

Asia-Pacific Office of the CFA Institute Centre for  
Financial Market Integrity

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# Related-Party Transactions

Cautionary Tales for  
Investors in Asia

**A Note on the Use of This Report:**

*Use of terminologies.* Because of variations in nomenclature across jurisdictions in Asia, this report uses the term “related-party transactions” (RPTs) interchangeably with the terms “connected transactions,” “related transactions,” “interested-person transactions,” “intercompany deals,” and “intragroup transactions.”

*Case citations.* This report provides actual cases of related-party transactions that occurred in different markets in the Asia-Pacific region. They were gathered primarily from published reports in major English-language newspapers and websites and secondarily from stock exchange and securities commission websites, academic and other institutions’ papers, proxy statements, and company annual reports. Each case source is attributed in the footnotes; we have not contacted the companies involved in these cases.

*Currencies.* Monetary values relevant to cases found in this report are the values as reported by the source materials. Where a U.S. dollar conversion is provided in parenthesis next to the local currency amount, it is only for reference purposes and is provided using the exchange rate at September 2008.

*Acknowledgments.* The CFA Institute Centre thanks the individuals and institutions that participated in this report and respects their request to remain anonymous.

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# **Related-Party Transactions: Cautionary Tales for Investors in Asia**

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# Introduction

## What are related-party transactions?

A related-party transaction takes place when a deal is entered into by at least two entities—where one has control over the other or where the parties come under the same control of another. The International Accounting Standards Board (IASB) defines it as a transfer of resources, services, or obligations between related parties regardless of whether a price is charged.<sup>1</sup> The Financial Accounting Standards Board (FASB) defines it as a transaction between related parties even though it may not be given accounting recognition; for example, one entity may receive services from a second, related entity without charge and without recording a receipt of services.<sup>2</sup>

*Related-Party Transactions: Cautionary Tales for Investors in Asia* introduces readers to the prevalence of related transactions in the region and how they affect the interests of minority shareholders. Focusing on Hong Kong, China, and South Korea, the report first highlights how the practice and concept of related-party transactions differ between Asia and the West. It then discusses how the nature of such transactions varies according to the different models of concentrated ownership within the region. Through examples of actual cases, the report identifies some of the ways related transactions have disadvantaged minority investors and then explores how effective the prevailing systems of checks and balances have been in protecting minority investors. Finally, the report explores how these protective systems could be improved.

The following exhibits outline the two standard setters' definitions of related parties and their examples of common related-party transactions.

### Exhibit 1A. Definitions of "Related Party"

Financial Accounting Standards Board (FASB) Definition	International Accounting Standards Board (IASB) Definition
<ul style="list-style-type: none"> <li>a) Affiliates of an enterprise</li> <li>b) Entities for which investments in their equity securities would be required to be accounted for by the equity method by the enterprise</li> <li>c) Trusts for the benefits of employees, such as pension and profit-sharing trusts that are managed by or are under the trusteeship of management</li> <li>d) Principal owners of the enterprise</li> <li>e) Its management</li> <li>f) Members of the immediate families of principal owners of the enterprise and its management</li> <li>g) Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests</li> </ul>	<ul style="list-style-type: none"> <li>a) Parties related through control (parent companies, subsidiaries, and fellow subsidiaries) or parties with joint control or significant influence over the entity</li> <li>b) Associates</li> <li>c) Joint ventures</li> <li>d) Key management personnel</li> <li>e) Close members of families or individuals referred to in (a) or (d)</li> <li>f) An entity where any individuals referred to in (d) or (e) above jointly control, significantly influence, or hold significant voting power in the entity</li> <li>g) Post-employment benefit plans for the benefit of employees of the entity or related parties of the entity</li> </ul>

<sup>1</sup>IASB, "Amendments to IAS 24 *Related Party Disclosures*," International Accounting Standards Board (June 2008):3 (<http://www.iasb.org/NR/rdonlyres/5D737095-AA21-43F7-8D93-220FEA370807/0/RPDProjectUpdateJune08.pdf>).

<sup>2</sup>FASB, Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, Financial Accounting Standards Board (March 1982):4 ([www.fasb.org/pdf/fas57.pdf](http://www.fasb.org/pdf/fas57.pdf)).

**Exhibit 1B. Examples of Related-Party Transactions**

FASB RPT Examples	IASB RPT Examples
<ul style="list-style-type: none"> <li>a) Sales, purchases, and transfers of realty and personal property</li> <li>b) Services received or furnished, such as accounting, management, engineering, and legal services</li> <li>c) Use of property or equipment by lease or otherwise</li> <li>d) Borrowings and lendings</li> <li>e) Guarantees</li> <li>f) Maintenance of bank balances as compensating balances for the benefit of another</li> <li>g) Intercompany billings based on allocations of common costs</li> <li>h) Filings of consolidated tax returns</li> </ul>	<ul style="list-style-type: none"> <li>a) Purchases or sales of goods</li> <li>b) Purchases or sales of property and other assets</li> <li>c) Rendering or receiving of services</li> <li>d) Leases</li> <li>e) Transfers of research and development</li> <li>f) Transfers under license agreements</li> <li>g) Transfers under finance agreements (including loans and equity contributions in cash or in kind)</li> <li>h) Provisions of guarantees or collateral</li> <li>i) Settlement of liabilities on behalf of the entity or by the entity on behalf of another party</li> </ul>

Sources 1A and 1B: FASB Statement of Financial Accounting Standards (FAS) No. 57, *Related Party Disclosures*; IAS 24, *Related Party Disclosures* Technical Summary.

The concept of control underscores these definitions. IAS 24, the standard after which most local accounting rules in Asia are patterned, considers parties related if one has “the ability to control the other, or to exercise significant influence or joint control over the other party, in making financial and operating decisions.” FAS No. 57, meanwhile, defines control more broadly as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.” Regardless of the nuances in both definitions, parties that figure in related transactions are often management, principal owners, immediate families, and affiliates.

### Why related-party transactions, and why now?

International investors have been investing in Asia for decades. First, any listed Asian company that is big and liquid enough to be on the radar of foreign investors is likely to be a part of a larger business group, either as its flagship or as one of its affiliates. Some of its affiliates may also be listed, while others are privately held. Second, ownership of a typical Asian conglomerate is likely to be concentrated in a single group: a family or the state. In family-controlled entities, senior management and board positions, including chair and chief executive, are often filled by family members. In state-controlled entities, these roles are filled by political appointees. In other words, if there is such a thing as an Asian business model, it is that the business is managed by a dominant shareholder who also has controlling ownership in other, often diverse, interests.

These affiliations formed under the umbrella of common ownership are not just on paper; they are exploited as needed. The dominant control structure makes it easy for related-party transactions to take place, especially when some of the entities complement or exist to support the operations of others.

For example, NWS Holdings is a HKD15 billion-a-year<sup>3</sup> (USD1.9 billion) Hong Kong-based group engaged in infrastructure development in the city and other parts of China. The listed company has a “master services agreement” in which affiliates agree to provide services—from construction and landscaping to engineering, security, and guarding—to one another. These agreements are not unique. Review any component of a stock index in Asia—from a bank in China, to a carmaker in India, to a paper mill in Indonesia—and the analyst will be hard pressed to find one that is completely independent, with no ownership affiliation to another corporate entity.

<sup>3</sup>Consolidated revenues for the year ending 30 June 2007.

Related-party transactions are legitimate activities and serve practical purposes:

- They are recognized in corporate and taxation laws.
- They have their own standards for accounting treatment.
- Systems of checks and balances have been built around them to make sure they are conducted within these boundaries.

Continuing connected transactions, such as those of NWS Holdings, are supposed to have prior consent of shareholders and be subject to disclosure and ceilings in contract values to ensure that they are conducted under terms that would not expropriate wealth from minority shareholders.

But in corporate structures where no separation of ownership and control exists, related-party transactions can be tainted with conflicts of interest that could shortchange unwitting investors. A listed company could deposit its surplus cash to its unlisted parent for an indefinite period, denying itself and its minority shareholders the opportunity to generate higher returns through strategic investments. Or, it could buy assets from an unlisted affiliate at an inflated price, a clear form of channeling the fortunes of a public entity into the private interests of the same controlling shareholder. Indeed, connected transactions in Asia have been known as a common tool for dominant shareholders to expropriate wealth from minority investors.

Not surprisingly, related-party transactions also have been proven to undermine corporate value. A study of mainland Chinese companies in 2004 found that the more frequently a company engaged in connected transactions, the lower its firm value dropped.<sup>4</sup> A study in 2005 found that companies that granted loans to related parties also received lower market valuations than did companies that either minimized or avoided the practice entirely.<sup>5</sup> Moreover, a study in 2006 concluded that Hong Kong-listed companies experienced “negative abnormal [stock] returns” by simply making an announcement of a connected transaction.<sup>6</sup> These studies suggest that although related-party transactions are not necessarily abusive, they can negatively affect shareholder value just by virtue of being related.

## Relating RPTs to the Asian crisis

Although related-party transactions have long been a standard feature of the Asian business landscape, the degree of risk associated with RPTs emerged only after the breakout of the financial crisis in 1997. That crisis highlighted the one characteristic flaw in the business model that family-controlled businesses in Asia had pursued until then: the emphasis on growth over profitability pursued through aggressive diversification and funded by aggressive borrowing. As currencies crumbled, overly leveraged companies defaulted on their debts, putting pressure on other affiliates—healthy or weak—that acted as their lenders, co-lenders, or guarantors. Minority shareholders could only watch aghast as companies tried to expropriate funds in order to remain viable and engaged in such actions as making improper transfers of cash or assumptions of debt, purchasing assets at inflated prices, and making outright bailouts of failing subsidiaries.

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<sup>4</sup>Qiao Liu and Zhou Lu, “Earnings Management to Tunnel: Evidence from China’s Listed Companies,” working paper (Hong Kong University of Science and Technology, February 2004): [http://www.hiebs.hku.hk/working\\_paper\\_updates/pdf/wp1097.pdf](http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1097.pdf).

<sup>5</sup>Guohua Jiang, Heng Yue, and Charles M.C. Lee, “Tunneling in China: The Surprisingly Pervasive Use of Corporate Loans to Extract Funds from Chinese Listed Companies,” Research Paper Series #31-06, Cornell University, Johnson School of Management (November 2005):19–20 ([http://www.baf.cuhk.edu.hk/research/cig/pdf\\_download/JLY\\_060221\\_CUHK.pdf](http://www.baf.cuhk.edu.hk/research/cig/pdf_download/JLY_060221_CUHK.pdf)).

<sup>6</sup>Yan-leung Cheung, P. Raghavendra Rau, and Aris Stouraitis, “Tunneling, Propping and Expropriation: Evidence from Connected Party Transactions in Hong Kong,” Working Paper No. 9/2004, Hong Kong Institute for Monetary Research (May 2004):13 ([http://www.hkimr.org/cms/upload/publication\\_app/pub\\_full\\_0\\_2\\_83\\_wp200409\\_text.pdf](http://www.hkimr.org/cms/upload/publication_app/pub_full_0_2_83_wp200409_text.pdf)).





# When Insiders Deal

## Reaping the benefits with the challenges

Governed by transfer-pricing rules, most related-party transactions are institutionalized activities that oil the gears of business groups globally. Related activities may include leasing of property, sharing of assets and resources, group procurement to take advantage of economies of scale, shared-service arrangements for back-office functions, intercompany financing, and other treasury management techniques.

## The good news

The first benefit that related-party transactions can offer is contracting efficiency. Related parties can be spared the obstacles or delays that often occur in negotiating contracts with third parties. Conceivably, related parties can draw up contracts with each other more quickly than they can with non-related entities. Such arrangements are especially convenient for those in the business of providing a variety of services; dealing with related companies can help them avoid the delays often experienced with third-party suppliers. For a contract manufacturer, for example, connected transactions can be a key element to the formation of a vertically integrated business model. These companies, as well as their clients, consider it a strategic and cost advantage that they are able to control their inventory and processes without the risk of surprises from unpredictable suppliers.

Hong Kong's Yue Yuen Industrial (Holdings) Limited is an example. This maker of footwear and apparel for Nike and other brands contracts with Taiwan-listed Pou Chen Corporation as well as unlisted Golden Brands Developments Limited—both controlled by the Tsai family, its substantial shareholder—for raw material supplies and services ranging from leather tanning to provision of dormitory accommodations for its workers.<sup>7</sup> These transactions are conducted under normal commercial terms, independently audited, and appropriately disclosed to or approved by minority shareholders; thus, they can be a superior option to the uncertainty that comes with dealing with unfamiliar third parties who may not follow the stringent workplace standards of Yue Yuen's image-conscious clients.

A second potential benefit of related-party transactions is strategic feedback. Persons affiliated with the company may be able to provide relevant knowledge if they represent certain groups with whom the company does business. A company with a large number of suppliers, customers, and advisers may need to nominate individuals to the board who are aligned with these entities to ensure that the company has the expertise it needs to make reasoned decisions.<sup>8</sup> A convenience store chain, for example, may have a franchisee on its board of directors to make sure that it gets ready feedback on how its planned branding campaign would affect franchisees; a supplier, meanwhile, could provide insights on how logistical changes would alter the supply chain.<sup>9</sup>

A third benefit of RPTs is the facilitation of investment. A distressed medium-sized company listed in the secondary board, for example, may find itself with limited access to bank credit lines; as such, it may resort to a loan from a wealthy officer or board member who has superior knowledge of its financial and operating prospects.<sup>10</sup>

<sup>7</sup>Yue Yuen Industrial (Holdings) Limited, "2007 Annual Report," (2007):26–27, 101–105 (<http://202.66.146.82/listco/hk/yueyuen/annual/2007/ar2007.pdf>).

<sup>8</sup>As recommended in *The Corporate Governance of Listed Companies: A Manual for Investors* (Charlottesville, VA: CFA Institute Centre for Financial Market Integrity, 2005):14–16, 18–19 (<http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n6.4003>).

<sup>9</sup>Michael Ryngaert and Shawn Thomas, "Related Party Transactions: Their Origins and Wealth Effects," (September 2007):6 (<http://ssrn.com/abstract=970689>).

<sup>10</sup>Ibid.

## The bad news

Nonetheless, there are pitfalls in related-party transactions; the line between what is legitimate and abusive can be crossed easily. In a structure like Yue Yuen's, the listed entity may agree to pay an unlisted affiliate above-market prices for its goods or services or buy the affiliate's assets, even if they add no strategic value to the first entity's operations. Again using the convenience store scenario as an example, the company could contract with its franchisee on the board (who might also be a relative of a senior manager) as a consultant and overpay him for his advice. In the case of the distressed company, the loan could come with a provision that dilutes the ownership of minority shareholders, such as by giving the officer or director the right to purchase shares of the company at a preferential price.

How bad can related-party transactions get? At their worst, these transactions played a key role in some of the most spectacular corporate failures in recent memory, which, in turn, were responsible for wiping out billions of dollars in shareholder value and denting overall investor confidence in the capital markets.

## Sample cases

A case that fully encapsulates both the benefits and challenges of the Asian family business model may be found in the history of the Sinar Mas Group of the Widjaja family of Indonesia. Its founder started the business in 1969 by investing in a cooking-oil plant and then diversified gradually into palm oil, pulp and paper, and financial services. In 1999, the Jakarta-listed Bank Internasional Indonesia, of which the Widjaja family had owned 89 percent, was recapitalized and taken over by the Indonesian government after the bank collapsed under the weight of bad loans. At the time of its recapitalization, the bank was found to hold USD1.2 billion in outstanding loans to subsidiaries of the Sinar Mas Group, equivalent to 52 percent of the bank's total loans.<sup>11</sup> Another Widjaja-controlled bank, the privately held BII, faced a liquidity crunch when it was unable to return the deposits of two Singapore-listed affiliates because it had lent them on to two other struggling affiliates.

That was only the beginning. In 2001, Asia Pulp & Paper (APP), the Sinar Mas Group's flagship that was then listed on the New York Stock Exchange, defaulted on a staggering USD13.4 billion in debt. The company had an attractive profile: With USD3 billion in sales and state-of-the-art facilities throughout Asia, it was the largest player in its industry. But a 20 percent drop in global paper prices drove APP to default on its loans, which then caused the crash of its stock price to 12 cents (from USD15 in 1995)<sup>12</sup>, its eventual delisting, and its litigious restructuring.

During the restructuring, the auditing firm KPMG reported numerous questionable related-party transactions within the Sinar Mas Group. In 2000, advances worth USD504 million were made by APP subsidiaries to two other subsidiaries, which, in turn, paid USD182 million to buy tracts of land from the Widjaja family at a time when they told creditors they were facing a cash crunch. In 2001, two subsidiaries renewed pulpwood purchase agreements with two other subsidiaries at agreed prices that were not pegged to production costs. One subsidiary was also not allowed to offset the loans it extended to the subsidiary from which it bought pulpwood. Furthermore, auditors found that five companies registered in the British Virgin Islands, later discovered to be APP affiliates, owed the company USD1 billion; however, APP discontinued its claims against them because "it was better to focus our efforts on more substantial claims."<sup>13</sup>

APP completed its restructuring in April 2005 and remains one of the largest pulp-and-paper producers in the world. Most of Asia's family-owned conglomerates have also since recovered by exercising more prudent financial management.

<sup>11</sup> Bambang Setiono, "Debt Settlement of Indonesian Forestry Companies," Center for International Forestry Research (2007):20 ([http://www.cifor.cgiar.org/publications/pdf\\_files/Books/BSetiono0701.pdf](http://www.cifor.cgiar.org/publications/pdf_files/Books/BSetiono0701.pdf)).

