

## **Chinese Corporate Debt and its Effects on the Interests of Minority Shareholders**

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**Abstract:** This article concerns minority shareholders' interests in the increasing Chinese corporate debt threat. It illustrates the costs and benefits of debt in the context of corporate governance. It then looks into a number of listed non-state-owned Chinese companies to examine their gearing levels. The article explains possible conflicts between majority and minority shareholders, and how the interests of minority shareholders can be undermined. Although certain legal mechanisms are available for minority shareholders, the article finds that they are not effective in the context of debt control. This article suggests the introduction of stakeholders' society approach. However, to implement such concept requires substantial and radical change in corporate law and culture.

**Keywords:** Company law, corporate governance, ethics, minority shareholders

### **1. Introduction**

The debt-to-GDP ratio of China increased significantly in recent years. Among all debts in China, corporate debt plays an important role. A number of renowned listed companies are heavily indebted. As one of the major sources of financing, debt has its advantages, such as avoiding dilution of control and providing tax shielding. Some also view debt as an external corporate governance mechanism, to keep managers aware. Nevertheless, the use of debt can result in majority shareholders expropriating the interests of minority shareholders. High gearing levels can undermine the interests of minority shareholders in the company.

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This article takes 30 privately owned Chinese companies as samples and compares them to overseas companies to examine the debt level of the Chinese companies. It looks at how the interests of minority shareholders may be affected, and how conflicts arise between majority and minority shareholders. It finds existing minority shareholders who do not intend to allow the company to become riskier have few options to intervene in the company's decision making.

This paper finds highly indebted Chinese listed companies have a common issue of concentration of ownership. This provides majority shareholders with great voting power, hence strong control in the company. In addition, derivative claims and shareholders' remedies available for minority shareholders are not applicable when it comes to companies' debt control. Shareholders' remedies usually require management of a company to have breached relevant laws, regulation, fiduciary duties, or the constitution of the company. Even if majority shareholders have expropriated minority shareholders' interests, it is not easy for the court to intervene. Apart from that, each jurisdiction has its own features, which could make things more difficult. For example, the emphasis of US courts on the "business judgment rule" makes judicial intervention in corporate decision making difficult.

The last part of this article discusses whether there are ways for minority shareholders to maximise their own protection against any potential expropriation arising from the high debt levels in Chinese companies. To protect minority shareholders, one solution is to introduce the stakeholders' society approach. This part of the article assesses the cost and benefits of both the shareholders' value approach and the stakeholders' society approach, and the feasibility of introducing the latter into Chinese corporations.

## **2. Debt as a Source of Financing**

### **2.1 An Overview**

The Modigliani and Miller Theorem famously states the value of a firm is not relevant to how the firm is financed. In other words, the value of unleveraged firm ( $V_U$ ), is equal to the value of the leveraged firm ( $V_L$ ).<sup>2</sup> This is known as proposition I of the Modigliani and Miller Theorem. Furthermore, as the required rate of equity is usually higher than the required rate of debt due to the riskier nature of equity, it is sometimes suggested that using more debt reduces the total

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<sup>2</sup> Modigliani and Miller, 'The Cost of Capital, Corporate Finance and the Theory of Investment' [1958] *The American Economic Review* Vol. XLVII No.3 268

cost of capital. Proposition II of the Modigliani and Miller Theorem, however, suggests that by issuing more debt, the required rate of return of equity becomes higher as the remaining equity becomes riskier, just riskier enough to make the cost of capital remain constant. This, again, suggests changes in corporate structure do not affect the cost of capital of a firm, and thus the value of the firm.<sup>3</sup>

However, the Modigliani and Miller Theorem is based on a number of assumptions. Most importantly, the model assumes the absence of cost of financial distress, agency costs and taxes.<sup>4</sup> Financial distress refers to the costs a firm incurs in a bankruptcy or reorganisation, and other costs, such as agency costs, that arise when the creditworthiness of the firm is in doubt.<sup>5</sup> Such costs can be divided as direct costs and indirect costs. Direct costs refer to the costs which are directly incurred in the process of a reorganisation or a bankruptcy, such as legal expenses and court fees.<sup>6</sup> Indirect costs, on the other hand, are considered more significant, yet harder to measure. Indirect costs arise sometimes when the firm is facing the threat of default. It may increase the firm's cost of operation as other parties, such as suppliers, may not be willing to trade with a defaulting firm.<sup>7</sup>

The Modigliani and Miller Theorem has an assumption of the absence of costs of financial distress. However, in reality, it is apparent financial distress cost is an important factor a firm must keep in mind. By failing to honour its financial obligations, a firm might, at its extreme, go bankrupt. When the costs of financial distress are high, it is likely governance issues will occur and the firm would suffer higher agency costs.<sup>8</sup>

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<sup>3</sup> Modigliani and Miller, 'The Cost of Capital, Corporate Finance and the Theory of Investment' [1958] *The American Economic Review* Vol. XLVII No.3 271

<sup>4</sup> Modigliani and Miller, 'The Cost of Capital, Corporate Finance and the Theory of Investment' [1958] *The American Economic Review* Vol. XLVII No.3 266

<sup>5</sup> Stewart Myers, 'Capital Structure' [2001] *Journal of Economic Perspective* Vol.15 No.2 89

<sup>6</sup> D Hillier, M Grinblatt and S Titman, *Financial Markets and Corporate Strategy* (2<sup>nd</sup> European edn, McGraw-Hill 2012) 524

<sup>7</sup> D Hillier, M Grinblatt and S Titman, *Financial Markets and Corporate Strategy* (2<sup>nd</sup> European edn, McGraw-Hill 2012) 525-526

<sup>8</sup> Stewart Myers, 'Capital Structure' [2001] *Journal of Economic Perspective* Vol.15 No.2 95

## 2.2 Debt as a Governance Mechanism

Nonetheless, debt is sometimes viewed as a mechanism to resolve agency problems. As for the conflict of interests between managers and shareholders, some argue that by financing through debt, the firm essentially removes “free cash flow” out of the hands of managers, and therefore prevents managers from “consuming” cash. Furthermore, debt gives managers of the firm incentives of keeping the firm’s level of liquidity at a certain amount, as they must generate enough cash flow to fulfil the firm’s future debt obligation.<sup>9</sup>

Likewise, debt not only gives equity holders an opportunity to expropriate interests from other stakeholders, it sometimes gives debt holders a chance to gain stronger control of the company. When a firm is under financial distress but not in the process of liquidation, debt holders may gain control by acquiring the crucial power of forcing the firm into bankruptcy. This may allow debt holders to influence the firm’s policy.<sup>10</sup>

However, debt, as a governance mechanism, is not without its limits. Rather than eliminating governance issues, debt may create further governance problems, namely by creating conflicts between debt and equity holders. The threat of financial distress itself is capable of affecting a company’s investment and operation activities, and its current value. The latter is the main reason many companies maintain a rather conservative debt-to-equity ratio.<sup>11</sup>

