending firm was Chinese, the spillover to innocent RM firms was only -0.026 percent. But when the offending firm was non-Chinese, it rose to -0.224 percent. We call this the transmission effect. These results point to investors engaging in deductive generalisation underpinned by entrenched negative stereotypes of Chinese firms, even though most of the alleged wrongdoers were American.

That’s not all. Further analysis show that even Chinese firms that had gone public via the more orthodox route of initial public offerings, rather than reverse mergers, suffered negative spillover (-0.456 percent) from RM-related malfeasance, whether the offender was Chinese or not. It would seem that the only “crime” of these firms was being Chinese.

Media impact

We also studied the impact of the US media – a shaper of public perception. We collected 8,079 articles with the word “China” or “Chinese” in the title published in major US newspapers between 2006 and 2016. We identified 753 media reports on RMs in the same period, of which 133 mentioned purported poor accounting practices by Chinese RM firms.

In general, we found that the US media discussed reverse mergers in ways that expressed prejudice, with Chinese RMs disproportionally portrayed as wrongdoers and described in terms of their nationality rather than business characteristics. This, despite **evidence** that Chinese RMs exhibited *higher* financial reporting quality than US and other foreign RM firms.

For each accusation event we then counted the total number of positive and negative China-related articles published one day prior. Our analysis shows that media coverage that was on balance negative towards China and Chinese businesses amplified the spillover effects outlined above.

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Specifically, when an RM firm was accused of wrongdoing at a time when there was more anti-China media coverage, innocent Chinese RM firms experienced even more negative spillover. When the offending firm was Chinese, anti-China sentiments increased the salience of the firm's "Chinese-ness" while decreasing the salience of its "RM-ness", thus reducing the negative spillover to all other RM firms.

Finally, we found no difference in terms of spillover experienced by innocent US RM firms and non-Chinese foreign RM firms. Taken together, these results show that Chinese stereotyping was driving the spillover, rather than the "home bias" in capital markets that can hobble foreign firms.

All too human

We believe our study is one of the first to address financial markets' possible susceptibility to national prejudice. Our results provide systematic evidence of generalisation and discrimination in US markets, despite potential economic consequences. Investors, after all, are only human.

The associated economic and social costs could be large. The US stock market **dwarfs** those of even its closest competitors, presenting a potential gold mine for capital-hunting companies such as Chinese e-commerce giants Alibaba and Pinduoduo. But in 2019, Chinese IPOs in the US more than halved in valuation compared to the 2018 tally, in tandem with rising anti-China political rhetoric in Washington.

While the IPOs rebounded in 2020 amid global market exuberance, new **legislation** that could delist Chinese companies if they did not submit audited accounts to American regulators – something that is banned by Beijing – could stem the inflow again. The flight from New York could be a lost opportunity for both US investors and Chinese firms, even as bourses in Europe, Hong Kong and China benefit.

"Hate has no place in America" , said US President Joe Biden last month when he **signed into law** a bill that aims to fight rising anti-Asian hate crimes. Financial market players should pay heed.

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About the research

"How Inductive and Deductive Generalization Shape the Guilt-by-Association Phenomenon Among Firms: Theory and Evidence" is published in *Organization Science.*

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