<sup>12</sup> Michael Shari, "Asia's Worst Deal," *BusinessWeek* (13 August 2001): [http://www.businessweek.com/magazine/content/01\\_33/b3745003.htm](http://www.businessweek.com/magazine/content/01_33/b3745003.htm).

<sup>13</sup> ADB, "Part Three: Case Study – Asia Pulp & Paper Group," in *Promoting Regional Cooperation in the Development of Insolvency Law Reforms* (Manila, Philippines: Asian Development Bank, 2008):15 (<http://www.adb.org/Documents/Reports/Insolvency-Law-Final-Report/part03.pdf>).

History, however, does repeat itself.

In January 2007, the Taiwanese government took over a privately owned retail bank and a financing firm that had collapsed after two listed companies controlled by their majority shareholder, the Rebar Group owned by the Wang family, declared insolvency in December 2006. Chia Hsin Food and Synthetic Fiber Company owed TWD19.9 billion (USD618 million), and China Rebar Company, which had interests in insurance and broadband, owed TWD20.7 billion (USD643 million).<sup>14</sup> Accused of embezzling billions, the couple that founded the Rebar Group fled to California; their children, who ran most of the group's businesses, were detained for various allegations, including fraud.<sup>15</sup>

### ***A Confucian Legacy: Illustrating Asia's three ownership models***

A discussion of related-party transactions can be better appreciated when framed in the context of how the parties involved became related. In Asia, the concept of related party carries a deeper meaning than its legal definition. One characteristic that binds East Asian cultures together is the Confucian tradition that supports a hierarchical system of social relations and emphasizes the value of family and filial piety.<sup>16</sup> The latter is particularly strong: To this day, pursuit of personal interest that goes against the family's interest (often set by its figure of authority) is frowned upon; discord results in the loss of face. Ingrained in the population's psyche, this principle has translated into the way Asia's corporate sector has evolved and been governed.

For political and economic reasons, the ownership structure of Asian business groups has varied by country. The CFA Institute Centre believes there are now three distinct ownership models observable in Asia. In the state-ownership model—predominant in China but also in countries with a number of semi-privatized assets, such as Pakistan, the Philippines, Indonesia, and Thailand—a government proxy, such as an industry regulator or an asset management company, sits atop an army of business interests. In the circular-ownership model unique to Korea, companies within a group own stakes in one another in a complex web of ownership arrangements. (This model is different from the cross-shareholding model known to Japan, in which two companies mutually own stakes in each other. Although this practice also exists in Korea, it has been banned since 2002 among *chaebols* with assets in excess of KRW2 trillion.) In the holding company model—prevalent across Asia but best exemplified in Hong Kong—a family, usually led by a founding male figure, controls an umbrella entity that owns a cascade of subsidiaries.

#### **State-ownership model**

In China, the government remains the majority shareholder of almost all listed companies. Each industry (e.g., telecommunications) will have one umbrella entity, often the ministry that regulates it, with a number of holding companies (e.g., China Telecom Corporation, China Mobile) that operate nationally through subsidiaries, usually in partnership with the local government (e.g., China Mobile Guangdong, China Mobile Zhejiang). It is not uncommon for units of one government agency to hold tiny stakes in the businesses of another.

Often, the entities that get listed in China are those that are doing well financially. They may have been in operation for years or were newly incorporated to house the good assets carved out of various existing companies in the group. Unlike privatizations in most countries, the Chinese government, often through an asset-management company, retains a substantial amount of ownership in the listed company. Prior to 2005, these shares were classified as “non-tradable shares”—that is, the state could not sell its shares to the market without due legislation. (In 2005, non-tradable shares accounted for 63.51 percent of all outstanding stock.<sup>17</sup>) Under this scenario,

<sup>14</sup>Jimmy Chuang, “Two Held as Rebar Scandal Lumbers On,” *Taipei Times* (12 January 2007): <http://www.taipetimes.com/News/front/archives/2007/01/12/2003344404>.

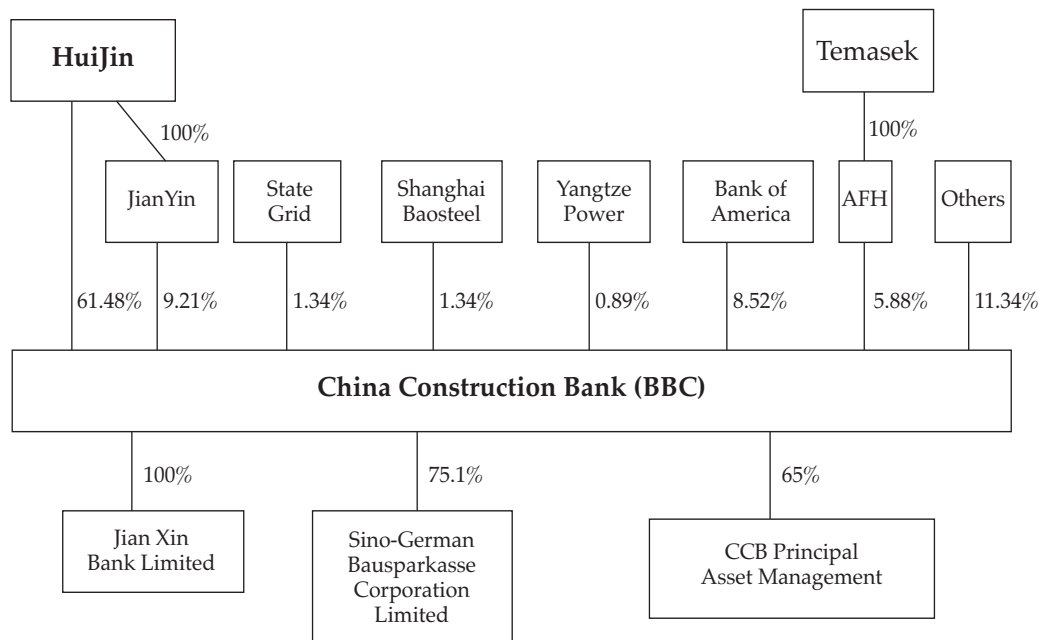
<sup>15</sup>Vivian Wai-yin Kwok, “Taiwan Pays HSBC to Take Bust Bank Off Its Hand,” *Forbes.com* (14 December 2007): [http://www.forbes.com/markets/2007/12/14/hsbc-chinese-bank-markets-equity-cx\\_vk\\_1214markets02.html](http://www.forbes.com/markets/2007/12/14/hsbc-chinese-bank-markets-equity-cx_vk_1214markets02.html).

<sup>16</sup>Sang-Woo Nam, “Business Groups Looted by Controlling Families, and the Asian Crisis,” Research paper 27, ADB Institute (November 2001):5–6 (<http://www.adbi.org/files/2001.11.rp27.controlling.families.crisis.pdf>).

<sup>17</sup>Guohua Jiang, Heng Yue, and Charles M.C. Lee, “Tunneling in China: The Surprisingly Pervasive Use of Corporate Loans to Extract Funds from Chinese Listed Companies,” Research Paper Series #31-06, Cornell University, Johnson School of Management (November 2005):5 ([http://www.baf.cuhk.edu.hk/research/cig/pdf\\_download/JLY\\_060221\\_CUHK.pdf](http://www.baf.cuhk.edu.hk/research/cig/pdf_download/JLY_060221_CUHK.pdf)).

the government had, in theory, no interest in the current share prices of listed entities, and by extension, in minority shareholders' interests. To align these interests, China undertook a swift share-reform program, converting non-tradable into tradable shares. This process was completed in 2007. As a matter of policy, however, the government still tightly holds its shares in state-owned enterprises (SOEs).

**Figure 1. Ownership in China Construction Bank after Its IPO in 2004**



Source: Based on information from Joseph Fan, "Controlling Problematic Related Party Transactions of Banks in Asia," Presentation before OECD & BIS Seminar on Corporate Governance for Banks in Asia, Hong Kong (19–20 June 2006):30 (<http://www.oecd.org/dataoecd/50/1/37178522.pdf>).

### Circular-ownership model

In Korea, the corporate landscape is dominated by *chaebols*—powerful, family-controlled conglomerates that started in the 1950s and were encouraged by the economic initiative of the former military state. After the Second World War, the *chaebol* was considered by the government as key to the country's transformation from an agrarian to an industrial economy. One of the main characteristics of the present *chaebol* is its matrix of circular ownership among affiliates: Companies own shares in one another, with the founding family looming over them, but there is no clear holding company. To a certain extent, this is similar to the *keiretsu* structure of Japan, which also evolved after the war and was also meant to block foreign shareholders from taking over domestic players.<sup>18</sup>

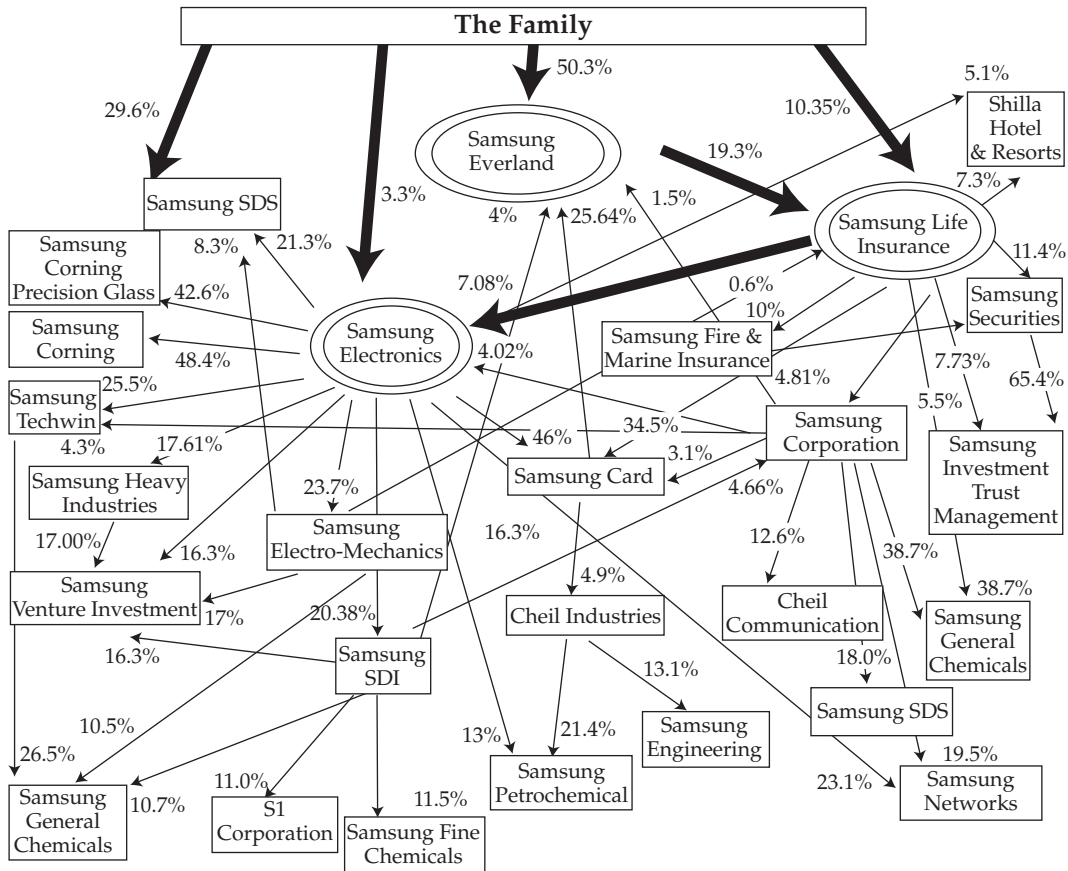
What differentiates the *chaebol* and the *keiretsu* is their relationship with banks. Both conglomerate structures funded their growth primarily through bank loans. Japanese banks took equity ownership in their borrowers, in part as a way of ensuring that the companies stayed capable of repaying their debts. This helped the transformation of the pre-war *zaibatsu*—or family-owned businesses—into the current *keiretsu*, which has a more diversified ownership that is typically free from the influence of a single family. Apart from banks, key customers and suppliers also owned blocks of shares in the *keiretsu*—a situation that exists to this day. Korean banks, however, did not demand ownership in their borrowers, in part because the favorable treatment the government extended to *chaebols* gave them the assurance that these industrial groups would not fail.<sup>19</sup> As such, *chaebol* ownership remained in the hands of the founding families.

<sup>18</sup>Randall Morck and Masao Nakamura, "Been There, Done That. The History of Corporate Ownership in Japan," Finance Working Paper No. 20/2003, European Corporate Governance Institute (July 2003): [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=422120](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=422120).

<sup>19</sup>Yitae Kim, Kwangwoo Park, Ronald A. Ratti, and Hyun-Han Shin, "Do Main Banks Extract Rents from their Client Firms?" Working Paper Series 2002-9, Hitotsubashi University Center for Economic Institutions (June 2002): <http://cei.ier.hit-u.ac.jp/working/2002/2002WorkingPapers/wp2002-9.pdf>.

In 1972, the Korean government introduced an act that induced *chaebols* to go public in order to diversify their ownership base. On top of the public offer, companies were required to set aside at least 20 percent of shares for their employees.<sup>20</sup> To retain control, family owner-managers arranged for the group businesses to take equity in one another through complex circular ownership, thereby giving them a disproportionate amount of voting rights relative to their cash-flow rights. According to 2005 data from the Korea Fair Trade Commission (KFTC), these circular holdings allowed controlling families to exercise an average of 69 percent of voting rights in individual *chaebol* affiliates despite owning only 22 percent of their shares.<sup>21</sup>

**Figure 2. The Lee Family's Samsung Dynasty**



Source: Based on information from Mark Mobius, Presentation before the Brazilian Institute of Corporate Governance (February 2005):52 (<http://www.ibgc.org.br/Download.aspx?Ref=Eventos&CodArquivo=106>).

<sup>20</sup>Kwang S. Chung and Yen Kyun Wang, "Republic of Korea" chapter in *Corporate Governance and Finance in East Asia*, edited by Juzhong Zhuang, David Edwards, and Virginia A. Capulong (Manila, Philippines: Asian Development Bank, 2001):112 ([http://www.adb.org/Documents/Books/Corporate\\_Governance/Vol2/vol2.pdf](http://www.adb.org/Documents/Books/Corporate_Governance/Vol2/vol2.pdf)).

<sup>21</sup>E. Han Kim and Woonchan Kim, "Corporate Governance in Korea: A Decade after the Asian Financial Crisis," Law and Economics Research Paper No. 123, University of Texas Law (December 2007):11 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1084066](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1084066)).

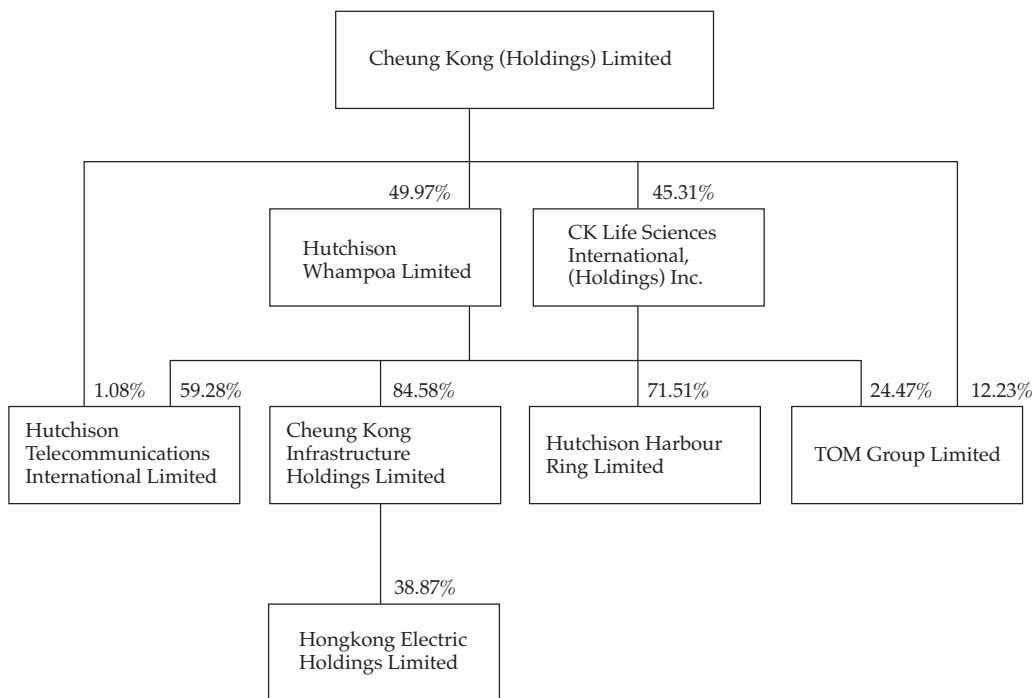
### Holding company model

The structure of Hong Kong conglomerates is simpler to illustrate, taking the form of a pyramid with the controlling family at the top exerting influence over a number of businesses at the bottom through a handful of key interests in between.