## 2.3 The Increasing Chinese Corporate Debt Threat

### 2.3.1 Total Debt Level in China

A number of financial institutions and organisations have expressed their views that China’s total debt has risen to a significantly high level as a percentage of its GDP. The *Financial Times* points out that Chinese total debt rose to 237% of its GDP in April 2016. The figure is measured through the data of “total social financing” from the People’s Bank of China, which includes loans borrowed by the non-financial sector from banks and other financial institutions. The data also include figures on both central and local government debt, as provided by the

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<sup>9</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 51

<sup>10</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 51

<sup>11</sup> Stewart Myers, ‘Capital Structure’ [2001] *Journal of Economic Perspective* Vol.15 No.2 97-98

Chinese Finance Ministry and National Audit Office.<sup>12</sup> Another widely cited report issued by consultancy firm McKinsey & Company, suggests by 2014, Chinese debt rose to a level of 282% of its GDP. The report also shows from 2007 to 2014, Chinese debt as a percentage of its GDP increased 83%.<sup>13</sup>

Comparatively, the *Financial Times* research shows, by September 2015, China's debt level was the fourth highest in the World, behind Japan, Greece and Italy, and ranked ahead of all emerging economies.<sup>14</sup> The McKinsey report suggests a similar result, with China's debt level higher than a number of advanced economies, such as the US, Germany, South Korea, and most of the emerging economies.<sup>15</sup>

Although the two research papers adopt different approaches and come up with different resulting figures, they both conclude that (1) the Chinese debt threat has been getting more serious in recent years; and (2) it is relatively high in comparison with both advanced and emerging economies.

### 2.3.2 Chinese Corporate Debt Threat

The McKinsey report indicates that, among the 282% Debt-to-GDP ratio, 125% is attributable to debt owed by non-financial corporations, and another 65% to debt owed by financial institutions. In other words, debt owed by both financial and non-financial corporations combined equals 190% of China's GDP. To observe the debt level of Chinese companies, this article measures the debt-to-equity ratio of 30 non-state-owned Chinese companies. These ratios are then compared with those of 30 other listed foreign companies, 15 Hong Kong companies and 15 US companies. The main reason for using Hong Kong and US companies as comparisons is because Hong Kong and the US are the two most favourable listing destinations of Chinese companies, which means the regulations applicable to a Chinese company listed in Hong Kong/the US are similar to the regulations

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<sup>12</sup> G Wildau and D Weinland, 'China Debt Load reaches record high as Risk to Economy Mounts' *Financial Times* (London, 24 April 2016)

<sup>13</sup> R Dobbs, S Lund, J Woetzel and M Mutafchieva, 'Debt and (Not Much) Deleveraging' (*McKinsey Global Institute*, February 2015) 75-90

<sup>14</sup> G Wildau and D Weinland, 'China Debt Load reaches record high as Risk to Economy Mounts' *Financial Times* (London, 24 April 2016)

<sup>15</sup> R Dobbs, S Lund, J Woetzel and M Mutafchieva, 'Debt and (Not Much) Deleveraging' (*McKinsey Global Institute*, February 2015) 75-90

applicable to Hong Kong and US companies. This is important as the regulatory environment often affects company behaviour.

Table A below shows the debt-to-equity ratio of listed non-state-owned Chinese companies, according to the revenue generated in 2015. Traditional accounting textbooks often suggest debt-to-equity ratio should be measured by the company's long-term liabilities plus preference shares, if any, divided by shareholders' funds or shareholders' funds plus long-term liabilities.<sup>16</sup> However, this definition may not be consistent with what is preferred by securities analysts and the listed Chinese companies. For example, Lenovo, the largest privately owned listed Chinese company, calculates its debt-to-equity ratio by dividing the sum of its long-term loans, short-term loans and long-term notes by its total equity.<sup>17</sup> In addition, a number of Chinese companies have a very small amount of long-term borrowings yet a relatively large amount of short-term borrowings (for example, Gome<sup>18</sup>). It therefore makes more sense to include not only long-term loans but short-term loans and long-term notes, if any. Thus, in this article, the calculation of the "debt" component in the debt-to-equity ratio include (1) long-term borrowings; (2) short-term borrowings; and (3) long-term notes, if any.

The Chinese companies measured are not limited to those incorporated in mainland China, but include those with major business operations in the mainland. This article measures listed companies only, regardless of whether the listing is domestic or international, in order to obtain more reliable and up-to-date information. State-owned companies are excluded as they may have missions other than profit generation, as assigned by state and local governments of the People's Republic of China.

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<sup>16</sup> John Dyson, *Accounting for Non-Accounting Students* (8<sup>th</sup> ed. Pearson Education Ltd 2010) 231

<sup>17</sup> Lenovo Group Ltd, *2015/16 Annual Report* 186

<sup>18</sup> Gome, *Annual Report 2015* 85

Table A: The 30 largest non-state-owned mainland Chinese companies by revenue in 2015, as measured by *Fortune* Magazine:<sup>19</sup>

#	Company Name	Listing Destination	Debt-to-equity Ratio
1	Lenovo	Hong Kong	107%
2	Vanke	Shenzhen (China)	40%
3	Midea Group	Shanghai (China)	7.16%
4	WH Group	Hong Kong	58.21%
5	JD.com	NASDAQ (US)	18.89%
6	Evergrande	Hong Kong	208.88%
7	Suning Commerce Group	Shenzhen (China)	36.21%
8	Dalian Wanda	Hong Kong	100.4%
9	Qingdao Haier	Shanghai (China)	10.12%
10	Country Garden	Hong Kong	100.45%
11	Tencent	Hong Kong	50.32%
12	TPV Technology	Hong Kong	36.01%
13	Alibaba	NYSE (US)	2.29%
14	New Hope Liuhe	Shenzhen (China)	275.05%
15	Fosun	Hong Kong	117%
16	Gome	Hong Kong	11.98%
17	BYD	Hong Kong; Shenzhen (China)	104.48%
18	Shimao Properties	Hong Kong	126.11%
19	Zhongsheng Group	Hong Kong	124.62%

<sup>19</sup> Fortune Magazine, 'Fortune China 500 2015' (in Chinese)  
<[http://www.fortunechina.com/fortune500/c/2015-07/08/content\\_242835.htm](http://www.fortunechina.com/fortune500/c/2015-07/08/content_242835.htm)> accessed 1 July 2016

20	Digital China	Hong Kong	57.65%
21	Longfor Properties	Hong Kong	83.96%
22	Baidu	NASDAQ (US)	5.38%
23	Shenzhen Aishidi	Shenzhen (China)	80.32%
24	Gemdale	Shanghai (China)	53.11%
25	Belle International	Hong Kong	3.41%
26	Agile	Hong Kong	116.68%
27	Yonghui Supermarkets	Shanghai (China)	0
28	Guangzhou R&F Properties	Hong Kong	112.6%
29	Dashang	Shanghai (China)	467.88%
30	Greentown China	Hong Kong	97.10%

Among the 30 largest non-state-owned companies in China, 19 of them have a debt-to-equity ratio of more than 50%. Twelve of them have debt-to-equity ratios of more than 100%. The top three companies with the highest debt-to-equity ratio are Dasheng (467.88%), New Hope Liuhe (275.05%) and Evergrande (208.88%). Table B and Table C show the debt-to-equity ratio of 15 Hong Kong-based listed companies and 15 US-based listed companies respectively.