Unlike the *chaebol's* circular matrix, ownership in Hong Kong's pyramidal conglomerates is generally one-directional. A controlling shareholder—in some cases still the founding patriarch, in others the second generation—owns the largest block of shares in a holding company, which, in turn, holds the largest block in a handful of key subsidiaries. These subsidiaries may in turn be group companies in themselves, forming smaller units in charge of various aspects of the enterprise. This structure may cascade further down, but rarely does a second- or third-level subsidiary own shares in an entity at the same level as itself; it is even rarer for a subsidiary to have a stake in an entity above it. Like *chaebols*, however, pyramiding also helps preserve the control of the shareholder at the top of the pyramid over the entities at the bottom.<sup>22</sup>

The characters at the top of the pyramid—the founding patriarch and the family as a whole—often maintain their ownership in the holding company in a few ways. The founder may hold his shares directly or through a privately held entity; members of his family may hold their interests through one or more trusts. A 2003 study found that 81.17 percent of companies in Hong Kong are family controlled (where a family is the largest shareholder owning at least 10 percent of outstanding shares), which is far greater than the average of 48.85 percent for the rest of East Asia. Almost all companies adopted pyramid structures to exert corporate control, with the majority having the listed entity at the first layer of the control pyramid.<sup>23</sup>

**Figure 3. How Li Ka-Shing Controls Hong Kong's Most Valuable Conglomerate**



Source: Based on information in Cheung Kong (Holdings) Limited, "Group Structure," website figure, Cheung Kong (Holdings) Limited (31 October 2008): [http://www.ckh.com.hk/eng/about/about\\_group.htm](http://www.ckh.com.hk/eng/about/about_group.htm).

<sup>22</sup>Larry H.P. Lang, C.K. Low, and Raymond W. So, "Economic Analysis Co-Relating the Performance of Listed Companies with their Shareholders' Profile," Chinese University of Hong Kong (April 2003):2-3 ([http://www.cr.gov.hk/en/standing/docs/economics\\_e.pdf](http://www.cr.gov.hk/en/standing/docs/economics_e.pdf)). "Suppose Family X owns 51 per cent of company A, which owns 51 per cent of company B, which owns 51 per cent of company C, which owns 50 per cent of company D. The family therefore controls 50 percent of the shares of D (the smallest holdings in the control chain). However, its ownership stake is only 6.7 per cent (multiplication of all ownerships, i.e. 51% x 51% x 51% x 50% = 6.7%) because of the pyramiding."

<sup>23</sup>Ibid.

# Conglomerates

## What's different about related-party transactions in Asia?

Paul Chow, chief executive of the Hong Kong Exchanges and Clearing Limited (HKEx), offers this brief but precise summary of what differentiates related-party transactions in Asia from those in the West: "In Hong Kong, most companies are family-owned, so we have to put our corporate governance emphasis on connected transactions between the major shareholders and the companies. This is different from the Western world where they have a more diversified shareholding structure, so their corporate governance measures focus on management behavior."<sup>24</sup> Although Chow refers only to Hong Kong, the idea also applies to other publicly listed, family-controlled businesses in Asia because most of them share the same characteristic of having concentrated ownership.<sup>25</sup> It also applies to China, where majority ownership falls on one entity: the state.

In key developed markets, like those in the West, listed companies are more likely to have diffused ownership and no group affiliation. Senior executives are not likely to have been significant investors before assuming their posts, and the majority of the board of directors are likely to be independent of senior management. In short, there is a separation of ownership and control. Related transactions in these circumstances are, therefore, different in nature and motivation from those in Asia. They are more likely to create business opportunities between a company and its senior executives, and they are often commercial or financial transactions between a listed company and any of its controlling shareholders' other business interests.

In the United States, a study of disclosures from 1,261 companies found that most related transactions prior to the enactment of the Sarbanes–Oxley Act of 2002 (SOX) took place between corporations and individual managers.<sup>26</sup> Of these, the majority was in the form of loans—from employment-related loans to officers (such as housing and stock-purchase loans), to loans extended to directors, officers, and major shareholders for various uses. Loans to these individuals numbered more than loans to such investments as joint ventures. They also outnumbered other business activities, such as sales and research and development. From this one may assume that related-party transactions in the United States before SOX had been motivated by personal enrichment, either directly or through earnings management in order to inflate results; presumably, directors' bonuses were a factor as well.<sup>27</sup>

In Asia, a look at relevant disclosures in the annual report of a typical listed company will support academic findings that most related transactions are made not between a company and its officers but between the company and other corporate entities. Following are disclosures of related-party transactions at the Hong Kong Stock Exchange (HKSE) on 18 and 19 September 2008.

<sup>24</sup>"Poor Governance Report Rejected," *South China Morning Post* (9 September 2004).

<sup>25</sup>Stijn Claessens, Simeon Djankov, Joseph Fan, and Larry Lang, "Expropriation of Minority Shareholders: Evidence from East Asia," Working Paper No. 2088, World Bank Policy Research (June 1999):27 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=620647](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=620647)). Authors find the following ultimate control rights of the single largest shareholder in Hong Kong, 28.08%; Indonesia, 33.68%; Japan, 10.33%; Korea, 17.78%; Malaysia, 28.32%; Philippines, 24.36%; Singapore, 27.52%; Taiwan, 18.96%; Thailand, 35.25%.

<sup>26</sup>Mark Kohlbeck and Brian Mayhew, "Related Party Transactions," AAA 2005 FARS Meeting Paper:91 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=591285](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=591285)).

<sup>27</sup>"Sarbanes-Oxley Act of 2002," University of Cincinnati College of Law (2002): <http://www.law.uc.edu/CCL/SOact/sec402.html>. Section 402 of the Sarbanes–Oxley Act now prohibits personal loans to directors and executive officers.

**Exhibit 2. Samples of Related-Party Transactions Disclosed to the HKSE**

Listed Company	Nature of Disclosed Transaction
C Y Foundation Group	Acquisition of 100 percent of a company owned by chairman and his spouse
Wo Kee Hong (Holdings) Limited	Purchase of a unit of vintage Ferrari from a director and controlling shareholder
Great Wall Motor Company	Acquisition of companies in China
China Resources Logic	Acquisition of China Resources Gas
Sino Union Petroleum and Chemical International	Acquisition of HKD600 million worth of shares from the chair of the board
Central China Real Estate	Acquisition of 100 percent of CCRE Forest Peninsula from a connected person
Lippo China Resources	Joint announcement of continuing connected transactions (tenancy agreement)
Hong Kong Chinese	
Honghua Group	Continuing connected transactions (sales and purchases framework agreements)
Advanced Semiconductor Manufacturing Corporation	Continuing connected transactions (product sales, technology transfer, and software licensing)
Zhongda International Holdings	Continuing connected transactions (sales of products and raw materials)

Naturally, the motivation behind the use of each model of related transactions is different. One such motivation already described is contracting efficiency, which could work to the minority shareholders' advantage if it translates to good operating results. Another motivation—to maintain control of companies within the group—is not as clear-cut. Some companies, for example, have chosen to raise capital by selling securities to related parties instead of external investors, leaving doubts as to whether they would have received a better deal otherwise. Others have simply chosen to finance new ventures with intragroup funds instead of seeking strategic partners. Ultimately, expropriation of wealth from minority shareholders is also a motivation; volumes of studies associate expropriation with the Asian conglomerate business model.<sup>28</sup>

**China**

Related-party transactions are inherent to companies in a centrally planned economy. Where the state owns every business entity, all companies are by definition affiliated; conducting business transactions with one another at an arm's length is an alien concept. A coal mining company may transport its haul through a railway operator in order to meet the needs of a power-generating company, and with all of them being ultimately controlled by the state, a proper accounting of the costs of goods and services exchanged may be the least of their priorities—especially where a profit motive does not exist.

<sup>28</sup>Stijn Claessens, Simeon Djankov, Joseph Fan, and Larry Lang, "Expropriation of Minority Shareholders in East Asia," Working Paper No. 2000-4, Center for Economic Institutions Working Paper Series (July 2000):5–6 (<http://cei.ier.hit-u.ac.jp/working/2000/2000WorkingPapers/wp2000-4.pdf>). Claessens et al. (2000), for example, states: "When large shareholders effectively control a corporation, their policies may result in the expropriation of minority shareholders. The conflicts of interest between large and small shareholders can include outright expropriation, i.e., controlling shareholders enriching themselves by not paying out dividends, or transferring profits to other companies they control; or de facto expropriation through the pursuit of non-profit-maximizing objectives by large investors."



Not surprisingly, related-party transactions were rampant in the Chinese stock market as soon as it was reestablished by the government in the early 1990s. This move, which gave birth to the Shanghai and Shenzhen Stock Exchanges, was crucial to the government's resolve to bring market orientation to the economy, such as by privatizing state-owned enterprises (SOEs) and transforming them into professionally run corporations. Many of the first to list were subsidiaries of holding companies, which, in turn, were controlled by state ministries or local governments. In most cases, what actually got listed was a newly incorporated entity holding the better-performing assets that had been carved out from various units of the SOE. This was done in order to meet certain requirements, such as profitability for three consecutive years prior to an initial public offering (IPO).

Despite having gone public, however, many of these subsidiaries had still not separated themselves from the group in terms of accounts, personnel, and operations; related-party transactions were just as easy and convenient as before.<sup>29</sup> As such, the listed companies retained their identity as operating units answerable to the group, not to their own shareholders. At the same time, some parent companies, especially those managed at a local-government level, carried the mentality that IPOs—which were often successful because of the attractive assets injected into the listed entities and the investment enthusiasm of the rising middle class—were a route to instant cash. Listed subsidiaries were likened to automated teller machines.

In the most extreme cases, some parent companies took back the good assets from the listed subsidiary after benefiting from the IPO proceeds, leaving shareholders of the listed company with bad assets and worse prospects. In the first-ever case of delisting in China, ST Monkey King Company, a maker of electrical switches, saw its assets shrink from RMB3.4 billion (USD499 million) at the end of 1999 to RMB70 million (USD54 million) by February 2001.<sup>30</sup> The city government where the group was headquartered admitted to taking RMB524 million (USD77 million) worth of the group's assets.<sup>31</sup> It was also discovered that the parent company used ST Monkey King to guarantee up to RMB3 billion (USD440 million) in loans to pay the salaries of its 30,000 workers.

But perhaps the most common way of siphoning off assets during the early days of the stock market in China was by borrowing heavily from listed affiliates with no intention of repayment. A study of 1,200 companies over five years until 2002 showed that most related-party transactions were intercompany loans and borrowings, followed closely by sales and purchases. Rental expenses were the fourth most common deals, followed by loan guarantees between related parties and service expenses.<sup>32</sup> In 2002, regulator-run Shanghai Securities News reported that 91 companies listed in Shanghai disclosed to the exchange that they had substantial amounts of loans due from their parent firms. Of them, 36 did not expect to be repaid, and 55 did. Of the latter group, 14 did not know how and when they were going to receive the payment, and 23 said they expected to be paid in kind (such as with land, buildings, or trademarks).<sup>33</sup>

The case of Sanjiu Medical & Pharmaceutical Company demonstrates this problem. One of the largest in its sector in China, the company disclosed in 2001 that in the year ending 2000 it had deposited USD137.7 million of its funds to a related company, Shenzhen Financial Leasing, for an annual interest of 3 percent. This, however, was to the detriment of its own financial situation. Between Sanjiu's listing in Shenzhen in November 1999 and the end of 2000, its long- and short-term debts soared 1,100 percent, from USD14.2 million to USD188.9 million, carrying annual interest rates from 3.5 to 9.5 percent.<sup>34</sup>

<sup>29</sup> Joe Zhang, "China's Corporate Governance: Update," research report, UBS Warburg (12 December 2000).

<sup>30</sup> RMB stands for renminbi.

<sup>31</sup> "Monkey King Could Be Delisted," *People's Daily* (23 March 2001): [http://english.people.com.cn/english/200103/23/eng20010323\\_65781.html](http://english.people.com.cn/english/200103/23/eng20010323_65781.html).

<sup>32</sup> Joseph Fan, "Controlling Problematic Related Party Transactions of Banks in Asia," presentation before OECD and BIS Seminar on Corporate Governance for Banks in Asia, Hong Kong (19–20 June 2006):30 (<http://www.oecd.org/dataoecd/50/1/37178522.pdf>).

<sup>33</sup> Joe Zhang, "China's Corporate Governance: Update," research report, UBS Warburg (12 December 2000).

<sup>34</sup> "Poor Governance Report Rejected," *South China Morning Post* (9 September 2004).

Following public uproar over reports of similar cases, in 2003 government agencies and regulatory bodies started to tighten control over related-party transactions. Since then, the state legislature, the China Securities Regulatory Commission (CSRC), and China's two stock exchanges have introduced a series of shareholder reform measures—including the amendment of existing laws and the enactment of new ones to promulgate guidelines on shareholder protection in general and related-party transactions in particular. The government, for example, banned listed companies from providing loan guarantees to their parents and required the latter to settle their loans to subsidiaries starting in 2006.

Perhaps the most significant measure taken was the creation of the State-Owned Assets Supervision and Administration Commission (SASAC) in 2003 to oversee the governance of SOEs. Its explicit mandate was to prevent management from misappropriating assets and to usher in Western-style governance systems in these companies. Representing the state's majority stake, SASAC can appoint directors and assign inspectors to monitor management behavior. In the last two years, it has also appointed independent non-executive directors. SASAC is tasked to ensure that companies comply with relevant rules and regulations, including those pertaining to related transactions, thereby standardizing and professionalizing self-dealing between parent companies and subsidiaries (at least in theory).

Although these measures have not completely eradicated the risk of expropriation, they have perhaps led to the decline in the number of new related-party transactions in China, which went down from 2,190 in 2002 to 1,105 in 2007.<sup>35</sup>

### **Hong Kong**

Although Hong Kong has enjoyed free enterprise since the start of British rule in the 1800s, Chinese family business groups did not thrive there until the years before and after the communist takeover of China—when the merchant class from the coastal provinces fled the country and settled in the former colony, Taiwan, and in Malaysia, Singapore, and the rest of Southeast Asia. To build a new life, entrepreneurs relied on family capital and the ties of kinship, resulting in the creation of businesses that complemented one another and employed family members.<sup>36</sup> The relatively young history of business groups in Hong Kong helps explain why concentrated ownership remains its dominant business model.<sup>37</sup> Even now, more than 90 percent of listed companies have a shareholder who owns more than a 20 percent stake<sup>38</sup> and who takes an active role in management, often as both chair and chief executive.

As such, the risks of related-party transactions are a perennial concern in the Hong Kong Stock Market. In an investor-education article, the Securities and Futures Commission (SFC) warned that:

*In Hong Kong, business is often a family affair. The vast majority of publicly quoted companies are dominated by family shareholders. Sometimes, as little as 25, or even 10 percent, of a company's stock will be freely traded on the market, so control rests with the majority shareholders. That control can be hidden in a corporate maze of other companies, quoted and unquoted. When these interlinked enterprises deal with each other, the potential for conflict of interest is enormous.*<sup>39</sup>

<sup>35</sup>Weidong Zhang, "Related Transactions Based on the Analysis of China's Listed Companies," prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong (13–14 May 2008):6.

<sup>36</sup>Chwo-Ming Joseph Yu, "Networked Firms in the Republic of China: Toward a Hybrid Shareholder Model," National Changchi University, Taiwan (2007).

<sup>37</sup>"Time Limit for Cosy Deals," *South China Morning Post* (1 July 2000). "Edward Chow, former chairman of the Hong Kong Society of Accountants, explained that Hong Kong is barely in the second generation of Chinese business tycoons, whereas the Ford business dynasty in the United States is now on the fourth, and the Cadbury and Sainsbury dynasties in the United Kingdom on the third. 'In the Western world, connected transactions have become a thing of the past with the dilution of shareholdings. Unfortunately for this part of the world, they have been a fact of life,' says Chow."

<sup>38</sup>George Wehrfritz, "Safe Haven? The Slippery Slope," *Newsweek International* (2 May 2005): <http://www.newsweek.com/id/51876>.

<sup>39</sup>"Dangerous Connections," *South China Morning Post* (15 October 2000).

These risks multiplied when the HKEx allowed the listing of companies from the mainland in the 1990s. The different legal systems between the two jurisdictions meant that investors in the special administrative region could not use the local securities ordinance to chase assets that had been illegally shifted across the border. Currently, 148 “H shares” and 93 “red chips” (companies incorporated in Hong Kong and China but over which the Chinese government retains majority control), as well as 203 mainland private enterprises, are trading in Hong Kong and make up 57 percent of market capitalization.<sup>40</sup>

Connected transactions do occur frequently in Hong Kong. Although the HKEx does not publish periodic tallies, the listed-companies section of its website shows such transactions accounting for 10 percent of all announcements on any given day. The website also reveals 47 enforcement actions involving connected transactions from 2001 to July 2008. Most of them were censures or criticisms for delayed disclosures or non-disclosure.

In November 2005, for example, the HKEx censured retailer HyComm Wireless for not filing the announcement and circular and for not seeking the shareholder approvals necessary for certain connected transactions around the sale of five of the company’s subsidiaries to its chair and CEO. HyComm did not disclose that the executive had not made any payments for the asset transfer on its due date and also did not disclose that the group had extended a loan to him through the subsidiaries without interest, security, or a repayment date.<sup>41</sup>

In 2004, a study by the Hong Kong Institute for Monetary Research found that two-thirds of a sample of 328 related-party disclosures involved transactions that were *a priori* likely to result in expropriation of the listed company’s minority shareholders: asset acquisitions (92), asset sales (54), equity sales (18), trading relationships (32), and cash payments (25). The study found that companies suffered significant declines in shareholder value both during the initial announcement of the transaction and in the 12 months after; moreover, companies with concentrated ownership were more likely to violate listing rules on connected transactions.<sup>42</sup>

### South Korea

Perhaps the most compromising corporate structure in Asia is the *chaebol* of South Korea. Derived from the Korean words *chae*, meaning finance, and *bol*, meaning lineage or faction, it loosely translates to “conglomerate” but has a strong connotation of exclusivity.<sup>43</sup> Its most remarkable characteristic is the web of circular ownership formed among companies within the group, which renders them almost impenetrable to external influence. Built over time, the current *chaebol* structure thrives through related-party transactions that entrench management and retain wealth within the controlling family.

Through its direct ownership of various subsidiaries, which, in turn, have mutual equity investments in one another, a family’s 4 percent stake in one company could translate into 40 percent of its voting rights. The result is that non-family shareholders are unable to assert their views on corporate decisions or elect their nominees for independent directors, let

<sup>40</sup>Paul Chow, “Opportunities and Challenges of HKEx and the Hong Kong Securities and Derivatives Market,” Presentation given at the JP Morgan Asia Pacific Banking and Insurance conference, Hong Kong (12 June 2008):25 (<http://www.hkex.com.hk/press/speech/sp080612.pdf>). As of 31 May 2008, the 444 mainland companies make up 36 percent of the total 1,248 listed companies in Hong Kong.

<sup>41</sup>HKEx, “The Listing Committee of The Stock Exchange of Hong Kong Limited Criticises Hycomm Wireless Limited (the Company) for Breaching Paragraphs 8(1), 8(2), 11(1) and 11(3)(i)(c) of the then Listing Agreement,” press release, Hong Kong Exchanges and Clearing Limited (31 August 2004): <http://www.hkex.com.hk/news/hkexnews/040830news.htm>.

<sup>42</sup>Yan-jeung Cheung, P. Raghavendra Rau, and Aris Stouraitis, “Tunneling, Propping and Expropriation: Evidence from Connected Party Transactions in Hong Kong,” Working Paper No. 9/2004, Hong Kong Institute for Monetary Research (May 2004):13 ([http://www.hkimr.org/cms/upload/publication\\_app/pub\\_full\\_0\\_2\\_83\\_wp200409\\_text.pdf](http://www.hkimr.org/cms/upload/publication_app/pub_full_0_2_83_wp200409_text.pdf)).

<sup>43</sup>Wonhyuk Lim and Jongryn Mo, “The Dynamics of Post-Crisis Reform in Korea,” Korea Development Institute (August 2002):4 (<http://www.kdischool.ac.kr/UserFiles/File/2004%20Fall/1.%20MPP%20Courses/MST006/5.%20drrwh.pdf>).

alone take control. These characteristics are believed to be the factors behind the “Korea discount”—the idea that investors’ anticipation that *chaebols* would disenfranchise them has caused the Korean market to trade at consistently lower valuations than its peers.<sup>44</sup>

Instrumental to the post-war government’s industrialization plan, the *chaebols* received favorable treatment in every aspect of operation—including easy access to finance, financing incentives, management-friendly labor laws, and special licenses and approvals.<sup>45</sup> As Lee Nam-Kee, former chairman of the Korea Fair Trade Commission (KFTC), described: “During the years before the crisis, *chaebols* were given royal treatment as heroes of Korea’s economic growth, and the general public believed that any investment made by the *chaebol* was fuel for Korea’s economic advancement.”<sup>46</sup> These groups pursued aggressive expansion by investing in diverse, unrelated industries. In order for controlling families not to dilute their ownership, they funded their activities mostly with debts from banks that lent to companies simply by virtue of their *chaebol* affiliation.

Prior to the Asian crisis, much of the *chaebols*’ growth had been attributed to questionable related-party transactions, mostly involving financial, asset, and operational subsidization. A *chaebol* affiliate, for example, would deposit funds to a bank, which would then either use the money to lend to the depositor’s affiliates at below-market rates or to buy their commercial paper. Mutual debt guarantees among *chaebol* companies were a common practice and were often demanded by banks themselves regardless of the financial health of the guarantor. This proved risky. As many groups experienced during the crisis, a bankruptcy of one affiliate triggered a chain reaction that affected the rest of the group.

In other cases, a related party would either buy stocks issued by an affiliate at prices higher than market value or supply real estate, services, securities, and other assets at well above or below market prices. Although these equity investments and intragroup transactions were vital to the *chaebols*’ expansion, the practice became such a habit that investments were made for their own sake. *Chaebol* leaders refused to acknowledge businesses’ failures, believing they were “too big to fail.” This dynamic ultimately weighed down on the conglomerates’ profitability. By 1997, the KFTC found that individual affiliates of the top 30 *chaebols* in Korea had not only been failing to make profits but also were hemorrhaging in the billions of dollars. Banks, too, were found to be massively undercapitalized. When the crisis struck, the Korean economy went into a tailspin, and with it came the collapse of 16 of the country’s top 30 *chaebols*.

No case exemplifies the impact of related-party transactions on the *chaebols*’ collapse better than that of the Daewoo International Corporation. In the years leading up to the Asian crisis, Daewoo had grown just like any other *chaebol*—through rapid expansion into various industries, from shipbuilding and heavy machinery to electronics and telecommunications, and funded by bank debts and interlocking guarantees. Its founder, Kim Woo-Chung, had envisioned that the group could also become a global presence in car manufacturing. Even as the Korean currency plunged from KRW900 to KRW1,960 to the U.S. dollar in the four months ending in January 1998, Kim thought Daewoo could offset its adverse impact through further expansion. That month, Daewoo Motor acquired SsangYong Motor.<sup>47</sup>

<sup>44</sup>In 2004, UBS estimated that the average price-to-earnings ratio of Asian emerging market companies is 13.6, China’s 14.3 percent, and Korea’s 9.1. By 2006, Morgan Stanley estimated that the discount has narrowed to 23 percent.

<sup>45</sup>Joongi Kim, “A Forensic Study of Daewoo’s Corporate Governance: Does Responsibility Lie Beyond the Chaebol and Korea?” *Northwestern Journal of International Law and Business*, vol. 28, no. 3 (2005):14 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=760064](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=760064)).

<sup>46</sup>Lee Nam-Kee, “Korea Fair Trade Commission and Economic Reform in Korea,” *Korea Times* (1 June 2002):1 (<http://ftc.go.kr/data/hwp/20020601.doc>).

<sup>47</sup>Joongi Kim, “A Forensic Study of Daewoo’s Corporate Governance: Does Responsibility Lie Beyond the Chaebol and Korea?” *Northwestern Journal of International Law and Business*, vol. 28, no. 3 (2005):14 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=760064](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=760064)).

The acquisition involved the assumption of SsangYong's USD2.43 billion debt. This added to Daewoo group's own cross-guarantees, which exceeded USD10 billion, and foreign debt, which reached as much as USD35 billion because of the devaluation. Daewoo Motor enlisted Daewoo International Corporation and Daewoo Heavy Industries for financial support and even pressured employees to purchase its own cars through interest-free loans provided by affiliates. As the group's profitability faltered, further weighed down by its massive debts, Daewoo resorted to accounting and loan fraud through further related-party transactions—including the use of affiliates and a Great Britain-based financial unit to manipulate exports and obtain fake invoices, asset swaps between affiliates at discounted or inflated values, and transfer of liabilities to off-balance-sheet accounts.<sup>48</sup> Daewoo International Corporation was liquidated in 1999.

Intragroup transactions among *chaebols* were the root of structural inefficiencies in the Korean corporate sector. In 2002, the KFTC revised its regulations for the 30 largest *chaebols* by assets, as follows: Groups with assets over KRW5 trillion were prohibited from making equity investments in other companies (within or outside the group) in excess of 25 percent of their net assets, and from making mutual equity investments and providing mutual debt guarantees. Business groups with assets in excess of KRW2 trillion were banned from cross-shareholding and mutual debt guarantees.

Is a repeat of the Daewoo saga now a distant possibility? It may be too soon to tell. Corporate governance watchers in Korea are worried by the current government's plan to ease regulations against *chaebols*' ownership of banks. Currently, *chaebols* may hold no more than 4 percent of voting rights in commercial lending institutions. Government planners are working to raise the limit to 15 percent, supposedly in a move to counter the growing control of foreign investors in Korean banks that increased substantially during the previous administration's liberalization efforts. Corporate governance thinkers believe that the move risks giving *chaebols* easy access to bank capital, and consequently, a new avenue for misallocation of internal capital and expropriation.

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<sup>48</sup>Ibid.



# Cautionary Tales

## What related-party transactions should investors in Asia look out for?

Diligent readers of financial reports will look at disclosures of related-party transactions when they notice anomalies in a financial statement. Auditors consider such transactions, outside the normal course of business, as the second most effective red flag in detecting fraudulent financial reporting (second only to restricted access to information or communication with the board or the audit committee).<sup>49</sup> Significant transactions that occur toward the end of a reporting period; unusual purchases, sales, and repurchases of assets within a short period of time; sudden jumps in receivables; sizable long-term commitments to a supplier; heavy dependence on one customer; such special trade terms as extended credit with certain customers—all give rise to reasonable suspicions of earnings management through connected transactions.

Earnings management, however, has yet to be established as a primary reason for related-party transactions in Asia. Instead, most studies have tended to associate them with abuse of independent shareholders' rights. The following cases support that observation. In general, each case cites situations that exposed investors to at least one of two distinct but related risks: expropriation of wealth and deprivation of wealth opportunity. These risks, in turn, arise from two incentives. The first is wealth formation, achieved through the transfer of assets and profits of a publicly traded company to the private interest of its controlling shareholder. The second, which derives from the first, is appropriation of control that is realized by either the dilution of minority ownership or the usurpation of corporate opportunity.

### *The China syndrome*

The incentives for appropriating wealth and control in public companies are obvious for family-controlled conglomerates, but do the same incentives also apply to state-owned enterprises? Because executives at some SOEs are appointed by the Communist Party leadership, analysts have suggested that past attempts at managing earnings using related-party transactions may have been driven by political ambition: The better their companies look, the greater their chances of recognition in the politburo. Some have also suspected that parents of listed companies are motivated by the need for capital to rehabilitate weaker, unlisted affiliates by helping them meet the listing criteria, such as three consecutive years of profitability. Another explanation is the intent to do a rights issue, which requires SOEs to have a minimum 10 percent return on equity in the last three years.<sup>50</sup> Of course, personal enrichment has also been a factor. In recent years, China has convicted a few senior executives for corporate misdeeds, including the former CEO of the Hong Kong-listed subsidiary of Bank of China, who received a suspended death sentence in 2005 for embezzling USD2.7 million.<sup>51</sup>

Financial reports are not the best places to look for potential anomalies in related-party transactions in Asia. Unlike in the United States, where quarterly 10-Q and annual 10-K reports are mandated to include disclosures of such transactions, periodic reports in Asia are thin documents detailing nothing more than a few selected line items in a financial statement and the balance sheet. In order to preempt potentially harmful connected transactions—or to at least learn about them sooner than the release date of the annual report—investors should look at regulatory disclosures, such as the “listed-company announcements” section of some stock exchanges.

<sup>49</sup>Glen D. Moyes, Ping Lin, Raymond M. Landry II, and Handan Vicdan, “Internal Auditors' Perceptions of the Effectiveness of Red Flags to Detect Fraudulent Financial Reporting,” (2006):15–16 (<http://ssrn.com/abstract=961457>).

<sup>50</sup>Chunyang Huang, “Essays on Corporate Governance Issues in China,” Helsinki School of Economics (2007):48 (<http://hsepubl.lib.hse.fi/pdf/diss/a295.pdf>).

<sup>51</sup>Chris Buckley, “Lax Management at China's Banks Remains a Concern for Regulators and Investors,” *New York Times* (8 February 2005): <http://www.nytimes.com/2005/02/08/business/worldbusiness/08yuan.html>.

Following are some particular types of related transactions that have caught the attention of investors and market cases that show the result of such transactions.

## Expropriation of wealth

Expropriation of wealth refers to those instances when a related-party transaction takes away existing funds from a listed company or exposes it to undue risks and liabilities for the exclusive benefit of controlling shareholders. Common methods of expropriation are commercial and financial transactions at distorted values or for no justifiable reasons.

### *Asset sales and purchases between related parties*

- In 2006, two New York-based hedge funds successfully rallied minority shareholders of NASDAQ-listed Gravity Co., a South Korean online gaming company, to oust Gravity's chief executive and chief operating officers based on their decision to acquire two gaming interests from related parties in 2005.

In the first transaction, Gravity acquired gaming software developed by GungHo Online Entertainment, a company owned by its Tokyo-based majority shareholder. A committee formed by the minority shareholders, led by hedge funds Moon Capital Management and Ramius Capital Group, alleged that the USD6 million price Gravity paid for the asset was "unwarranted and excessive" and that the purchase, recorded just days before the end of GungHo's fiscal year, was entered into principally to boost GungHo's earnings and allow it to exceed estimates. In the second transaction, Gravity paid USD7.7 million to acquire a company 40 percent owned by its chief operating officer. Minority shareholders alleged that the acquisition was overpriced and only "rescued a marginal business owned by a friend" of the CEO.<sup>52</sup>

The committee moved to oust the two directors from the board in a proxy resolution. In a response to Institutional Shareholder Services (ISS), the proxy advisory firm, Gravity argued that:

*valuation reports is (sic) not widely developed in Asia and the evaluation of a particular game is something that our management is very good at. We...feel strongly that it would have been a waste of corporate resources to hire an independent firm who would have only been able to provide a superficial and meaningless report based on cash flows...which just simply would not help in the decision-making process.*<sup>53</sup>

At the extraordinary meeting in December 2006, 86.9 percent of minority investors and holders of Gravity's American Depositary Shares voted in favor of the removal of the two executives.<sup>54</sup> In July 2008, both of them resigned, along with two members of the audit committee.<sup>55</sup>

- In 2004, Norwegian fund Kistefos Investment agreed to an out-of-court settlement of its three-year court battle against the Hong Kong-listed conglomerate Pacific Challenge Capital (now called New Times Group). The fund had alleged that the group, whose interests range from zinc trading to financial services, had been "oppressive and unfairly prejudicial" to minority shareholders in a series of transactions beginning in 2000.<sup>56</sup> In the first transaction, Kistefos, which at the time owned 21 percent of Pacific Challenge,

<sup>52</sup>Gravity Co., Ltd., "Exhibit 7 – Preliminary Proxy Statement," The Gravity Committee for Fair Treatment of Minority Shareholders (20 November 2006): <http://www.secinfo.com/dr8S1.v78.c.htm>.

<sup>53</sup>"ISS Recommends That Gravity Shareholders Vote to Remove Ryu and Baik as Directors at Upcoming Extraordinary General Meeting," Business Wire (18 December 2006): [http://findarticles.com/p/articles/mi\\_m0EIN/is\\_2006\\_Dec\\_18/ai\\_n16912441](http://findarticles.com/p/articles/mi_m0EIN/is_2006_Dec_18/ai_n16912441).

<sup>54</sup>"87% of Gravity's Disinterested Shareholders Vote to Remove Ryu and Baik as Directors," Business Wire (26 December 2006): [http://findarticles.com/p/articles/mi\\_m0EIN/is\\_2006\\_Dec\\_26/ai\\_n27094769](http://findarticles.com/p/articles/mi_m0EIN/is_2006_Dec_26/ai_n27094769).

<sup>55</sup>Press release, Gravity Co., Ltd. (1 July 2008).

<sup>56</sup>"Petition Made against the Company under Section 111(1) of the Companies Act 1981 of Bermuda," announcement, Pacific Challenge Capital Limited (13 March 2001): [www.hkexnews.hk/listedco/listconews/sehk/20010314/LTN20010314013.doc](http://www.hkexnews.hk/listedco/listconews/sehk/20010314/LTN20010314013.doc).



claimed that the company sold its core brokerage business to a related party for an undervalued price. The buyer, who held 9.84 percent of Pacific Challenge shares, bought the brokerage at 1.3 times annual net earnings (a third of its IPO valuation).<sup>57</sup>

The second transaction was the proposed buyout of internet start-up Cents.com, 60 percent owned by Pacific Challenge's chairwoman, for HKD170 million (USD21.8 million). The company had been incorporated only six months prior to the proposal; outside of its internet-domain registration and 10 employees, it had net assets of HKD5.9 million (USD758,300), including a HKD6.7 million (USD861,120) loan to its parent.<sup>58</sup>

Kistefos succeeded in urging other shareholders to vote against the buyout. Three weeks later, Pacific Challenge enlarged its share capital by 20 percent in a private placement to two investors. At the time of settlement, Kistefos's stake in Pacific Challenge had declined to 14.4 percent.

- In June 2002, the controlling family of Korean *chaebol* Hyundai Motor Group succumbed to market pressure and withdrew a plan to sell a privately held entity to Hyundai Mobis, one of the carmaker's listed subsidiaries. Just eight months before, *chaebol* chairman Chung Mong-Koo and his son Chung Eui-Sun acquired a greater than 50 percent stake in Bontec Co., an unlisted electronic auto-parts manufacturer, for KRW13,000 (USD11.34) a share. They planned to merge Bontec in an all-share swap with Hyundai Mobis, which supplies auto parts and after-sales services to affiliates Hyundai Motor and Kia Motors. The deal would have been a windfall for the family: It valued Bontec shares at KRW60,000 (USD52.32) each,<sup>59</sup> abetted by what analysts believed was a large order from Kia Motors.