Table B: The 15 largest Hong Kong companies in 2015, as measured by *Forbes* magazine using a composite score from equally-weighted measures of revenue, profits, assets and market value (excluding banks and financial institutions):<sup>20</sup>

#	Company Name	Debt-to-Equity Ratio
1	Citic Pacific	90.02%
2	CK Hutchison	55.28%
3	Jardine Matheson	6.49%
4	Sun Hung Kai Properties	17.49% (2015/16 Interim)
5	Cheung Kong Property Holdings	20.47%
6	CLP Holdings	54.97%
7	Swire Pacific	22.57%
8	New World Development	31.4%
9	MTR	11.3%
10	Wheelock	23.15%
11	Henderson Land	19.01%
12	Hong Kong Exchanges	11.38%
13	Cathay Pacific Airways	131.29%
14	Link REIT	20.43%
15	Power Assets Holding	7.61% (Interim)

<sup>20</sup> Forbes Magazine, 'The World's Biggest Public Companies'  
<http://www.forbes.com/global2000/#/country:Hong%20Kong> accessed 1 July 2016

Table C: The 15 largest US companies by revenue in 2015, as measured by *Fortune* magazine:<sup>21</sup>

#	Company Name	Debt-to-Equity Ratio
1	Walmart	3.24%
2	Exxon Mobil	21.88%
3	Apple Inc.	46.89%
4	Berkshire Hathaway	32.59%
5	McKesson	72.62%
6	UnitedHealth Group	75.49%
7	CVS Health	76.02%
8	General Motors	21.73%
9	Ford Motors	463.6%
10	AT&T	102.03%
11	General Electric	194.89%
12	AmerisourceBergen	551.37%
13	Verizon	617.61%
14	Chevron	25.03%
15	Costco	56.69%

In general, Hong Kong companies have low debt-to-equity ratios. Only 4 companies among the 15 measured companies have a debt-to-equity ratio above 50%. Three of the most indebted Hong Kong companies are: Cathay Pacific Airways (131.29%), Citic Pacific (90.02%) and CK Hutchison (55.28%). Among the 15 US companies, however, 9 of them have a debt-to-equity ratio above 50%. The three highest geared companies being Verizon (617.61%), AmerisourceBergen (551.37%) and General Electric (194.89%).

Although a number of US companies have relatively high debt-to-equity ratios, US companies in general also have lower amounts of total equity outstanding,

<sup>21</sup> Fortune Magazine, 'Fortune 500 2016' <<http://beta.fortune.com/fortune500>> accessed 1 July 2016

resulting in a higher debt-to-equity ratio. Likewise, some of the governance factors discussed below do not usually occur in US companies. One key difference between US and Chinese companies is the former have diversified rather than concentrated ownership, and majority shareholders seldom have absolute power in corporate decision making.

### **3. Conflict of Interest between Majority and Minority Shareholders**

Jensen and Meckling (1976) argue agency problems mainly arise from two types of conflicts of interest: (1) the conflict of interest between managers and shareholders; and (2) the conflict of interest between debt and equity holders.<sup>22</sup> While the occurrence of these conflicts between managers and shareholders is less relevant to the firm's choice of financing instrument, conflicts between debt and equity holders only exist when there is a risk of default.<sup>23</sup>

However, if concentration of ownership exists in a company, it is likely that another form of agency problem may arise, namely the expropriation of minority shareholders' interests. By looking into a great number of East Asian Companies, Claessens et al. (1999) establish a link between concentration of ownership and the expropriation of minority shareholders' interests. They find a higher concentration of ownership and thus, voting rights, is associated with lower market valuation of the company.<sup>24</sup>

Diminishing returns to shareholders significantly undermine minority shareholders' interests. Accounting ratios show that if the firm is gaining high profits, both return on equity (ROE) and earnings per share (EPS) increase. Nonetheless, when the company is suffering from losses, both ratios go down. This reflects debt's effect as "leverage" that either boosts a company's profits or losses.

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<sup>22</sup> Jensen and Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' [1976] *Journal of Financial Economics* 3 308

<sup>23</sup> Stewart Myers, 'Capital Structure' [2001] *Journal of Economic Perspective* Vol.15 No.2 96

<sup>24</sup> S Claessens, S Djankov and L Lang, 'Expropriation of Minority Shareholders in East Asia' (2009) <<http://www1.worldbank.org/finance/assets/images/expropriation.pdf>> accessed 14 July 2016

Return on equity is generally measured by the company's after tax net income for the year divided by common shareholders' equity.<sup>25</sup> If company A generates an after tax net income of £1,000 and the common shareholders' equity is worth £10,000, the return on equity is 10%. If company A decides to raise more capital, assume it will generate an extra net income of £500 with extra capital of £2,000. If A chooses to raise the capital through equity issuance of £2,000, the new ROE would be  $1,500/12,000 = 12.5\%$ . However, if A decides to raise capital through debt, the return of capital would be  $1,500/10,000 = 15\%$ . The same results arise in the calculation of other ratios such as earnings per share. Earnings per share is calculated by a company's after-tax net income per share divided by market price per common share.<sup>26</sup> Assume the market price per share remains the same, increase in earnings that is due to the increase in investment financed through debt, leads to an increase in earnings per share.

A rise in return on equity and earnings per share is prima facie beneficial to both majority and minority shareholders. However, it should be noted these ratios may not transform into real monetary benefits for minority shareholders. For instance, the company may use the earnings to make further investments instead of paying out dividends. It is not uncommon for majority shareholders, who hold senior positions in the company to receive hefty remuneration and perks. Dividends may affect the return management and owners gain from the company. Furthermore, as mentioned, although debt can provide a greater return to equity holders, by the same token, it can produce greater loss to equity holders. The latter would also need to bear the burden of interest payments, and more importantly, greater risk of financial distress.

### 3.1 Concentration of ownership

It is likely that one governance factor causing the Chinese corporate debt threat is the concentration of ownership. By concentrating ownership, majority shareholders gain substantial control over the company and are able to dictate the company's policies and decisions. Most of the measured indebted Chinese companies have concentrated ownership, which reflects the problem of a correlation between concentration of ownership and high debt level in Chinese companies.

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<sup>25</sup> Financial Times, 'Definition of Return on Equity (ROE)' (*Lexicon*)  
<<http://lexicon.ft.com/Term?term=return-on-equity--roe>> accessed 13 July 2016

<sup>26</sup> Financial Times, 'Definition of Earnings per Share (EPS)' (*Lexicon*)  
<<http://lexicon.ft.com/Term?term=earnings-per-share--EPS>> accessed 13 July 2016

### 3.1.1 Concentration of Ownership at a Glance

General corporate governance theories suggest that active monitoring of a company requires control in the company. In order to introduce new ideas or policies, or to reject a corporate decision, the monitor of a company must exercise certain control, which can take two forms, formal control and real control.<sup>27</sup> One of the most important forms of formal control is the concentration of ownership.