Hyundai Mobis canceled the plan after a rare dialogue with investors, who dumped the company's shares when rumors of the deal flew. Corporate governance watchers believed, however, that the incentive for the deal was not only financial gain but also to start the hereditary transfer of leadership in Hyundai group from the elder Chung to his only son. Through his 30 percent stake in Bontec, the younger Chung, then 32-years old, would have acquired a sizable financial stake in Hyundai Mobis, which is a nexus in the group's circular-ownership structure. (At the time, it owned 11.5 percent of Hyundai Motor and 17.5 percent of Kia Motors.<sup>60</sup>) In 2005, while Bontec remained private, Chung Eui-Sun was appointed president of Kia Motors and a director of Hyundai Mobis.<sup>61</sup>

### ***Financial assistance through provisions of loans, guarantees, and collateral***

- In 2007, minority shareholders of China National Offshore Oil Corporation (CNOOC)—the Hong Kong-listed, Chinese-owned oil explorer that tried to acquire Unocal Corporation in 2005—voted down the company's proposal to deposit up to RMB6.8 billion (USD997.5 million) of its cash to an unlisted, Beijing-based sister company, CNOOC Finance. The vote came two years after the Hong Kong Exchange issued a public censure of CNOOC for breaching disclosure rules in light of its "financial assistance" to CNOOC Finance, of which it owned 31.8 percent. The HKEx found that from 2002 to 2004, CNOOC deposited cash in the finance unit and received interest without the requisite disclosure and shareholder approval. Including interest income, its outstanding balance with the finance affiliate reached RMB6.6 billion, equivalent to 16.6 percent of its net tangible assets<sup>62</sup> and well above the 3 percent threshold for disclosure under HKEx rules.

<sup>57</sup>"Skidding on Skins," *South China Morning Post* (19 June 2002).

<sup>58</sup>David Webb, "Cents and Sensibility," *webb-site.com* (11 July 2000).

<sup>59</sup>Manish Singhai, "Protecting Minority Shareholders from Improper Dilution," Presentation given at the Fourth OECD Asian Roundtable on Corporate Governance, Mumbai (11–12 November 2002):3–4 (<http://www.oecd.org/dataoecd/49/44/2484696.ppt#265,1,Slide>).

<sup>60</sup>Gina Chon, "Hyundai Mobis Scraps Merger," *The Daily Deal* (13 June 2002): [http://www.accessmylibrary.com/coms2/summary\\_0286-93410\\_ITM](http://www.accessmylibrary.com/coms2/summary_0286-93410_ITM).

<sup>61</sup>Norman Thorpe, "Hyundai Mobis: The Ties that Bind – and Confuse," *Automotive News* (11 August 2005): [http://findarticles.com/p/articles/mi\\_hb6674/is\\_/ai\\_n26629373](http://findarticles.com/p/articles/mi_hb6674/is_/ai_n26629373).

<sup>62</sup>HKEx, "The Listing Committee of the Stock Exchange of Hong Kong Limited Censures CNOOC Limited (the Company) for Breaching Paragraph 2 of the then Listing Agreement and the then Rule 14.26(6) of the Exchange Listing Rules," press release, Hong Kong Exchanges and Clearing Limited (6 October 2005): <http://www.hkex.com.hk/news/hkexnews/051006news.htm>.

CNOOC spin-off China Oilfield Services suffered the same fate in 2004, when minority shareholders rejected its proposal to deposit up to 40 percent of its 2003 revenue (then equivalent to USD148 million) to CNOOC Finance. In fact, entities like CNOOC Finance are known as “non-bank financial institutions,” which are sanctioned by the China Banking Regulatory Commission as vehicles for large corporations to centralize their treasury-management operations. In its 2007 resolution, CNOOC said it saved RMB18 million (USD2.64 million) in 2006 by using the settlement and deposit services of CNOOC Finance instead of commercial banks.<sup>63</sup> As a result of the high-capitalization requirement, only a handful of large entities have been granted license to establish them. Nonetheless, the history of tunneling in China has rightfully made investors wary of intercompany financing.

- In October 2007, Sinopec Finance—a joint venture between Hong Kong-listed oil producer Sinopec Corporation (China Petroleum & Chemical Corporation) and its unlisted parent China Petrochemical Corporation—became the first-ever financial institution in China to issue local bonds.<sup>64</sup> According to Sinopec Finance, the RMB4 billion (USD587 million) offer would “support (China Petrochemical’s) core business, fund mid- to long-term investments, and improve the asset-debt structure and intergroup financial settlement capacity.”<sup>65</sup> As an indirect financial assistance, the bonds exposed Sinopec to the risk that its parent would deviate from the stated use of proceeds. Analysts have said that the inherent risks of these arrangements to investors, especially as they apply to Chinese SOEs in Hong Kong given that the parent companies are subject to a different legal regime, are lack of transparency and weak legal protection.
- In May 2008, Hong Kong-listed Nanjing Panda Electronics Group Company, a satellite communications equipment manufacturer, announced that a court in China had frozen 192.8 million of its shares (about 30 percent of its total assets) until 2010. The order came as its parent company, Panda Electronics, which owned the frozen shares, became entangled in a contractual dispute with its lender, Bank of China.<sup>66</sup> The parent had used its shares in the listed company as collateral for the loans. Although details of the dispute were scant, Nanjing Panda disclosed to the Hong Kong Exchange in June 2007 that its parent had been trying to “fulfill its obligations under the relevant loans and to proactively liaise with the relevant parties so that the frozen shares could be free from encumbrances and the shares pledges could be redeemed.”<sup>67</sup>

Although Nanjing Panda assured investors that the freezing of the shares had no impact on its own operations, the freeze revealed its parent company’s deep financial troubles, which could potentially risk Nanjing Panda’s own assets. In August 2007, the HKEx censured Nanjing Panda for its failure to disclose and seek shareholders’ approval for the RMB2.18 billion (USD320 million) in unsecured loans it extended to three of its China-based affiliates.<sup>68</sup> The risks were especially significant given that Nanjing Panda’s chair and vice chair are also the chair and party secretary, respectively, of its state-owned parent.<sup>69</sup>

<sup>63</sup>“Investors Sink CNOOC Plan on Cash Hoard,” *South China Morning Post* (3 April 2007).

<sup>64</sup>Press release, China International Capital Corp (18 October 2007).

<sup>65</sup>“Sinopec Finance to Sell 4b Yuan Bond,” *South China Morning Post* (16 October 2007).

<sup>66</sup>“Nanjing Panda’s 193M Shares Frozen for Further 2 Years,” Infocast News (6 May 2008).

<sup>67</sup>Nanjing Panda, “Announcement in Relation to (i) Transfer of 25% Equity Interest in Hua Fei Color Display Systems Company Limited (ii) Shares Held by Panda Electronic Group Company Limited Continue to be Frozen (iii) Unusual Price Fluctuation of A-Shares,” press release, Nanjing Panda Electronics Company Ltd. (1 June 2007): [www.panda.cn/panda/admin/news/edit/uploadfile/200773115119246.pdf](http://www.panda.cn/panda/admin/news/edit/uploadfile/200773115119246.pdf).

<sup>68</sup>HKEx, “The Listing Committee of the Stock Exchange of Hong Kong Limited (the ‘Listing Committee’) Censures the Following Parties for Breaching the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the ‘Exchange Listing Rules’),” press release, Hong Kong Exchanges and Clearing Limited (8 August 2007): <http://www.hkex.com.hk/news/hkexnews/070809news.htm>.

<sup>69</sup>Toh Han Shih, “Court Freezes Nanjing Panda Shares,” *South China Morning Post* (3 November 2005): [http://www.accessmylibrary.com/coms2/summary\\_0286-11190556\\_ITM](http://www.accessmylibrary.com/coms2/summary_0286-11190556_ITM).

At any rate, it would not have been Nanjing Panda's first trouble with an affiliate. In 2005, a Chinese court ordered it to give up its 51 percent stake in a mobile communications subsidiary and 95 percent in another to repay the combined RMB120 million (USD17.6 million) in debts the subsidiaries had incurred. Nanjing Panda's stock plunged 44 percent on its first trading day after it made the announcement.<sup>70</sup>

### ***Fraud and embezzlement***

- In September 2005, Gu Chujun, chairman and controlling shareholder of China's largest refrigerator maker Guangdong Kelon Electrical Holdings Company, was arrested and subsequently found liable for inflating the company's profits and embezzling at least RMB592 million (USD86.8 million) through related-party transactions. A company statement in January 2006 said an investigation found that Gu had used Kelon Electrical Holdings Company and Greencool Technology Holdings, a company he controlled—along with 29 other affiliates between them—to siphon off the amount from Kelon, which is listed on both the Hong Kong and Shanghai Stock Exchanges.<sup>71</sup>

The China Securities Regulatory Commission (CSRC) also found that Kelon overstated its profits by up to RMB1.22 billion (USD179 million) from 2003 to 2004 through joint investments and purchases of goods among the affiliated companies.<sup>72</sup> The case was *déjà vu* for the company. In 2001, the CSRC found RMB1.26 billion in undisclosed advances by Kelon to its heavily indebted parent, Guangdong Rongsheng Electric Holding Company. The advances were made through various bank borrowings, purchases of raw materials, payment of advertising costs, bank guarantees, and debt transfers. The incident brought Kelon to a liquidity crunch, which eventually led to Gu's takeover.<sup>73</sup>

### ***Bailout***

- The bailout of SK Global (renamed SK Networks) by its parent, the energy-to-telecommunications *chaebol* SK Corporation (SK Corp.), is perhaps Asia's most remarkable case of conflict between a controlling shareholder and its independent investors. The year-long saga highlighted the biggest risk investors face when dealing with family-controlled business groups: their limited ability to influence corporate decisions regardless of the size of their investment. Sovereign Asset Management was no ordinary investor in SK Corp.; with 14.99 percent of outstanding shares, the Monaco-based fund was its single largest shareholder. The controlling family, represented by chairman Chey Tae-Won, owned fewer shares, but because of the *chaebol's* circular ownership, its voting rights were in excess of 30 percent.<sup>74</sup>

The timeline shown in Exhibit 3 illustrates how Sovereign and other investors persevered in exercising their rights to prevent the parent company from throwing a lifeline to an ill-fated affiliate. The case started in March 2003 when government investigators discovered accounting irregularities at the *chaebol's* trading arm, SK Global, including USD1.2 billion in inflated profits and USD5.6 billion in hidden losses.<sup>75</sup> As the subsidiary faltered, SK Corp. came under pressure from SK Global's creditors to provide assistance; by June, its

<sup>70</sup>Carol Chan, "Panda Dives on First Day Back from Trading Halt," *The Standard* (13 September 2005): [http://www.thestandard.com.hk/news\\_detail.asp?we\\_cat=2&art\\_id=1191&sid=4525462&con\\_type=1&d\\_str=20050913&fc=2](http://www.thestandard.com.hk/news_detail.asp?we_cat=2&art_id=1191&sid=4525462&con_type=1&d_str=20050913&fc=2).

<sup>71</sup>"Kelon Executives Embezzled US\$73 Million," *China Daily* (24 January 2006): [http://english.peopledaily.com.cn/200601/24/eng20060124\\_237805.html](http://english.peopledaily.com.cn/200601/24/eng20060124_237805.html).

<sup>72</sup>Chris Oliver, "China's Guangdong Kelon Fined for Overstating Profit," *MarketWatch* (5 July 2006): <http://www.marketwatch.com/news/story/chinas-guangdong-kelon-fined-overstating/story.aspx?guid=%7B2481F6B2-F372-4242-9E28-55743C3EC4BA%7D>.

<sup>73</sup>"Kelon Agrees on Deal Instead of Debt Payment," *South China Morning Post* (23 November 2002).

<sup>74</sup>E. Han Kim and Woochan Kim, "Corporate Governance in Korea: A Decade after the Asian Financial Crisis," Law and Economics Research Paper No. 123, University of Texas Law (December 2007): [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1084066](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1084066).

<sup>75</sup>Song Jung-a, "Court Backs Proposed SK Corp Stock Sale," *Financial Times* (24 December 2003): [http://search.ft.com/ftArticle?queryText=court+backs+proposed+sk&id=031224000917&ct=0&nclck\\_check=1](http://search.ft.com/ftArticle?queryText=court+backs+proposed+sk&id=031224000917&ct=0&nclck_check=1).

board of directors approved a bailout plan that earned the ire of its investors. The plan involved swapping KRW850 billion (USD741 million) in debt SK Global owed to SK Corp. for newly issued shares in SK Global.<sup>76</sup> The deal was meant to improve the subsidiary's balance sheet to limit the reduction in the value of the loans creditors could recover.

In December 2003, SK Corp. dealt a double blow to its shareholders. It announced that it was setting aside KRW143 billion (USD125 million) to lend to another subsidiary, SK Shipping, and that it could not rule out further loans. In 2004, the company faced a cash shortage of KRW170 billion (USD148 million).<sup>77</sup> (Earlier that year, SK Shipping had written off KRW239.2 billion [USD209 million] in unaccounted-for commercial paper in what analysts believed was an improper support of SK Global.<sup>78</sup>) On top of that, SK Corp. announced it was selling treasury shares equivalent to a 10.4 percent stake in the company to a handful of local financial institutions, including lenders of SK Global. Sovereign filed an injunction against the plan, calling it a move to further diminish its voting rights. The court, however, sided with SK Corp., which claimed that the deal was meant to boost the company's financial position.<sup>79</sup>

### *Korean credit-card companies*

South Korea's recovery from the financial crisis was aided by rapid growth in consumer spending, which, in turn, was fueled by easy availability of credit. By 2004, a few *chaebol*-run credit-card companies, which had been criticized and punished by regulators for such poor risk management as extending credit to teenagers and the unemployed, came to the brink of bankruptcy because of payment defaults.

- In December 2004, the telecommunications-to-chemicals LG Group injected KRW500 billion into LG Card (which had suffered a KRW5.6 trillion [USD4.9 billion] loss in 2003) after long negotiations with the troubled company's creditors. The creditors threatened to liquidate what was then the country's largest credit-card company unless its parent came to its rescue. Listed affiliates LG Electronics and LG Chemicals, which earlier opposed the capital injection, agreed to contribute to the deal,<sup>80</sup> which was less than the KRW770 billion (USD671 million) the creditors had demanded. It was already the second bailout for LG Card, this time meant to prevent it from being de-listed from the local stock exchange. Earlier in 2004, creditors agreed on a USD4.5 billion rescue package in which LG Group agreed to provide KRW1.175 trillion (USD1.5 billion) in financial aid.<sup>81</sup>
- Also that year, Samsung Electronics announced that it would purchase KRW600 billion (USD523 million) worth of new shares to be issued by the loss-making Samsung Card, the second largest credit-card company, which would then diminish its stake in the subsidiary to around 40 percent from 61 percent. In February, Samsung Card unveiled a KRW1.5 trillion (USD1.3 billion) rights-issue plan to ease its liquidity crunch following a KRW1.3 trillion (USD1.1 billion) net loss in 2003.<sup>82</sup>

<sup>76</sup>"SK Corp. Backs Affiliate's Bailout," *Asian Wall Street Journal* (16 June 2003).

<sup>77</sup>"SK Corp to Lend 143.4 Billion Won to Support SK Shipping," *AFX Asia* (18 December 2003).

<sup>78</sup>"Sovereign Moves to Distance SK Corp from SK Global," *Dow Jones International News* (28 April 2003).

<sup>79</sup>"Sovereign Files Injunction against SK Corp's Treasury Stock Sale," *Dow Jones International News* (23 December 2003).

<sup>80</sup>"LG Card Receives \$960m Lifeline," *Financial Times* (31 December 2004): <http://lg-card-news.newslib.com/story/3117-1171522/>.

<sup>81</sup>Song Jung-a, "Parent Puts LG Card under Liquidation Threat," *Financial Times* (20 December 2004): [http://www.ft.com/cms/s/c224b258-522c-11d9-961a-00000e2511c8,Authorised=false.html?\\_i\\_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2Fc224b258-522c-11d9-961a-00000e2511c8.html&\\_i\\_referer=http%3A%2F%2Fsearch.ft.com%2Fsearch%3FqueryText%3Dparent%2Bputs%2Blg%2Bcard%2B](http://www.ft.com/cms/s/c224b258-522c-11d9-961a-00000e2511c8,Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2Fc224b258-522c-11d9-961a-00000e2511c8.html&_i_referer=http%3A%2F%2Fsearch.ft.com%2Fsearch%3FqueryText%3Dparent%2Bputs%2Blg%2Bcard%2B).

<sup>82</sup>"Samsung Elec to Buy Back \$1.74 bln Shares," Reuters (7 April 2004).