The *Financial Times* defines concentration of ownership as individual investors and large-block shareholders holding a substantial amount of shares within the firm.<sup>28</sup> Concentration of ownership is viewed by some as an effective governance mechanism. The rationale is when a small number of shareholders have concentrated a substantial amount of ownership (i.e. shares) in the firm, the shareholders in effect have gained control in the company and thus, it is much easier to put forward governance measures they may want to impose.<sup>29</sup> For example, if the object of the firm is to maximise profits and the senior management is failing to do their job, the shareholders with substantial control in the firm may choose to replace the poorly performing management with a new management team. In addition, it is also easier for the substantial shareholders to take other approaches such as the launch of a proxy fight.<sup>30</sup> Indeed, the fact that substantial shareholders own the majority of the firm's shares means they also bear excessive risks, giving them sufficient incentive to monitor the company and to take appropriate measures if the matters go wrong.<sup>31</sup>

Nevertheless, concentration of ownership can create governance issues. When a shareholder or a small group of shareholders have gained a large control of the company, or in an extreme case, absolute control of the company (i.e. owns more than 51% of the company's shares), majority shareholders can pursue their own

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<sup>27</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 36

<sup>28</sup> Financial Times, 'Definition of Concentration of Ownership' (*Lexicon*)  
<<http://lexicon.ft.com/Term?term=ownership-concentration>> accessed 6 July 2016

<sup>29</sup> A Shleifer and R Vishny, 'A Survey of Corporate Governance' [1997] *Journal of Finance* Vol. LII No.2 753

<sup>30</sup> A Shleifer and R Vishny, 'Large Shareholders and Corporate Control' [1986] *Journal of Political Economy* Vol. 94 No.3 463

<sup>31</sup> A Shleifer and R Vishny, 'A Survey of Corporate Governance' [1997] *Journal of Finance* Vol. LII No.2 758

interests while ignoring the interests of other shareholders (i.e. minority shareholders) or stakeholders.<sup>32</sup> First, substantial shareholders can make good use of their controlling power in the firm to give themselves preferences or privileges at the expense of other stakeholders. This can be done by giving themselves special dividends or by exploiting business relationships with companies they have connections with.<sup>33</sup> Moreover, if majority shareholders also serve as the firm's managers, it is highly likely they will grant themselves excessive remuneration packages, at the expense of minority shareholders and other stakeholders.

Second, substantial shareholders are capable of expropriating the interests of debt holders, by making the firm taking excessive risks.<sup>34</sup> When the company is riskier, shareholders enjoy unlimited upside benefits; yet, their losses are limited by the monetary value of the shares they own. Debt holders, in contrast, suffer from higher risks as the probability of the company defaulting on debt becomes higher. The value of debt therefore diminishes, whereas the value of equity rises. Value is then transferred from debt holders to equity holders.

### **3.1.2 Concentration of Ownership in Chinese Companies**

Looking into the measured Chinese companies which have a debt-to-equity ratio at or above 50%, a significant number among such companies have concentrated ownership. Table D below shows the correlation between the indebtedness of Chinese companies and its ownership structure:

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<sup>32</sup> A Shleifer and R Vishny, 'A Survey of Corporate Governance' [1997] Journal of Finance Vol. LII No.2 758

<sup>33</sup> A Shleifer and R Vishny, 'A Survey of Corporate Governance' [1997] Journal of Finance Vol. LII No.2 758-759

<sup>34</sup> M Jensen and W Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' [1976] Journal of Financial Economics 3 337

Table D:

#	Company	Debt-to-Equity Ratio	Substantial Shareholder(s) holding shares of 25% or above	Single Shareholder holding shares of 51% or above	Two shareholders combined holding shares of 51% or above
1	Lenovo	107%	√		
2	WH Group	58.21%			
3	Evergrande	208.88 %	√	√	
4	Dalian Wanda	100.4%	√	√	
5	Country Garden	100.45 %	√	√	
6	Tencent	50.53%			
7	New Hope Liuhe	275.05 %	√	√	
8	Fosun International	117%	√	√	
9	BYD	104.48 %	√		√
10	Shimao Property	126.11 %	√	√	
11	Zhongsheng Group	124.62 %	√	√	
12	Digital China	57.65%			
13	Longfor Properties	83.96%	√		
14	Shenzhen Aishidi	80.32%	√	√	
15	Gemdale	53.11%			
16	Agile	116.68 %	√	√	
17	Guangzhou R&F Properties	112.6%	√		√

18	Dasheng	467.88 %			
19	Greentown China	97.1%	√		√

Among the 19 companies that have a debt-to-equity ratio of 50% or above, 14 of them have substantial shareholders who own over 25% of the companies' shares. 12 companies are owned by one or two shareholders who hold over 50% of the companies' shares.

As suggested earlier, although large investors can use their voting power to put forward reform proposals and be a significant source of monitoring power, they may also use such power to give themselves preferential treatment, or to expropriate the wealth of minority shareholders and/or stakeholders. Table D demonstrates there is a link between the indebtedness of Chinese companies and its concentration of ownership. One potential reason for these companies to raise debt is substantial shareholders intend not to dilute their percentage of shares and hence, to maintain their voting power in the company.

As a consequence, not only do majority shareholders have incentives to continue raising debt and increasing the debt level of the company, there is no possible way for other stakeholders to control the indebtedness of the company. When the debt level is high within a company, there are often conflicts between substantial shareholders and debt holders. The risk of financial distress is then borne by debt holders whereas substantial shareholders enjoy unlimited upside benefits. The correlation between the indebtedness of Chinese companies and concentration of ownership suggests it is possible for majority shareholders to use their control to expropriate interests from other stakeholders, especially debt holders. For example, majority shareholders who are working also as senior managers of the company can choose to award themselves with over the top remuneration packages and refuse to pay out dividends. Conversely, minority shareholders fail to enjoy the profits generated by the company.

Furthermore, concentration of ownership may lead to decline of external financing. Creditors and minority shareholders may lose interest in investing in the company for fear their interests would be expropriated by the controlling shareholders.<sup>35</sup> Consequently, while creditors are lending money to the company,

<sup>35</sup> A Shleifer and R Vishny, 'A Survey of Corporate Governance' [1997] Journal of Finance Vol. LII No.2 760

they might be looking at the credibility of the controlling shareholders instead of the company's financial position. When it comes to Chinese companies, this may be even more true as Chinese banks and financial institutions often take substantial shareholders' reputation, their relationship with the institutions, and other personal factors into consideration.

### 3.1.3 The Diminished Effect of Takeovers as Governance Mechanism

Another governance problem caused by concentration of ownership is the effect of takeovers as a corporate governance mechanism is diminished. Some view the threat of being taken over as an incentive to keep managers on their toes, and replacing a poorly performing management team creates synergy that motivates a merger or acquisition.<sup>36</sup> Many believe when the management of the target company is underperforming, to replace them with a new management team is a good way to improve company performance.<sup>37</sup> Arguably, takeovers not only can address corporate governance issues, they are also capable of providing profits and value to shareholders of the post-merger entity.<sup>38</sup> Nevertheless, it should be pointed out that takeover threats may force managers to act "myopically" and focus on achieving short-term performance at the expense of long-term benefits. Furthermore, takeovers may attract some value-reducing raider to gain control over uncoordinated shareholders.<sup>39</sup>

Although the outcome of threats of mergers and takeovers might be uncertain, takeovers as governance mechanism do have some value. However, due to the highly concentrated ownership structure of many Chinese companies, hostile takeovers have become very difficult, if not impossible. Assuming no specific clauses in a company's articles give minority shareholders special voting power, when a small number of substantial shareholders accumulate enough shares, they have sufficient voting power and therefore are capable of defending control in the company.<sup>40</sup> At the extreme where such shareholders own 51% or more shares,

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<sup>36</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 43

<sup>37</sup> B Pettitt and K Ferris, *Valuation of Mergers and Acquisitions* (2<sup>nd</sup> edn Financial Times Press 2013) 7

<sup>38</sup> M Jensen and R Ruback, 'The Market for Corporate Control' [1983] *Journal of Financial Economics* 11 9-10

<sup>39</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 43

<sup>40</sup> A. Shleifer and R. Vishny, 'A Survey of Corporate Governance' [1997] *Journal of Finance* Vol. LII No.2 753

they can dictate the company's policy, which includes the rejection of any friendly or hostile takeover bids.<sup>41</sup> In fact, one of the reasons companies choose to raise funds through debt instead of equity is that shareholders refuse to lose control over the company.<sup>42</sup> The fear of the company being taken over creates further incentives for majority shareholders to finance through debt.

#### **4. Lack of Legal Mechanisms for Minority Shareholders**

Laws and regulations have always had an important role in the protection of minority stakeholders' interests. For example, company law governs the kind of relationship individuals or organisations are entering into with the company; procedural law, on the other hand, ensures legitimate contractual relationships can be enforced by state power, if necessary.<sup>43</sup> Some suggest legal protection is an important way to minimise the effect or efficiency of majority shareholders, or company insiders, to expropriate the interests of other stakeholders. In other words, with weak legal protection, at its extreme, parties who are in control of the company can acquire the company's profit perfectly, at the expense of the interests of other stakeholders.<sup>44</sup>

##### **4.1 Protection Mechanisms for Minority Shareholders**

High debt levels can create conflicts of interest between majority and minority shareholders. Some may argue that if minority shareholders of publicly-traded companies are fearful of being expropriated, they could always choose to leave. One problem with this argument is that these shareholders may face limited investment opportunities and staying with the company may be the best option

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<sup>41</sup> A. Shleifer and R. Vishny, 'A Survey of Corporate Governance' [1997] *Journal of Finance* Vol. LII No.2 755

<sup>42</sup> A. Shleifer and R. Vishny, 'A Survey of Corporate Governance' [1997] *Journal of Finance* Vol. LII No.2 762

<sup>43</sup> M Jensen and W Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' [1976] *Journal of Financial Economics* 3 311

<sup>44</sup> R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, 'Investor Protection and Corporate Governance' [2000] *Journal of Financial Economics* 58 6

available.<sup>45</sup> Hence, it might be in the minority shareholders' interests to turn things right in the company rather than to leave the company once and for all.

In every jurisdiction, there should be mechanisms providing protection to minority shareholders. In general, laws and regulations concerning minority shareholders' protection can come from different sources, including bankruptcy law, company law, securities law, etc. Stock exchanges and securities regulatory bodies also have rules and regulations that companies are required to follow. Yet, laws and regulations can only be effective if they are enforceable.<sup>46</sup> Minority shareholders' interests cannot be duly protected without proper enforcement mechanisms.

When companies are controlled by majority shareholders and are becoming riskier, minority shareholders who feel their interests are harmed may want to have their voices heard. If the managers fail to take their advice into account and the interests of the company or the minority shareholders themselves are violated, they may want to intervene by seeking assistance from regulators and the state. In doing so, the main mechanisms available to them include derivative claims and shareholders' remedies.

Derivative claims allow (usually minority) shareholders to sue on behalf of the company against wrongdoers who have harmed the interests of the company.<sup>47</sup> Shareholders' remedies usually include unfair prejudice petitions, dissolution of the company and compulsory share repurchase. Unfair prejudice petitions are more common in jurisdictions with English common law heritage. For example, § 994(1) of the UK Companies Act 2006 provides that a minority shareholder can bring a petition of unfair prejudice on the grounds that 'the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some parts of its members'<sup>48</sup> or 'any actual or proposed act or omission of the company is or would be prejudicial'<sup>49</sup>.

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<sup>45</sup> S Claessens, S Djankov and L Lang, 'Expropriation of Minority Shareholders in East Asia' (2009) <<http://www1.worldbank.org/finance/assets/images/expropriation.pdf>> accessed 14 July 2016

<sup>46</sup> R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, 'Investor Protection and Corporate Governance' [2000] *Journal of Financial Economics* 58 7

<sup>47</sup> A Dignam and J Lowry, *Company Law* (8<sup>th</sup> edn Oxford University Press 2012) 186

<sup>48</sup> Companies Act 2006 (UK), § 994(1)(a)

<sup>49</sup> Companies Act 2006 (UK), § 994(1)(b)

#### 4.2 Derivative Claims and Shareholders' Remedies in China

China has introduced the Anglo-American style derivative action into its domestic law. Art. 151 of the Chinese Companies Law states if a director, supervisor or senior manager violates any provision of law, administrative regulations, or articles of association, and the company suffers loss due to such violation as provided in art. 149, a shareholder of a limited liability company, or shareholder(s) of a company limited by shares who has held 1% or more of the company's shares for more than 180 consecutive days can make a written request to the company's board of supervisors, or board of directors if the wrongdoer is a supervisor, to commence a legal action against the wrongdoing director or supervisor, on behalf of the company. If the supervisors or directors of the company refuse to commence the action within 30 days, or there is an emergency, the shareholder has the right to commence the action on his own, for the interests of the company.<sup>50</sup> Art. 152 further provides that, if the interest of a shareholder is harmed by the violation of any provision of law, administrative regulations, or articles of association, the shareholder has the right to initiate proceedings against the company on his own behalf.<sup>51</sup>

Although China has a framework for shareholders' derivative action, commentators often find it far from satisfactory. First, the rightful claimant to initiate a derivative action is strictly limited to current shareholders who have been holding the company's shares for a significant period of time. It fails to recognise shareholders who have already left the company yet whose interests might be violated by the company's management. Second, no provision covers the allocation of costs in a derivative action. Cost allocation is a key issue in a derivative action, as minority shareholders sometimes have to be ensured that even if they lose the litigation, the legal costs are covered by the company. This provides incentives for shareholders to act when they believe their interests are harmed by those who control the company.<sup>52</sup>

Third, and most importantly, for listed companies which are incorporated as companies limited by shares, it is difficult for individual shareholders to meet the

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<sup>50</sup> Companies Law of the People's Republic of China 2013, art. 149 and 151

<sup>51</sup> Companies Law of the People's Republic of China 2013, art. 152

<sup>52</sup> J Kirkbride, S Letza and C Smallman, 'Minority Shareholders and Corporate Governance: Reflections on the Derivative Action in the UK, the USA and in China' [2009] *International Journal of Law and Management* 217

1% threshold for *locus standi* to initiate an action. Even in companies where shareholdings are more dispersed, considering the time and effort one needs to gather minority shareholders together, it is still not easy to proceed with a derivative action.<sup>53</sup>

Although the *locus standi* requirements and cost allocations are ways to avoid malicious litigations, at some point they also bar minority shareholders who believe that their company is harmed from achieving justice.<sup>54</sup> Not surprisingly, derivative actions are not popular as a means for minority shareholders in China to seek remedy.