**Exhibit 3. A Foreign Fund Manager's Battle Against a *Chaebol's* RPT**

<b>SK Corp.: A Series of Unfortunate Events</b>	
27 Feb 03	Prosecutors announce USD1.2 billion account manipulation by SK Global (renamed SK Networks).
11 Mar 03	SK chair charged with account manipulation.
17 Mar 03	Moody's downgrades group's credit rating to Ba2. SK Corp.'s share price falls by half in a week.
3 April 03	Sovereign Asset Management announces acquisition of 8.6 percent interest.
14 Apr 03	Sovereign publicly asks for corporate governance improvements.
16 Apr 03	Sovereign discloses its expanded interest of 14.99 percent in SK Corp.
4 Jun 03	Sovereign opposes SK Corp.'s financial support for SK Networks.
10 Jun 03	Hermes Pension Management petitions court for voting right suspension of three directors.
13 Jun 03	Chey Tae-Won, chairman of SK Corp., sentenced to three years in jail.
14 Jun 03	Hermes' court petition succeeds.
15 Jun 03	SK Corp.'s board approves bailout of SK Networks, including a USD800 million debt-to-equity swap.
17 Jun 03	Sovereign asks for resignation of three directors.
11 Aug 03	Lazard, Sovereign's adviser, demands replacement of three directors and spin-off of SK Telecom.
22 Sep 03	Chey released on bail.
24 Sep 03	Lazard opposes Chey's return to work.
26 Oct 03	SK Corp. resolves details of 15 June 2003 bailout decision.
20 Nov 03	Sovereign announces its plan to oust three directors at the annual general meeting (AGM).
11 Dec 03	Sovereign begins to solicit support from institutional investors.
22 Dec 03	Local minority shareholder groups declare support for Sovereign.
26 Dec 03	SK Corp. sells 10 percent of its treasury shares to friendly parties. Share price declines, reflecting end of proxy fight; chair had acquired enough support at the forthcoming AGM.
9 Jan 04	Son Kil-Seung, CEO of SK Corp., arrested on misappropriation of SK Shipping's corporate fund.
30 Jan 04	SK Corp. proposes to increase outside directors to over half of the board.
30 Jan 04	SK Corp. announces 2003 results: Net earnings declined by almost 90 percent as a result of losses of affiliates.
2 Feb 04	Franklin Templeton and Wellington each disclose 5 percent stakes. Foreigners own more than 50 percent of SK Corp.'s shares.
22 Feb 04	SK Corp. proposes six new directors. Outside directors make up 70 percent of board.
12 Mar 04	Sovereign loses at AGM.
15 Mar 04	Sovereign reiterates request for Chey to resign.
26 Mar 04	SK Corp. establishes a special committee to improve corporate governance.

Source: Based on information from Franklin Templeton.

## Deprivation of wealth opportunity

Deprivation of wealth opportunity refers to actions by controlling shareholders to either enlarge or appropriate the amount of control they already have over listed entities or to take exclusive advantage of wealth-creating opportunities derived from listed entities.

Appropriation of control can happen through such transactions as mergers with related parties or the issuance of new shares, convertible bonds, or other equity-linked instruments to related parties. Although valuations in these deals may (or may not) be fairly determined, the ulterior motive is for controlling shareholders to reinforce or consolidate their influence in the listed company. As a consequence, minority investors suffer not only from short-term erosion in the value of their shares in cases of dilution; their interests also get marginalized because the long-term outcome is management entrenchment—in Asia's case, the long-term domination of controlling shareholders on the company's board.

Excluding other shareholders from corporate opportunity, or usurpation, occurs when a controlling shareholder creates a business opportunity outside the listed company's operations; it is a private endeavor. The result is that minority shareholders are robbed of an opportunity from which the company as a whole should have had the priority to benefit. In the United States, usurpation "might be considered a damage caused by a director to potential interest of the company by diverting any company's business opportunities on his own or third parties' account."<sup>83</sup> Where separation of ownership and control exists, the act is a breach of fiduciary duty by a director and can result in litigation; the case is often brought by the company that lost the opportunity.<sup>84</sup> In Asia, the legal framework for these cases is a blur because commercial codes tend to stipulate that directors owe fiduciary duty to the company—in other words, to themselves.

Deprivation of wealth opportunity also occurs when the majority shareholder takes away the most valuable asset of a company through privatization or the sale of its core assets. Although independent shareholders almost always have to vote on these related transactions, they sometimes end up getting the raw end of the deal by being offered an unattractive valuation with no recourse to a clear alternative strategy. Knowing that the controlling shareholder has an intention to sell, they carry the burden of uncertainty as to the future of the company if they reject the deal. The case raises the issue of the independence of shareholders who are allowed to vote on such transactions and opens the possibility of related parties (who are not allowed to vote) to then lend their shares to others who will vote in their favor.

### *Sample cases: Appropriation of control*

- In July 2008, a Korean court acquitted senior executives of Samsung Group, including former chairman Lee Kun-Hee, on charges of breach of fiduciary duty for their roles in the issuance of convertible bonds by two affiliates to Lee's son, Lee Jae-Yong. One of the affiliates is Samsung Everland, the *de facto* holding company of Samsung Electronics, the most valuable asset of Korea's largest *chaebol*. The year before, two senior Everland executives were convicted by the same court of the same charges. The case continues to be the most cited example of how *chaebols* transfer control to family members by perpetrating ownership through behind-the-scenes transactions.

The case centers on the convertible bonds (CBs) issued by Everland and Samsung SDS to the younger Lee in 1996 and 1999, respectively. Directors of both affiliates were accused of underpricing the bonds, resulting in KRW250 billion (USD218 million) in losses for the group.<sup>85</sup> The conversion price of the Everland CBs was set at KRW7,700 (USD6.7) and Samsung SDSs at KRW7,150 (USD6.23), both a 90 percent discount to the

<sup>83</sup>Christian Campbell, *International Liability of Corporate Directors*, vol. II, 2007 ed. (Salzburg, Austria: Yorkhill Law Publishing, 2007):137.

<sup>84</sup>Lisa Peters, "Corporate Opportunity—A Primer," (Lawson & Lundell, 2001): <http://www.lawsonlundell.com/Resources/News-and-Publications/Corporate-Opportunity-A-Primer-Part-1>.

<sup>85</sup>"Samsung Chairman Guilty of Tax Evasion but Cleared of Other Charges," *The Hankyoreh* (17 July 2008): [http://english.hani.co.kr/arti/english\\_edition/e\\_national/299309.html](http://english.hani.co.kr/arti/english_edition/e_national/299309.html).

price at which their common stocks were trading in the over-the-counter market. Prosecutors alleged that the SDS deal was meant to give Lee managerial control in the IT-services company prior to its IPO and that the Everland deal would transfer to him his father's control over the group.<sup>86</sup> In 1999, Lee converted the bonds and became Everland's largest shareholder with a 25.1 percent stake.

In handing the guilty verdict to the two Everland executives in 2007, the Seoul High Court ruled that the decision by the board to issue the CBs took place without a quorum and was therefore void. (It did not, however, void the issuance itself.<sup>87</sup>) It also found that although existing shareholders had preemptive rights to subscribe to the issue, their decision to opt out was coordinated by "confidantes" of the senior Lee.<sup>88</sup> But in finding Lee and the other Samsung executives not guilty in the July 2008 verdict, the court ruled that because Everland's shareholders gave up their preemptive rights, the directors could neither be charged with misappropriation of funds nor be held liable for the losses Everland incurred. (It also dismissed the SDS case, saying its statute of limitations had expired.<sup>89</sup>)

### **Sample cases: Usurpation of corporate opportunity**

- In September 2007, the Korea Fair Trade Commission imposed a fine of KRW63 billion (USD55 million) on four Hyundai group companies for undue internal trading.<sup>90</sup> One of them was logistics company Glovis Co. The case, however, was just a symptom of a bigger issue. Shareholder activists cite Hyundai's relationship with Glovis as an exemplary case of how *chaebol* families privately benefit from opportunities that should have remained within the listed company.

In 2001, Hyundai chairman Chung Mong-Koo and his son Chung Eui-Sun established Glovis with just USD5 million in paid-up capital. Glovis' primary business was the local and international delivery of all vehicles made by affiliates Hyundai Motor and Kia Motors, currently the world's 10th and 16th largest carmakers. In 2004, the Chungs sold 20 percent of Glovis to Norwegian shipping company Wilh. Wilhelmsen. By 2005, Glovis' exclusive contract with the two automakers led to earnings of USD81.9 million on sales of USD1.58 billion.<sup>91</sup> That December, Glovis listed on the Korea Exchange. Based on its July 2008 price of about KRW60,000 (USD52.3) a share, the Chung's stake of 60 percent was worth about KRW1.3 trillion (USD1.1 billion).<sup>92</sup>

- In 2006, tax authorities in Korea began an investigation of Shinsegae Department Store (SDS) based on allegations of unfair wealth transfer to its controlling shareholder, the Chung family (not related to the Chungs of Hyundai). Central to the case is Gwangju Shinsegae Co., which SDS incorporated in the mid-1990s to operate a department store using the Shinsegae brand. In 1998, Gwangju sought an increase in paid-up capital, to which SDS gave up its right to subscribe. The Chung family took up the slack, becoming its largest shareholder with an 83 percent stake, and made further investments in 1999 when Gwangju was worth about KRW4,000 (USD3.5) per share. Gwangju has since listed, and its shares were trading at KRW127,000 (USD110) as of August 2008.<sup>93</sup>

<sup>86</sup>Jae-Seung Baek, Jun-Koo Kang, and Inmo Lee, "Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols," working paper (April 2005):3-4 (<http://ssrn.com/abstract=702042>).

<sup>87</sup>"Another Rap over the Knuckles of Samsung," *Chosun Ilbo* (30 May 2007): <http://english.chosun.com/w21data/html/news/200705/200705300021.html>.

<sup>88</sup>"Samsung Verdict Defies Reason," *The Hankyoreh* (17 July 2008): [http://english.hani.co.kr/arti/english\\_edition/e\\_editorial/299310.html](http://english.hani.co.kr/arti/english_edition/e_editorial/299310.html).

<sup>89</sup>"Samsung Chairman Guilty of Tax Evasion but Cleared of Other Charges," *The Hankyoreh* (17 July 2008): [http://english.hani.co.kr/arti/english\\_edition/e\\_national/299309.html](http://english.hani.co.kr/arti/english_edition/e_national/299309.html).

<sup>90</sup>Ryu Jin, "Hyundai-Kia Group Fined \$67 Mil. for Unfair Trading," *The Korea Times* (6 September 2007): [http://www.koreatimes.co.kr/www/news/biz/2007/09/123\\_9672.html](http://www.koreatimes.co.kr/www/news/biz/2007/09/123_9672.html).

<sup>91</sup>Moon Ihlwan, "Korea's *Chaebol* Syndrome Persists," *BusinessWeek* (3 May 2006): [http://www.businessweek.com/globalbiz/content/may2006/gb20060503\\_118188.htm?chan=search](http://www.businessweek.com/globalbiz/content/may2006/gb20060503_118188.htm?chan=search).

<sup>92</sup>Jisoo Lee, "Related Party Transactions: Approval by Boards and Shareholders in Asia, Korea Case Study," Presentation before the OECD 2008 Roundtable on Corporate Governance, Hong Kong (13-14 May 2008).

<sup>93</sup>"Shinsegae under Tax Probe," *Korea Times* (10 April 2006).

### Sample cases: Privatization and buyout of strategic assets

- In December 2007, minority investors of Henderson Investment Limited (HIL)—a diversified company with interests in utilities, infrastructure, and real estate—approved a proposal by controlling shareholder Henderson Land Development Company (HLD) to buy out its entire 39 percent stake in Hong Kong and China Gas (HKCG). The sole supplier of piped gas in Hong Kong, HKCG was a key asset in HIL’s portfolio. HKCG’s buyout was the closest the parent company has gone to enjoying the benefits of the subsidiary’s investment returns without sharing them with minority investors.

In 2002 and 2005, HLD tried and failed to buy the 32 percent of HIL shares it did not already own. In its first attempt, HLD made an all-cash offer of HKD7.60 (USD0.97) per HIL share, which minority shareholders promptly criticized for being too low. In a statement, Templeton Asset Management claimed it was even less than the HKD7.76 per share value of Henderson Investment’s stake in HKCG, let alone its other assets. Estimating HIL’s fair value at HKD11 a share, Templeton denounced its controlling shareholders—the family of Lee Shau-Kee, Hong Kong’s second richest man—for “taking advantage of the current poor market sentiments to buy up the company cheaply ... at the expense of the minority shareholders.”<sup>94</sup>

In 2005, HLD took a different tack, offering one of its shares for every 2.5 HIL shares, effectively valuing the latter at HKD13.23 (USD1.15). Investors again rejected the offer, which some had determined to be a 19 percent discount to the company’s net asset value.<sup>95</sup>

In the 2007 buyout of HIL’s shares in HKCG, HLD offered a cash-and-share deal equivalent to the average closing price of HKCG in the 10 previous trading days, which investors accepted. Shareholder activist and former HKEx independent director David Webb deemed the price as substandard for not adding a control premium for an asset with a proven cash-generation record. As a monopoly, HKCG has stable earnings and steady dividends, which had been held at 32 cents a share since 2002. After the HLD acquisition, HKCG announced it was raising its dividend to 35 cents a share.

- In 2006, minority shareholders of a Singapore-listed company were left in limbo over its ownership and underlying business after what became a bizarre case of failed privatization and asset divestment. The company involved was Pacific Century Regional Developments (PCRD), which has interests in broadband and property but whose main asset was a 23 percent stake in PCCW, a Hong Kong-listed telecom and cable TV operator. Earlier in 2006, controlling shareholder Richard Li Tzar-Ki—son of Hong Kong’s richest man, Li Ka-Shing—announced an interest in acquiring the 25 percent of PCRD that he did not already own as the first step to his eventual goal of selling the PCCW stake. By that time, Richard Li had approached two foreign private-equity firms to bid for the asset. However, that plan was thwarted when the Chinese government, which owns 20 percent of PCCW through an SOE, publicly denounced Li and said the telecom asset should remain in Chinese hands.<sup>96</sup>

In July 2006, an investor group led by a Hong Kong investment banker and long-time adviser of the elder Li made an offer for the PCCW stake, priced at a nearly 20 percent premium to its current market price. Richard Li entertained the offer, and in November, he asked PCRD shareholders to vote on two proposals: the first, his offer to privatize the company; the second, to sell the PCCW stake to the investor group.<sup>97</sup> Days before the vote, the investor group revealed its composition upon the demand of regulators. Two of its substantial backers, it turned out, were foundations run by Li Ka-Shing, from whom the younger Li had been estranged. In a rare display of family discord, Richard Li publicly expressed that he no longer wanted to sell the PCCW stake and that he would be “very happy” if PCRD shareholders voted against the investor group’s offer.

<sup>94</sup>David Webb, “Templeton Opposes Henderson Offer,” *webb-site.com* (11 November 2002): <http://www.webb-site.com/articles/hitemple.htm>.

<sup>95</sup>“Henderson Arm Buyout Collapses as Investors Rebel,” *South China Morning Post* (21 January 2006).

<sup>96</sup>Donald Gleenlees, “The Fall of the Hong Kong Deal Maker Richard Li,” *International Herald Tribune* (27 November 2006): <http://www.iht.com/articles/2006/11/27/business/pccw.php>.

<sup>97</sup>Benjamin Scent, “Shareholders Reject Li Bid to Privatize PCRD,” *The Standard* (25 November 2006): [http://www.thestandard.com.hk/news\\_detail.asp?pp\\_cat=2&art\\_id=32693&sid=11045891&con\\_type=1&d\\_str=20061125&sear\\_year=2006](http://www.thestandard.com.hk/news_detail.asp?pp_cat=2&art_id=32693&sid=11045891&con_type=1&d_str=20061125&sear_year=2006).



By then, the Singapore Exchange had decided that Li and the investor group were related parties and thus barred Li from voting his shares.<sup>98</sup> In the end, PCRDR shareholders overwhelmingly voted against the privatization, while a large majority voted against the sale of the PCCW stake because the premium was too small. Media reports have said that Richard Li continues to be looking for ways to unload the stake. In July 2008, PCCW announced a restructuring plan that carves out its telecommunications and media assets into a new company and sells up to 45 percent of it to investors.<sup>99</sup>

- In 2002, Boto International Holdings, what was then the world's largest maker of artificial Christmas trees, shocked the Hong Kong investment community when its chairman and controlling shareholder decided to sell its core business, which accounted for 97 percent of revenues, to the U.S. private equity firm the Carlyle Group. After the sale, the only thing left was a computer graphics and animation business run by the chairman's then-25-year-old son. The buyout offer valued the company's festive decorations and outdoor furniture assets at HKD1.1 billion (USD141 million), already slightly less than its market value prior to the announcement. But the deal also required that Boto retain HKD200 million (USD25.7 million) of the proceeds in case of future claims from the buyer, which would leave even less cash for minority investors.

The company rationalized the deal by saying that the industry had matured and that prospects had dimmed, particularly after its single largest customer, the U.S. department store chain K-Mart, filed for bankruptcy protection. Institutional investors disputed the claim vigorously, citing that management's outlook had been upbeat just prior to the Carlyle offer and presenting their own valuations and industry research in a media campaign to scupper the deal. Nonetheless, in spite of a negative voting recommendation by an independent auditing firm, a slight majority of independent shareholders, 53 to 47, voted in favor of the deal. This led a number of vocal investors to question the independence of some who were able to vote, including a former executive director who retired during the shareholder meeting and a trust established by a co-founder of the company.

### **An overview of related-party "wildcards" that affect minority shareholders**

Group-ownership structures, such as the three predominate models in Asia, do not have to engage in related-party transactions to pose a risk to investors. Simple affiliation can sometimes compromise minority interest when certain situations occur. These wildcard events (often unpredictable and sometimes controversial affairs involving controlling shareholders and their related parties) may not have an impact on the company's economic value or even lead to an immediate decline in its shareholder value. They may, however, pose a reputational risk when they create negative public opinion. More important, they may hint at larger governance challenges within the company—raising uncertainties about its future, casting a cloud on its outlook, and ultimately undermining the company's intrinsic value.