Other the other hand, art. 152 of the Chinese Companies Law provides that if directors or senior managers of the company have breached any law, regulation or provision of the company's constitution, and as a result shareholders' interests are harmed, such shareholders can initiate legal proceedings against the wrongdoers.<sup>55</sup> However, it is equally difficult for shareholders to bring a suit under art. 152. First, in reality, Chinese courts are reluctant to hear cases involving strong and sophisticated defendants, due to political and social reasons. Second, it is likely that shareholders would have to bear the costs of the litigation proceedings. Even if their claims are successful eventually, the cost and efforts required may create disincentives for shareholders.<sup>56</sup>

#### 4.3 Derivative Claims and Shareholders' Remedies in Hong Kong

The legal framework for shareholders' protection in Hong Kong is based largely on its counterparts in English law. The two major ways for shareholders of listed companies in Hong Kong to initiate legal proceedings against wrongdoers who harm either the company or the shareholders themselves (or both) are to initiate derivative claims and/or unfair prejudice petitions. The former is a suit against wrongdoers who harm the interests of the company, in which the company acts as

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<sup>53</sup> Fang Ma, 'The Deficiencies of Derivative Actions in China', [2010] *Company Lawyer* 152

<sup>54</sup> Fang Ma, 'The Deficiencies of Derivative Actions in China', [2010] *Company Lawyer* 155

<sup>55</sup> *Companies Law of the People's Republic of China* 2013, art. 152

<sup>56</sup> Xin Tang, 'Protecting Minority Shareholders in China: A Task for Both Legislation and Enforcement' In (forthcoming) Curtis Milhaupt (ed.) *A Decade after Crisis: Transforming Corporate Governance in East Asia*, London: Taylor & Francis Books  
<<https://www.law.umich.edu/workshopsandsymposia/intlworkshopseries/Documents/Paper%20-%20Tang%20Xin.pdf>> accessed 15 July 2016

the only legitimate claimant. The latter gives minority shareholders remedy for acts or omissions that are made unfairly prejudicial to them, and the shareholders are suing on their own behalf, instead of the company.

When the interests of a company are undermined, only the company itself can become the rightful claimant against any wrongdoer in Hong Kong. This is dictated by the leading English case of *Foss v Harbottle*, that if a harm is done to the company, only the company itself has the *locus standi* to initiate proceedings.<sup>57</sup> However, one exception to the *Foss v Harbottle* rule is derivative claims. The new Hong Kong Companies Ordinance provides a basic structure for derivative claims. Section 732(1) states that if misconduct is committed against the company, with the leave of the court, a shareholder may bring proceedings on behalf of the company.<sup>58</sup> With the leave of court, shareholders can also bring proceedings on behalf of the company if, because of the misconduct against the company, the company fails to bring proceedings in respect of any matter.<sup>59</sup> Section 731 defines “misconduct” as ‘fraud, negligence, breach of duty, or default in compliance with any Ordinance or rule of law’.<sup>60</sup> To encourage shareholders to act if the company suffers from wrongdoing, § 738(3) states that the court may make an order solely about costs in favour of the shareholder if it is satisfied that the shareholder is acting in good faith and has reasonable grounds for bringing or intervening in the proceedings.<sup>61</sup> Kwan (2006) summarises from established case law there are four occasions where shareholders can bring derivative claims on behalf of the company: first, the company is *ultra vires* or is involved in illegal transactions; second, the company has conducted transactions which require special majority; third, the company’s act amounts to fraud on the minority or abuse of power while the wrongdoer is in control of the company; and fourth, the company has conducted transactions or acts which harm shareholders’ rights as conferred by the company’s constitution.<sup>62</sup>

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<sup>57</sup> *Foss v Harbottle* (1843) 67 ER 189

<sup>58</sup> Companies Ordinance of Hong Kong (Cap.622), s.732(1)

<sup>59</sup> Companies Ordinance of Hong Kong (Cap.622), s.732(2)

<sup>60</sup> Companies Ordinance of Hong Kong (Cap.622), s.731

<sup>61</sup> Companies Ordinance of Hong Kong (Cap.622), s.738(3)

<sup>62</sup> Paul Kwan, *Hong Kong Corporate Law* (LexisNexis 2006) 323

It should be noted that the “no reflective loss” rule applies in derivative claim cases in Hong Kong.<sup>63</sup> It is ruled in *Prudential Assurance Co Ltd v Newman Industries Ltd* that a shareholder cannot obtain damages for diminution in share value which reflects a loss suffered by the company. As explained by the English Court of Appeal, this is because the shareholder does not actually suffer personal loss; his “loss” is suffered through the diminution of the company’s value.<sup>64</sup> Thus, even if shareholders suffer from loss in share value, they cannot receive any damages personally.

Similar to the English law, Hong Kong law also allows shareholders to initiate unfair prejudice petitions against the company. The court may grant unfair prejudice remedies when it is satisfied the company’s affairs are conducted in a way which is unfairly prejudicial to the shareholders in general or to one or more shareholders; or an actual or proposed act or omission of the company would be so prejudicial.<sup>65</sup> Although “company affairs” here are not limited to business matters and include capital structure, dividend policy, etc.,<sup>66</sup> it should be noted that mismanagement can hardly be a legitimate reason for the court to grant unfair prejudice remedies. This is partially because the court believes that by investing in the company, shareholders have taken the risk that the management may not be of the highest standard. Also, it is not in the court’s purview to intervene simply because the shareholders are in disagreement with the company’s policies.<sup>67</sup> On top of this, as in the leading case of *O’Neil v Phillips*, the claimant is usually required to show a breach of rules or show the majority shareholders are using the rules in a way regarded as contrary to good faith.<sup>68</sup>

Shareholders also have the right to ask for the court’s permission to dissolve the company if the court finds it is just and equitable to do so.<sup>69</sup> Whether the case is “just and equitable” is determined by the court on a case-by-case basis.<sup>70</sup>

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<sup>63</sup> Paul Kwan, *Hong Kong Corporate Law* (LexisNexis 2006) 309

<sup>64</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204

<sup>65</sup> Companies Ordinance of Hong Kong (Cap. 622), s.724(1)

<sup>66</sup> Paul Kwan, *Hong Kong Corporate Law* (LexisNexis 2006) 1074

<sup>67</sup> *Re Elgindata Ltd* [1991] BCLC 959

<sup>68</sup> *O’Neil v Phillips* [1991] 1 WLR 1092

<sup>69</sup> Companies Ordinance (Winding Up and Miscellaneous) of Hong Kong (Cap. 32), s.177(1)(f)

<sup>70</sup> *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360

Common situations which might trigger a winding-up include: the substratum of the company is gone; the company is used to promote fraudulent and/or illegal purposes; breakdown of mutual trust in a quasi-partnership; a deadlock among shareholders; and occurrence of oppression and misconduct in management.<sup>71</sup> However, the court may strike out the claimant's application on the basis that there is a reasonable offer from the majority shareholder to buyout the claimant's shares.<sup>72</sup>