Related-party wildcards are often observed in family-controlled businesses. In Asia, where many listed companies are still headed by the founding family's second generation, many of whom are now approaching retirement age, wildcard transactions are more likely to happen in the coming years as leadership goes through a generational shift. Succession of company leadership is a recurring theme. In some cases, a leadership vacuum is created and felt across the group when the chair of a conglomerate—who often plays the role of visionary and chief executive—passes away without having groomed or identified a successor. In other cases, rivalries between siblings and other family members, often involving leadership and ownership issues, get thrown into the limelight and lead to the formation of factions that split the loyalties of directors and cause confusion about group strategy in the process.

<sup>98</sup> Donald Gleenlees, "The Fall of the Hong Kong Deal Maker Richard Li," *International Herald Tribune* (27 November 2006): <http://www.ihrt.com/articles/2006/11/27/business/pccw.php>.

<sup>99</sup> Nisha Gopalan, "PCCW Draws Interest in HKT Group Stake Sale," *The Wall Street Journal Asia* (15 July 2008).

In 2008, variations of these cases played out in some of Asia's wealthiest families:

- In April, analysts began to question the future direction of Samsung Corporation when its chairman, Lee Kun-Hee, unexpectedly resigned after being indicted for various charges. (He was later found guilty of tax evasion but was given a suspended sentence.) With Lee's resignation came the dissolution of Samsung's Strategic Planning Office—the “group command center” that sets the strategy for all companies under the Samsung umbrella.<sup>100</sup> Lee Soo-Bin, chairman of unlisted Samsung Life Insurance, vividly illustrated the dependence of *chaebols* as follows: “Now, Samsung faces a complex crisis as it has no captain and rudder, and each affiliate should independently survive fierce competition for its existence.”<sup>101</sup> Although it is believed that Lee Jae-Yong, Lee's son, will take the corporate reins, he was assigned to an overseas unit for an indefinite period.
- In May, an appeals court allowed the board of the largest real estate developer in Hong Kong, Sun Hung Kai Properties (SHKP), to vote to replace its chairman, Walter Kwok. The decision capped the sibling rivalry that dragged down the company's market value by USD4 billion in less than two weeks.<sup>102</sup> Kwok, who was also chief executive, had been on leave of absence from SHKP since February. Although the company was mum about the situation, court filings revealed that his younger brothers, managing directors Thomas and Raymond Kwok, tried to remove him from the board because of his alleged bipolar affective disorder arising from his kidnapping 12 years earlier. A psychiatrist disproved the claim, and Walter Kwok won an injunction on 15 May, an hour before the board cast its vote. He lost in its final decision 11 days later.<sup>103</sup>

The case came as a shock to market participants who knew SHKP as one of the best-governed family-controlled companies in Hong Kong. Walter Kwok's brothers took charge of the business, which remains focused on property development “under the principle of collective leadership”<sup>104</sup> after their father passed away in 1990. Although the younger brothers cited medical reasons for their elder brother's ouster, media reports cited unnamed insiders who said the company had been displeased that Walter Kwok was making decisions on projects and investments without consulting the board, a charge he denied. Kwok was relegated to non-executive director and was replaced as chair by his 79-year-old mother, who owned 41 percent of the company's issued share capital.

- In July, a sibling rivalry in the family that created the largest private enterprise in India halted the creation of what could have been the seventh-largest mobile phone company in the world by subscriber numbers.<sup>105</sup> Two months prior, Reliance Communications (R-com), controlled by Anil Ambani, announced it was in talks to merge with MTN Group of South Africa. Anil Ambani planned to sell his 66 percent stake in R-com to MTN in a share-swap deal. It would have made R-com a subsidiary of MTN, with Ambani being the biggest shareholder of the merged entity.<sup>106</sup> In June, Mukesh Ambani, head of Reliance Industries (RIL), the former parent of R-com, sent a letter to the company saying RIL had the right of first refusal over any deal that involved the sale or swap of R-com shares. Citing legal and regulatory issues, R-com and MTN announced an end to the talks and what would have been the largest overseas acquisition by an Indian company.<sup>107</sup>

<sup>100</sup>Cho Young-ho, “Samsung Management's Reform Plan,” *Maeil Business Newspaper* (23 April 2008): [http://www.koreafocus.or.kr/design2/layout/content\\_print.asp?group\\_id=101991](http://www.koreafocus.or.kr/design2/layout/content_print.asp?group_id=101991).

<sup>101</sup>“South Korea's Largest Conglomerate Samsung in ‘Leadership Crisis,’ Top Executive Says,” *International Herald Tribune* (2 July 2008): <http://www.iht.com/articles/ap/2008/07/02/business/AS-SKorea-Samsung.php>.

<sup>102</sup>“Sun Hung Kai Votes to Replace Chairman,” *International Herald Tribune* (27 May 2008): <http://www.iht.com/articles/2008/05/27/business/27kwok.php>.

<sup>103</sup>Robin Kwong, “Sun Hung Kai Clan's Real-Life Soap Opera,” *Financial Times* (28 May 2008): <http://search.ft.com/iai?referer=&location=http%3A%2F%2Fsearch.ft.com%2FftArticle%3Fid%3D080528000234%26ct%3D0&ct=0&id=080528000234>.

<sup>104</sup>“Sun Hung Kai Properties Announces Changes to the Board,” press release, Sun Hung Kai Properties (27 May 2008): [http://www.shkp.com/en/scripts/news/news\\_press\\_detail.php?press\\_id=3705](http://www.shkp.com/en/scripts/news/news_press_detail.php?press_id=3705).

<sup>105</sup>“Reliance May Pay Premium for MTN Control,” Reuters (29 May 2008).

<sup>106</sup>Costas Paris and P.R. Venkat, “MTN, Reliance Close to Deal,” *The Wall Street Journal Asia* (3 July 2008): [http://online.wsj.com/article/SB121502670727923771.html?mod=todays\\_asia\\_corporate\\_news](http://online.wsj.com/article/SB121502670727923771.html?mod=todays_asia_corporate_news).

<sup>107</sup>Jackie Range, Eric Bellman, and Dana Cimilluca, “Sibling Rivalry Scuttles Telecom Talks,” *The Wall Street Journal Asia* (19 July 2008).

That was only the highest profile of all the deals in which both brothers have been trying to prevent each other from succeeding. They vied for leadership of what was then the Reliance Group since their father, the founder, died in 2002. In June 2005, with the intervention of their mother, the brothers agreed to break up the group: Mukesh took the core petroleum and petrochemicals business, and Anil took the smaller telecom, finance, and power interests. Many of the arguments that they have been using to thwart each other's deals, including the R-com/MTN merger, are based on that split. Their other conflicts include Anil's efforts to stop RIL from building power plants and a court battle over an increase in the price Anil's energy business has to pay RIL for the gas it supplies—a deviation from their original agreement.<sup>108</sup>

- Also in July, SJM Holdings, the casino group of Stanley Ho, who held a monopoly on Macau's gambling industry for four decades until 2002, completed its Hong Kong IPO—but at a scaled-down amount of USD494 million for 25 percent of its shares. SJM aimed to raise over USD1 billion for the same amount of shares in January, but the plan was delayed after the SFC ordered it to clarify its ownership structure.<sup>109</sup> Ho's sister, Winnie Ho, claimed in more than 30 lawsuits that she had been shortchanged when the parent company, STDM Investments, transferred assets to SJM. She also challenged the identity of the shareholders and the composition of the board of directors of STDM. Stanley Ho has claimed that the shareholder list of STDM had been lost for years.<sup>110</sup> A Hong Kong court rejected Winnie Ho's claims and cleared SJM's IPO; but by then, poor market conditions had prevented SJM from attaining the higher end of its pricing target and its shares fell on the first trading day.

<sup>108</sup>“A Lost Connection,” *The Economist* (24 July 2008): [http://www.economist.com/business/displaystory.cfm?story\\_id=11793156](http://www.economist.com/business/displaystory.cfm?story_id=11793156).

<sup>109</sup>Tom Mitchell and Justine Lau, “Regulatory Query Delays Macao Gaming IPO,” *Financial Times* (15 January 2008).

<sup>110</sup>Amy Or, “Sister of Casino Mogul Fights Stock Listing,” *The Wall Street Journal Asia* (9 July 2008).



# Investor Protections

## How are investors protected from related-party transactions?

As in most jurisdictions, related-party transactions in Asia are governed by layers of rules, regulations, and standards meant to ensure that they are conducted in a way that does not abuse the rights of independent shareholders.

One such layer is built on local accounting standards, which typically apply to all corporations and are determined by the relevant government agency, in collaboration with the self-regulatory organizations of the accounting and auditing professions. The second layer consists of stock exchange listing rules, which set the requirements for disclosure of financial and nonfinancial information. At the foundation of all layers are the listed companies' internal corporate governance systems—led by independent directors who see to it that corporate decisions are fair to all shareholders. In certain situations, minority shareholders and third-party advisers may also get involved in decisions on related-party transactions. Above all, these are corporate laws that sometimes set the boundaries for related-party transactions but always define the responsibilities of management and the fiduciary duty of the board of directors. A key element of investor protection against related-party abuses is the investor's opportunity to take directors to court through shareholder suits to seek remedy for corporate misdeeds.

### *Accounting standards*

In recent years, Asian regulators have gradually embraced the International Financial Reporting Standards (IFRS) set by the International Accounting Standards Board (IASB). The standards define related parties, determine the scope of related-party transactions, and determine how these transactions should be disclosed. The Hong Kong Financial Reporting Standards (HKFRS) have been identical to IFRS since 2005, and the Korea Accounting Standards Board (KASB), which had been adopting IFRS piecemeal, decided in 2006 to make full adoption mandatory for all listed companies beginning in 2011. The Chinese Ministry of Finance also mandated IFRS for all listed companies in January 2007; however, given its status as a centrally planned economy, its standards on related-party transactions (as well as fair-value measurement and business combinations of entities under common control) remain different from those of the IFRS. The IASB is in the process of helping China revise its existing standards and implementation guidance in this regard.

### *Listing rules*

In terms of investor protection, stock exchange listing rules on related-party transactions are even more directly relevant to minority shareholders. Although all Asian jurisdictions have regulatory frameworks to address the disclosure of these transactions, they differ on the value thresholds that determine which disclosures must be made and when or if independent shareholder approval is needed. These thresholds are normally determined by the value of the related-party transaction in relation to a variety of financial factors—such as net tangible assets, book value, market capitalization, and revenues.

In Korea, minority shareholders have no direct influence on a listed company's decision to enter into related-party transactions, and in general, they only get to know about such transactions once a year. The listing rules require companies to seek board approval for transactions exceeding 1 percent of annual revenue or total asset value and to report them to shareholders at a general shareholders' meeting. A set of transactions with a combined value in excess of 5 percent of annual revenue or total asset value is also subject to this regulation.<sup>111</sup> Outside of the listing rules, *chaebols* with assets in excess of KRW2 trillion (USD1.7 billion) have a special requirement, made mandatory by the Korea Fair Trade

<sup>111</sup>Sang-Woo Nam and Il Chong Nam, "Corporate Governance Reform in Asia: Recent Evidence from Indonesia, Republic of Korea, Malaysia and Thailand," Asian Development Bank Institute (October 2004):19 (<http://www.adbi.org/files/2005.01.book.corporate.governance.asia.pdf>).

Commission, for related transactions above KRW10 billion (USD8.7 million) or 10 percent of book equity to be approved by the board and disclosed to the public.<sup>112</sup> In any case, no prior shareholder approval of related-party transactions is required.

### *Independent directors*

In Hong Kong, independent shareholders are given a key role in approving substantial related-party deals. The listing rules require that all connected transactions valued at or greater than HKD10 million (USD1.28 million) or 25 percent of four percentage ratios—asset, revenue, equity capital, and transaction-value-to-market-capitalization—be disclosed to the public, approved by the board of directors, evaluated by an independent financial adviser, and subject to independent shareholders' approval.

Companies are required to publicly announce their proposed connected transactions, and issue a circular to shareholders. The circular must provide a clear and adequate explanation of the transaction, its advantages and disadvantages; a letter from the independent board committee explaining its decision on the deal; and a separate letter from an independent financial adviser explaining its evaluation. Approval of shareholders in a general meeting is required before the transaction can proceed, and a connected party with a material interest in the transaction is not allowed to vote on the resolution approving the transaction.<sup>113</sup>

Transactions valued at between HKD1 million (USD128,200) and HKD10million or 2.5 percent—25 percent of the percentage ratios—are not subject to shareholder approval. They are only required to be disclosed to the exchange.

In China, the Shanghai and Shenzhen Stock Exchanges follow similar standards to the ones in Hong Kong. A company engaging in a related-party transaction with a natural person (such as a director or his family member) must make a timely disclosure to the exchange if the deal exceeds RMB300,000 (USD44,000). Transactions with any related party valued more than RMB3 million (USD440,000), or more than 0.5 percent of the latest audited net assets, must also be disclosed. Those in excess of RMB30 million (USD4.4 million), or more than 5 percent of the latest audited net assets, must be disclosed and subject to third-party appraisal as well as to shareholders' approval at the general meeting. All three instances need the nod of independent directors, who must also provide their opinion in the disclosure.<sup>114</sup>

### *Internal corporate governance systems*

Apart from accounting standards and listing-rule requirements, companies' internal governance systems concerning related-party transactions are essential investor protection mechanisms. One line of defense lies with companies' policies and procedures for monitoring the transactions. In India, for example, companies are required to maintain a register of all related-party transactions that is open to inspection by shareholders.<sup>115</sup> In China, companies are required to have a separate management committee tasked with reviewing related-party transactions.<sup>116</sup>

<sup>112</sup>Woochan Kim, Youngjae Lim, and Taeyoon Sung, "What Determines the Ownership Structure of Business Conglomerates? On the Cash Flow Rights of Korea's Chaebol," Finance Working Paper no. 51/2004, European Corporate Governance Institute (September 2004): [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=594741](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=594741).

<sup>113</sup>Chapter 14A of the Hong Kong Exchange Listing Manual for Main Board Companies.

<sup>114</sup>Chapter 10 of the Shenzhen Stock Exchange Listing Rules.

<sup>115</sup>Sumant Batra, "India: National Experience with Managing Related Party Transactions," prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong (13–14 May 2008):29.

<sup>116</sup>Weidong Zhang, "Related Transactions Based on the Analysis of China's Listed Companies," prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong (13–14 May 2008):18. According to the paper, a survey by Shanghai Stock Exchange in 2008 showed that only 4.6 percent have complied with this requirement.

Another line of defense lies with directors' approval of these transactions. Here, independent non-executive directors and audit committees play a crucial role in determining the fairness of related transactions to minority shareholders. For this reason, regulators in most Asian jurisdictions require listed companies to have a minimum number of independent non-executive directors, as well as an audit committee with independent members.

In Korea, for example, the listing rules require that companies have at least one-fourth and no fewer than three of its board of directors be independent, whereas the commercial law requires two-thirds of the audit committee (which should have at least three members) to also be independent. In Hong Kong, the listing rules require companies to have at least three independent directors; audit committees must have only non-executive directors (at least one of whom must be independent) with appropriate professional qualifications or accounting or financial-management expertise. In China, the corporate governance code requires one-third of the board to be independent. A majority of the members of the audit committee (including its chair) must also be independent, and one of them must be an accounting professional.

### ***Shareholder suits***

The concept of shareholder action against companies and their directors, such as through securities class-action or derivatives suits, is not well developed in most Asian jurisdictions. Like director independence, however, the importance of shareholder suits has been recognized since the Asian Financial Crisis of 1997, and some governments have moved to provide legal redress to protect minority shareholders' rights.

In 2005, Korea introduced legislation on class-action suits against public companies—covering false disclosure in prospectuses and periodic financial reports as well as insider trading, market manipulation, and negligent external audits.<sup>117</sup> In China, the law provides for collective and representative suits, although they are not structured in the same way “class-action” suits work in the West. As it pertains to the securities market, the Chinese law allows for “representative suits with a fixed number of litigants,” and the applicable suits generally fall into six categories arising from property, partnership, and joint-liability disputes.<sup>118</sup> The new company law adopted in 2006, however, allows for derivatives action. Hong Kong law, in contrast, does not accommodate class action at all but does allow derivatives suits.

## **Are the investor protection mechanisms enough?**

To be sure, none of the mechanisms mentioned thus far—even when taken together—is enough to protect investors from abusive related-party transactions. The continued prevalence of questionable deals in Asia also suggests that the systems in place are not foolproof. There is no single weak link; each part of the chain has its own fundamental challenges that make each mechanism either difficult to practice or enforce. The CFA Institute Centre believes that the following four factors undermine investor protection against abusive related-party transactions in Asia.

### ***Inherent difficulties in reporting all related-party transactions***

The collapse of Enron Corporation and its auditor Arthur Andersen highlights the fact that audit failures do happen regardless of the rigor of accounting standards and the skill of external auditors. The statement remains true even absent any complicity between the company and its auditing firm. Accounting and auditing for material related-party transactions are inherently difficult—a fact that the American Institute of Certified Public

<sup>117</sup>E. Han Kim and Woonchun Kim, “Corporate Governance in Korea: A Decade after the Asian Financial Crisis,” Law and Economics Research Paper No. 123, University of Texas Law (December 2007): [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1084066](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1084066).