#### 4.4 Derivative Claims and Shareholders' Remedies in the US

Regarding shareholders' actions, the US legal framework is more complicated. First, the "business judgment rule" is a very significant presumption in US corporate law. The rule recognises the importance of the centralised management of a company, which requires shareholders or judges not to second guess business decisions made by directors or managers.<sup>73</sup> Thus, the court would only intervene when the conduct of directors or managers at least borders on acting fraudulently, illegally or in conflict of interests.<sup>74</sup> In addition, managers are assigned the power to take into account and balance interests of stakeholders other than shareholders. This originated from state-level legislation in the US which allows directors to consider the interests of stakeholders such as creditors, employees, suppliers, customers and the community.<sup>75</sup>

Second, US law distinguishes between derivative and direct actions. The key case of *Tooley* suggests that the court should be looking at whether the company or the suing shareholder suffers from the harm; this shall be determined by the court on the facts of each case.<sup>76</sup> As for derivative claims, rule 23.1 of the US Federal Rules of Civil Procedure suggests that shareholders have rights to initiate derivative action 'to enforce a right that the corporation or association may properly assert but has failed to enforce'.<sup>77</sup> In doing so, such shareholder is

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<sup>71</sup> Paul Kwan, *Hong Kong Corporate Law* (LexisNexis 2006) 1157

<sup>72</sup> *Re Tourmaline Ltd* [2000] 4 HKC 348

<sup>73</sup> C O'Kelley and R Thompson, *Corporations and other Business Associations* (5<sup>th</sup> edn, Aspen Publishers 2006) 236

<sup>74</sup> *Shlensky v Wrigley* [1968] 237 NE 2d 776

<sup>75</sup> C O'Kelley and R Thompson, *Corporations and other Business Associations* (5<sup>th</sup> edn, Aspen Publishers 2006) 242

<sup>76</sup> *Tooley v Donaldson, Lufkin & Jenrette, Inc.* [2004] 845 A.2d 1031

<sup>77</sup> Federal Rules of Civil Procedure (US) Rule 23.1(a)

required to be a shareholder of the company at the time of the transaction being complained of.<sup>78</sup> He would also need to show the effort he made to obtain the desired action from the directors or comparable authority;<sup>79</sup> and the reasons of not obtaining such action or not making such effort.<sup>80</sup> Last but not least, the derivative action would only be maintained when the shareholders ‘fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association’.<sup>81</sup> Direct shareholder claims allow shareholders to bring a claim against the company for their own interests, when the harm is done to themselves instead of the company, as ruled in the *Tooley* case. However, it should be noted that the “business judgment rule” applies to both derivative and direct actions. Thus, it is very difficult to bring a claim against the directors or managers of the company when there is absence of fraudulent or illegal acts committed by such directors or managers.

Other remedies available for minority shareholders include dissolution of the company and repurchase of minority shareholders’ shares. These mechanisms are mostly designed for closed-corporations or small companies which are comparable to partnerships. US courts define such kind of companies as companies with (1) a small number of shareholders; (2) no liquid market for share transfer; and (3) majority shareholders participating in the company’s management and operation.<sup>82</sup> The rationale of supporting claims in closed and small companies is that minority shareholders do not usually have a way to “quit” the company by transferring their shares. This lack of available alternative approach may lead to the majority shareholders exploiting the situation and compelling the minority shareholders to accept the damages they suffer.

The two mechanisms, dissolution and compelling repurchase, are interrelated. The court has discretionary power to order to dissolve a company. Before ordering for a dissolution, the court must be satisfied that it is the only way the claiming minority shareholder can reasonably expect a fair return from his investment or is reasonably necessary to protect their interest.<sup>83</sup> Other shareholders may prevent

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<sup>78</sup> Federal Rules of Civil Procedure (US) Rule 23.1(b)(1)

<sup>79</sup> Federal Rules of Civil Procedure (US) Rule 23.1(b)(3)(A)

<sup>80</sup> Federal Rules of Civil Procedure (US) Rule 23.1(b)(3)(B)

<sup>81</sup> Federal Rules of Civil Procedure (US) Rule 23.1(a)

<sup>82</sup> *Donahue v Rodd Electrottype Co.* (1975) Mass. Sup. Jud. Ct., 328 N.E.2d 505

<sup>83</sup> New York Business Corporations Law s.1104-a(b)

their company from being dissolved by buying out the shares of the claiming shareholder.<sup>84</sup>

#### **4.5 Concluding Remarks on Minority Protection Mechanisms in Hong Kong and the US**

As for derivative claims, judiciaries in Hong Kong and the US both hesitate to intervene in business decisions made by managers and directors. As demonstrated, the use of debt may lead to loss in value in shares when the market conditions are bad, yet, by the same token, it may bring more profits when the market conditions are good. The court would likely conclude that the way capital is structured falls within the category of business judgment.

Both Hong Kong and US law require a derivative action claimant to show that there is a breach of law, fiduciary duty, or articles of association, and the breach leads to loss of interests of the company. In relation to the control of debt, although it might bring damage to the interests of the company and its value, it is difficult to argue that it is caused by breach of rules or duty. It is absolutely legal for managers to decide whether to use debt or other ways to raise capital. As for directors' duties to the company, as long as directors are dealing with the affair with reasonable care and are in good faith, it is unlikely that they will be in breach of their duties.

An unfair prejudice petition under Hong Kong law is unlikely to be adopted in this situation. First, although mismanagement could be a potential cause for a petition for unfair prejudice, it is not likely a court would grant relief, as mismanagement is considered part of the risk an investor undertakes when she invests in a company. Second, the investor is unlikely to prove the "unfair prejudice" element. Although minority shareholders may suffer greater harm from the rise in debt level and risk of financial distress, it has to be proven that majority shareholders have acted in contrary to good faith.

As for the remedy of dissolution, it should be noted that it applies mostly in small, "quasi-partnership" type companies, and is considered the last resort of shareholders' disputes. It is very unlikely that the court would grant such remedy to minority shareholders of listed Chinese companies in Hong Kong or in the US. First, the grounds for dissolution usually require the company to be small in size

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<sup>84</sup> New York Business Corporations Law s.1118(a)

and/or have committed an unlawful act. Second, it is hard to imagine the court would allow Hong Kong or US listed Chinese companies to be dissolved without very sound reasons, due to the impact this would have on society.

## 5. Potential Resolution of the Issue

Remedies available for minority shareholders may not be effective enough for them to intervene in the company's decision making. Currently, both the two main remedies, namely derivative claims and unfair prejudice petitions, are difficult for shareholders to initiate. On the one hand, the difficulty is intentional, with the aim of reducing malicious litigation that might affect the company's operation. On the other hand, however, this limits minority shareholders' power and their incentive to commence legal proceedings when their interests or the interests of the company are violated.

Generally, legitimate business practices include raising debt to a risky level, or, at the extreme, expropriating interests from minority shareholders. The law usually does not get involved in commercial decision making and agencies' conflicts in a company. Some refer to corporate law as an "enabling statute", which means that judges and regulators always take a "hands-off" approach to company affairs. For example, courts with Anglo-American heritage apply the "business judgment rule" and hesitate to intervene in the operation of the company as long as the managers/directors are acting in good faith.<sup>85</sup>

Thus, to reduce the negative effect of gearing on the company and its stakeholders, the three major available remedies are: (1) to use the limited choices of legal and contractual mechanisms that are available mainly for creditors; (2) to put forward reform bills, either to impose stronger regulations on inside controllers, or, (3) ultimately, to amend the legal framework and head towards what might be termed a "stakeholders' society".

### 5.1 Shareholders' Value and Stakeholders' Society

Minority shareholders may commence derivative claims and/or other shareholders' remedies to protect their own interests. However, as demonstrated above, it is not

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<sup>85</sup> F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 2

likely that the court would intervene in the use of debt by the company. Thus, many call for the introduction of a stakeholders' society to replace the conventional shareholders' value position, to protect minority shareholders' interests, as well as the interests of other stakeholders.

The position of shareholder value was famously argued by Milton Friedman (1970). He stated that the responsibility of a business is to maximise its profits, which is in the best interests of its shareholders. First, as managers whose jobs are to run a business for the interests of its shareholders, profit maximisation should be the primary objective. If one would like to devote more time and effort for society, he could use his leisure time or get himself another job.<sup>86</sup> Second, the very reason why an agent is hired by a principal is that the latter expects the former to serve his interests. The duty of an agent to his principal does not require him to take other "social responsibilities".<sup>87</sup> Third, managers are presumably experts in managing businesses; even if they were to take on social responsibilities, how could they perform well in areas in which they are not experts? Fourth, how does the company balance the interests of different stakeholder groups when they are in conflict? Whose interests should the managers prioritise?<sup>88</sup> The main objective of a business is, thus, to maximise profits for the interest of its shareholders.

To mitigate conflicts between different stakeholders' groups, some are in favour of the stakeholders' society concept, which is seen as contrary to the traditional shareholders' value position. A stakeholders' society requires companies to adopt corporate structures and strategies that can take all stakeholders' interests into consideration.<sup>89</sup> Stakeholders usually include creditors, minority shareholders, employees, and the community. Proponents of the concept are usually fond of these following examples: first, companies should not maximise shareholders' interests at the expense of creditors; second, minority shareholders' interests

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<sup>86</sup> Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' *New York Times Magazine* (New York, 13 September 1970) 2

<sup>87</sup> Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' *New York Times Magazine* (New York, 13 September 1970) 3

<sup>88</sup> Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' *New York Times Magazine* (New York, 13 September 1970) 3-4

<sup>89</sup> S Ayuso and A Argandona, 'Responsible Corporate Governance: Towards a Stakeholder Board of Directors?' [2007] IESE Business School Working Paper No.701 2-3

should also be taken into account by the company; third, companies should not lay off employees when they are making large profits.<sup>90</sup>

It is worthwhile to distinguish approaches adopting the stakeholders' society concept and those which do not. Some approaches seem to be beneficial to stakeholders, yet actually aim at shareholders' value maximisation. For example, while providing employees with reasonable remuneration, job security and adequate training is beneficial to employees, they also help the company to build a good reputation, and to attract and retain talented employees, which ultimately helps in maximising shareholders' value.<sup>91</sup> Likewise, when a company spends money on environmental campaigns, it enhances the company's public image and hence improves shareholders' value.

Tirole (2006) points out the stakeholders' society concept usually refers to two views. First, the broad mission of management suggests that managers should maximise the sum of surpluses of different stakeholders' groups. Incentives should be created structurally to motivate managers in doing so. Second, the view of the sharing of control by stakeholders refers mainly to codetermination of different stakeholders, in other words, to include other stakeholders in the company's decision making. The Germanic two-tier board system is a major form of codetermination under such view.<sup>92</sup>

Nevertheless, apart from the arguments stated by Friedman (1970), there are some objections on whether a stakeholders' society is feasible. First and foremost, it is difficult to keep managers accountable and to measure their performance if the company adopts a stakeholders' society approach. Measuring managerial performance based on, for instance, improved welfare of employees is apparently more difficult than measuring how much profit the company makes, or how much return the company brings to shareholders, etc.<sup>93</sup> Second, as different stakeholder groups usually have different goals and objectives, to include every stakeholder group in the decision making process may lead to inefficiencies. It is not easy for stakeholders to arrive at mutually agreed corporate decisions. Managers would

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<sup>90</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 56

<sup>91</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 57

<sup>92</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 58

<sup>93</sup> Jean Tirole, 'Corporate Governance' [2001] *Econometrics* Vol.69 No.1 26

have to spend far more time and effort in balancing the interests of different groups.<sup>94</sup>

The high level of debt in Chinese companies may result in damage in minority shareholders' interests. Although the stakeholders' society approach may theoretically provide solutions to mitigate stakeholders' conflicts, it might not be very effective in reality. First, Chinese companies which are incorporated in China have already adopted the two-tier board system, as required by Chinese law. The supervisory board should be able to supervise and monitor the management board on behalf of stakeholders. However, the debt level of China-incorporated companies remains high and there are still rooms for expropriation of stakeholders' interests. Second, a large number of Chinese companies are incorporated and listed overseas. Many of these companies are operating with an Anglo-American corporate governance structure. Companies with an Anglo-American structure usually have a focus on shareholders' value. US companies, for example, have a culture of pursuing short-term profit maximisation for the interests of its shareholders.<sup>95</sup> Changing management concepts in these companies would require a radical change in corporate culture. Third, although there is seldom law that forbids management to take into account interests of stakeholders, there is seldom law that would force the companies to be responsible to stakeholders either. It is not realistic to expect the law to be amended so significantly; not only because lawmakers would be lobbied by senior managers and substantial shareholders not to pass such a law, but even if such a law is enacted, there would be difficulties in enforcing it.

## 6. Conclusion

The increasing use of debt has put many Chinese companies into a dangerous position. When a company is in a risky financial situation, it may create conflicts of interests between majority and minority shareholders. Concentration of ownership in the measured Chinese companies enables majority shareholders to gain strong control in the company, and become capable of using such power to push up their companies' debt-to-equity ratio. Concentration of ownership may not be a prima facie negative signal, yet the link between the indebtedness of Chinese companies and their concentration of ownership should not be ignored. Minority shareholders' interests can be affected by a company's high gearing

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<sup>94</sup> Jean Tirole, *The Theory of Corporate Finance* (Princeton University Press 2006) 59

<sup>95</sup> David Millon, 'The Two Models of Corporate Social Responsibility' [2011] Wake Forest Law Review 46 528

level. The volatility of share price is one example to examine how the return of shareholders can be undermined. In theory, minority shareholders can seek help from several remedies, yet it is unlikely they would be available for minority shareholders in indebted Chinese companies. Firstly, the management and majority shareholders have not committed an illegal act or omission. Secondly, the reluctance of judicial intervention in corporate decision making makes the initiation of such mechanisms very difficult. Thirdly, the costs and efforts required for commencing such actions may stop shareholders from doing so. It is not easy for minority shareholders to protect themselves from actual or potential loss of interests in the increasing Chinese corporate debt threat. Although it may seem that the introduction of the concept of a stakeholders' society may enhance the welfare of stakeholders, introducing such a radical change in corporate law and culture would inevitably require much time and effort.

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