<sup>118</sup>Michael Palmer and Chao Xi, “Collective and Representative Actions in China,” prepared for the Stanford Law School conference The Globalization of Class Action at Oxford, UK (13–14 December 2007):2–3 ([http://www.law.stanford.edu/display/images/dynamic/events\\_media/China\\_National\\_Report.pdf](http://www.law.stanford.edu/display/images/dynamic/events_media/China_National_Report.pdf)).

Accountants attributes to three distinct but related factors.<sup>119</sup> First, transactions with related parties are not always easily identifiable. This is especially true in Asia, where a company typically trades with numerous small, private enterprises, the ultimate ownership of which cannot always be determined. The situation gets more complicated when the trading partner is based overseas.

Second, auditors rely on management and principal owners to identify all related parties and related-party transactions. This, by definition, becomes ineffectual when the company insider had the prior intent of engaging in a questionable transaction with a related party; to avoid being detected, he or she can simply not disclose the relationship. In general, auditors assume that related-party deals are made under the normal course of business until proven otherwise; however, understanding the rationale for deals that do not follow the normal pattern entails questioning directors, who may not necessarily cooperate. Third, such transactions may not be easily tracked by a company's internal control. It is difficult, for example, to spot a deal between a company and a private entity whose controlling shareholder is a relative. Likewise, a subsidiary that initiated a related transaction may not have made the proper audit documentation to adequately report the transaction back to the head office.<sup>120</sup>

### ***Improvements in regulatory framework required***

In Korea, the listing rules require companies to seek board approval for related-party transactions above a certain threshold. However, the rules do not require shareholder approval, and investors are informed only after the board approval. Most other jurisdictions in Asia have provisions that require shareholder approval as well as separate trigger thresholds for director and shareholder approval.

Apart from listing rules, Korea has an additional layer of regulation for *chaebols*. The KFTC has rules governing related-party transactions, such as bans on cross-shareholdings and mutual debt guarantees, and a ceiling on equity investments among *chaebol* companies. KFTC rules, however, are mandated not to protect independent shareholders but, rather, to level the playing field between *chaebols* and smaller industry players.

Hong Kong's well-considered listing-rule provisions on connected transactions—which require disclosure, directors' approval, third-party review, and a shareholder vote depending on transaction value—could work as a model for other jurisdictions in the region. However, the rules in Hong Kong currently stand on shaky ground. The listing rules, as a whole, have no statutory backing, and violations are only lightly treated by the enforcement authority, the Hong Kong Exchange (HKEx). Of its 24 enforcement actions on connected transactions between 2001 and 2008,<sup>121</sup> none were dealt sanctions any heavier than a public censure or criticism.

In 2005, Hong Kong's Securities and Futures Commission (SFC) proposed that three major listing requirements—disclosure of price-sensitive information, periodic financial reporting, and connected transactions that require shareholder approval—be codified into the Securities and Futures Ordinance, which would transfer from the HKEx to the SFC the power to punish violators of the relevant rules. The government officially supported the proposals in 2007, and amendments to the relevant rules are now under consideration by the legislature.

The listing rules of the Shanghai and Shenzhen exchanges are promulgated by the China Securities Regulatory Commission (CSRC), which like the U.S. SEC has the power to investigate and prosecute securities fraud based on complaints from investors and insiders

<sup>119</sup>AICPA, "Accounting and Auditing for Related Parties and Related Party Transactions," American Institute of Certified Public Accountants (December 2001): [http://ftp.aicpa.org/public/download/news/relpty\\_toolkit.pdf](http://ftp.aicpa.org/public/download/news/relpty_toolkit.pdf).

<sup>120</sup>"Related Party Transactions: Issues Facing Auditors," *A Plus Magazine* (April 2006):32-33 ([http://www.hkicpa.org.hk/APLUS/06\\_april/tech.pdf](http://www.hkicpa.org.hk/APLUS/06_april/tech.pdf)).

<sup>121</sup>Based on a search of enforcement actions against "connected transactions" in the HKEx website, <http://www.hkexnews.hk/reports/enforcement/enforce.asp>.



as well as referrals from the stock exchange.<sup>122</sup> The CSRC also conducts random “on-site inspection” of listed companies on issues of accounting, disclosure, and related-party transactions.<sup>123</sup> Recent amendments to Chinese securities law have improved regulations to protect investors. But it remains to be seen how much the improved legislation will change business practices given that law enforcement has long been a concern in Mainland China.<sup>124</sup>

### ***Questionable independence of independent non-executive directors***

Although Hong Kong and Korea both require listed companies to have a minimum number of independent non-executive directors (INEDs) on their boards, and although most companies comply with the requirement, questions remain as to how independent directors appointed for the role truly are. This arises from the fact that controlling shareholders—given their concentrated ownership and disproportionate voting rights—get to vet the nominees and vote for them in the first place. In most of Asia, independent directors are almost always nominated by executive directors, who either are the owners themselves or were hired by them and are thus bound to represent their interests. As HKEx chief executive Paul Chow has cited in his presentations on corporate governance challenges in Hong Kong, “INEDs may not be truly independent if appointed by major shareholders.”<sup>125</sup>

Listing rules in Asia often set the parameters of what constitutes independence; however, the definitions ignore relationships built outside of kinship and business partnerships, such as friendships and other past connections that help establish personal loyalties. Real outsiders are usually not trusted; friends or close contacts of the controlling family fill the independent-director slots, acting as a rubberstamp to executive directors’ decisions.<sup>126</sup> Given the club mentality in corporate boards, a director with a dissenting opinion is more inclined to resign his post than battle with executive directors, especially when the company is running into trouble.<sup>127</sup> Because no limits exist on the number of times independent directors may serve on the board, their partiality is also prone to diminishing over time. And while cumulative voting of directors may help tip the balance in favor of minority shareholders’ interests, it is not mandatory and is unlikely to be applied to Asian companies with dominant shareholders.

### ***Impediments to taking legal action***

Although Korea has introduced laws to allow securities class-action suits, the rest of Asia has yet to catch up. In 2006, China introduced derivatives suits in its Corporate Law revision. The new law allows any shareholder of a limited liability company, as well as shareholders with more than a 1 percent stake in a joint stock company, to sue directors and senior management who violate laws and regulations or their articles of incorporation. However, derivatives suits are generally a costlier option than class-action suits and provide little to no incentive for minority shareholders to pursue. In a derivatives suit, the shareholder takes action against officers or directors on behalf of the company; he carries not only the burden of proof but also of legal cost. Should he win the case, the reward is paid to the company, and only then can the shareholder be reimbursed for the costs incurred.

<sup>122</sup>Gong-meng Chen, Michael Firth, Ning Daniel Gao, and Oliver M. Rui, “Is China’s Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions” (January 2005): <http://ssrn.com/abstract=711107>.

<sup>123</sup>Tong Daochi, “Capital Market Reform in China: The Role of Corporate Governance,” Presentation given at the REITI Policy Symposium “Corporate Governance from an International Perspective: Diversity or Convergence,” Tokyo (10 January 2003).

<sup>124</sup>Chenxia Shi, “Protecting Investors in China through Multiple Regulatory Mechanisms and Effective Enforcement,” *Arizona Journal of International and Comparative Law*, vol. 24, no. 2 (2007): <http://ssrn.com/abstract=1121254>.

<sup>125</sup>HKEx Chairman Paul Chow, opening remarks, Hong Kong Institute of Chartered Secretaries “Corporate Governance at the Crossroads” Conference, Hong Kong (8 January 2008).

<sup>126</sup>Simon S. M. Ho, “Corporate Governance in Hong Kong: Key Problems and Prospects,” CUHK Centre for Accounting Disclosure and Corporate Governance Research Paper No. 1 (August 2003):27 (<http://ssrn.com/abstract=440924>).

<sup>127</sup>SFC, “The Role of Independent Directors in Improving Corporate Governance,” press release, Hong Kong Securities and Futures Commission (14 October 2006): <http://202.66.146.82/regbod/hk/hksfc/press/p061014.pdf>.

In Hong Kong, the SFC tried to clear the cost impediments of derivatives suits to the shareholder but was met with disapproval. In May 2003, the SFC released a consultation paper empowering themselves to initiate derivatives actions against wrongdoers on behalf of shareholders in the public interest, and of the company concerned. Any damages awarded by the court will go to the concerned company and not to the aggrieved shareholders; the SFC proposes to bear the costs of such suits.

The proposal essentially took the financial burden off shareholders while still acting on their behalf, thus strengthening the status of derivatives suits as a deterrent against corporate abuses. The regulator, however, received criticism from the majority of respondents to its consultation, who argued that the HKSCF's primary role is to establish an appropriate regulatory framework and ensure proper compliance with it, not to interfere in commercial disputes among shareholders and use public funds in the process.<sup>128</sup>

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<sup>128</sup>SFC, "Consultation Paper on the Proposal to Empower the Securities and Futures Commission to Initiate a Derivative Action on Behalf of a Company," Hong Kong Securities and Futures Commission (18 November 2003): [http://www.sfc.hk/sfc/doc/EN/speeches/public/consult/derivative\\_action\\_consult\\_conclusion\\_eng.pdf](http://www.sfc.hk/sfc/doc/EN/speeches/public/consult/derivative_action_consult_conclusion_eng.pdf).

## Conclusion and Recommendations

Related-party transactions are a constant corporate governance risk in Asia. Although the concept is identical to its meaning in the West, the practice differs as a result of the ownership structure characteristic to the region. Many if not most of the largest listed companies in Asia are majority owned by families or the state—with diverse business interests—and because there is often no separation of ownership and control, related-party transactions are prone to misuse by families for their private interests or the state for its own agenda. Motivated by financial gain and a desire to perpetuate control, these deals vary from transfer of assets or sales of securities at unfair prices to financial assistance and outright bailout of related parties. Beyond the accounting definition of related-party transactions, disputes between members of controlling families also pose harm to the management of publicly listed entities and threaten shareholder value.

Abusive related-party transactions happen in Asia because of the weaknesses in the mechanisms that govern them. Independent non-executive directors are in the minority on Asian boards. Furthermore, the position loses its effectiveness as a management watchdog because controlling shareholders exercise their right to nominate and vote for the position. Shareholders often lack the vigilance to monitor and the determination to contest questionable deals, and investors' grievances are met with untenable options for legal redress. Indeed, related-party transactions embody a crucial caveat for investors in Asia: Management and regulation of publicly listed companies are still not oriented toward the protection of minority shareholders.

Good corporate governance is fundamental to free and efficient markets. Investors should be able to put their money in companies without fear that controlling shareholders will manipulate and misappropriate corporate assets at the expense of delivering returns to the investor. Families and state bodies that control businesses should realize that once listed, a company becomes a public trust, and a simple majority ownership does not grant them the right to overextend their influence in management in their own favor to the detriment of minority owners. Likewise, regulators should recognize that in light of the risks of concentrated ownership, independent shareholders should be given better representation on the board, as well as a greater say in the conduct of related-party transactions. Better investor protection is a task for all involved: the investor, the company, and the regulator.

### How to better protect investors from the risks of related-party transactions

With this in mind, the CFA Institute Centre for Financial Market Integrity puts forward the following recommendations as bases for initiatives toward the improvement of investor protection against abusive related-party transactions in Asia.

#### *Investors in Asian companies should try to engage controlling shareholders*

Given the weakness of investor protection mechanisms in Asia, investors should rely on their own diligence to prevent the likelihood of being disadvantaged by related-party transactions. Investors should be more vigilant when such transactions are disclosed and more critical when they are put up for a vote. Although the ownership structure of most Asian companies limits the board representation of minority or independent shareholders, investors should not demonstrate defeatist behavior by voting with their feet. Instead, they should exhaust all available avenues for expressing their views.

Lazard Asset Management's Korea Corporate Governance Fund, advised by shareholder activist Jang Ha-Sung, is perhaps the best-known example of a fund that has consistently, and at times successfully, taken *chaebol* managers to task. In 2006, the fund slowly built up a 5 percent stake in Daehan Synthetic Fiber Company and questioned business decisions it had made, including a plan to invest in the cable television venture of its parent, Taekwang Group.

The fund successfully sued the company to release its shareholder register, which enabled the Lazard fund to scrutinize related-party transactions within the *chaebol*. In December 2006, Taekwang announced it was reorganizing the group into a holding company structure and agreed to create investor relations departments for its subsidiaries.<sup>129</sup>

The Sovereign saga discussed earlier also proved that management could accommodate investors' demand for better governance. Apart from trying to block SK Corporation's bailout of its failed subsidiary, Sovereign also demanded the election of independent directors and the implementation of electronic proxy voting. Although Sovereign failed in its campaign, the *chaebol* made good on its promise to improve its corporate governance: It revamped its board structure by raising the number of independent directors and converted itself into a holding company structure. Similarly, although U.S. investor Carl Icahn and his partners failed to break up the Korean tobacco and ginseng manufacturer KT&G in 2006, they achieved the rare feat of a foreign minority shareholder winning a seat on the board of a Korean company through a proxy fight against management.<sup>130</sup>

### ***Related-party transactions should pass effective approval and disclosure processes***

Regulators in Asia that have not already done so should define material related-party transactions and the threshold values after which the transactions must be disclosed or subject to approval procedures. This will create a bright-line basis for the initial assessment of fairness. The thresholds must not be so high as to allow controlling shareholders to conduct a series of small deals with ultimately the same effect as a single large transaction, nor so low as to be costly and cumbersome to administer.

Under all circumstances, related-party transactions that reach the bright-line materiality threshold for approvals and disclosure should be reviewed by an independent financial adviser to ensure that only fair-market valuations are applied. Companies should consider setting up a committee to review related-party transactions—and disclose its findings to investors in a timely manner. Material transactions—specifically those that involve transfers of assets and that could lead to dilution of the minority stake—should be subject to shareholder approval in a voting by poll, with the related parties abstaining from the vote.

### ***Corporate boards should include more independent directors***

Given the dominance of companies with concentrated ownership in the Asian market, as well as the cultural and political reality that prevents an immediate change in this status quo, separation of ownership and control is the biggest governance challenge for most Asian companies. In theory, independent directors exist to make sure that management decisions are made for the benefit of all shareholders. In a situation where the managers are the owners themselves, it must be recognized that independent directors should have a special duty to represent exclusively the interests of independent shareholders. Directors have a duty of loyalty to the company; this duty, however, becomes self-serving for directors who are themselves controlling shareholders.

In the United States, independent directors must comprise a majority of the board of directors of listed companies. In the United Kingdom, boards are required to have “a balance of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.”<sup>131</sup> By definition, either proportion acts as a high barrier to prevent managers from engaging in self-dealing. The common practice in Asia is to set a minimum number of independent non-executive directors, usually three, in corporate governance

<sup>129</sup> Kyung Bok Cho, “To Court, Armed with Just Minority Shares,” *International Herald Tribune* (20 November 2007): <http://www.iht.com/articles/2007/11/20/bloomberg/sxfund.php>.

<sup>130</sup> E. Han Kim and Woochan Kim, “Corporate Governance in Korea: A Decade after the Asian Financial Crisis,” Law and Economics Research Paper No. 123, University of Texas Law (December 2007): [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1084066](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1084066).

<sup>131</sup> Financial Services Authority, “The Combined Code on Corporate Governance” (July 2003):6 ([www.fsa.gov.uk/pubs/ukla/lr\\_comcode2003.pdf](http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf)).

codes. Some listing rules require a minimum of one-third of the board to have independent directors. Even then, the requirement is not mandatory, and companies can simply either “comply or explain” their inability to follow the code provision. Regulators should consider measures to increase the number of independent directors to better represent the interests of minority investors.

### ***Asian companies should adopt greater transparency on related-party relationships***

Given the prevalence of the conglomerate structure that puts together the private and public interests of controlling shareholders under one umbrella, listed companies in Asia could be more transparent in their related-party relationships. One way of doing so is by voluntarily disclosing the identities and level of ownership of related parties that own a reasonably sizable portion of the company’s shares and by completely disclosing each of their subsidiaries and affiliated companies, indicating their level of ownership in these entities. In cases of tender offers and proxy solicitations, particularly those involving proposals of related-party transactions, companies should have the resources and ability to provide independent shareholders with the shareholder list at little or no cost.

As a best practice, companies should adopt and disclose a statement of policy on related-party transactions, formalizing the review process with a level of detail above and beyond what has been stipulated in regulatory requirements. Currently, some Asian jurisdictions require companies to publish a report on their compliance to the relevant corporate governance code. None of the existing codes, however, provides guidance on checks-and-balances procedures that companies may use when undertaking a related-party transaction. In a voluntary “Conflict of Interest and Related-Party Transactions Policy,” a company may define “related party” and “materiality,” express the circumstances under which it might engage with related parties, and outline its internal control procedures in dealing with conflict-of-interest situations.

### ***Regulations on related-party transactions should be backed by law***

Given the extent of losses minority investors can suffer when controlling shareholders extract corporate wealth from related-party transactions, making companies legally liable when they violate regulations on the conduct of such transactions is one way to ensure that minority investors are protected. This may be achieved by giving listing rules statutory backing, with appropriate civil penalties and orders of compensation in case of a breach. Another possible protection is to make legal redress of grievances a viable option for minority shareholders through the introduction of class-action suits to more effectively deter self-dealing abuses by controlling shareholders.

Ultimately, corporate laws in Asia should take into consideration the reality that minority investors are prone to abuses by controlling shareholders. As such, legal frameworks in the region should acknowledge that directors’ fiduciary duties are owed to all shareholders, including minority shareholders.



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