Research on the Impact of Fallback Share-Raising on Minority Shareholders' Interests

Take C&S Paper Company as an Example

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Abstract. Since 2015, the chairpersons or the actual controllers of the companies in China have been encouraging employees to increase shareholdings of their own companies by announcing Fallback Share-raising. This behavior which intends to stabilize or promote the companies' stock prices seems to be harmless to minority shareholders, however, it can imply that the company is already facing risks and the interests of minority shareholders, especially those who look for quick profits are likely to be harmed. This paper introduces the background and implementation of Fallback Share-raising, then lists several features. Based on these, the paper analyzes the risks for minority shareholders. C&S Paper Company is selected to measure the risks using event study methodology. Finally, the paper summarizes the existing harm and gives some suggestions on how to reduce the hazards of Fallback Share-raising.

Keywords: Fallback Share-raising · Corporate Behavior · Minority Shareholders' Interests · C&S Paper Company

1 Introduction

Fallback Share-raising is a guarantee in the form of official announcement initiated by the chairperson or actual controller of a company to encourage the employees to purchase the company's shares in a specified period. The guarantor promises that if an employee holds the shares to a certain time after the period and does not leave the company before that, the profits of the shares will be attributed to the employee after the lock-up period, and the losses will be made up by the guarantor.

The announcement is usually unexpected by the stock market and is rarely used by the company unless something has or will hurt its share price. The company is left to take the alternative way to save or prevent its share price from falling in a short time.

Fallback Share-raising first appeared in China in 2015, when the stock prices of China's A-share market collapsed rapidly after a continuous rise. To stabilize the stock market, the state decisively rescued the market by adopting a few measures including encouraging directors, supervisors and controllers of listed companies to increase shareholdings of their own companies to protect the interests of the investors [1]. Under this

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background, many companies put forward Fallback Share-raising alternatively. In order to regulate such behavior, China's Shenzhen Stock Exchange issued a notice on June 8, 2017, requiring companies to disclose the details of relevant terms.

The global economy is in a downturn influenced by the epidemic, and the stock market has been experiencing declines. A climbing number of companies in China have been putting forward Fallback Share-raising in recent years including C&S Paper, a leading household paper company. This paper selects C&S Paper Company as an example because it has been the first and only company to announce Fallback Share-raising during a rise of share price and it has a far-reaching impact on C&S Paper Company's share price. Investors flooded in for quick profits, most of whom are still trapped due to the ongoing decrease of the company's share price after the announcement which means interests of its minority shareholders have been seriously violated.

2 Essence and Features of Fallback Share-Raising

From the perspective of Option Theory, Fallback Share-raising is a European-style put option in its essence, because the employee acquires an option by purchasing the company's shares, and the option is exercised on the condition that the company's share price falls or fails to reach the expected rate of return in a specified period [2].

Features of Fallback Share-raising can be listed as follows based on the past.

- Most companies made the announcements when their stock prices fell, especially when the prices fell at a fast pace.
- The companies' stock prices were mostly stabilized or promoted with some rising successively, but soon afterwards many returned to a downward trend with some stayed in the depression and even a few companies delisted.
- Since 2017, more than 50% of the companies that made the announcements had seen declines in financial performances just before the initiations.
- Many companies' controlling shareholders reduced their holdings at high prices, and some encouraged employees to increase their holdings but then reduced their own holdings for cash after the announcements, while other executives followed.
- Many companies' employees purchased few shares, showing negative responses, not to mention that some announcements also limited the number of allowed employees.

3 Risks for Minority Shareholders in Fallback Share-Raising

3.1 Risk of Share Price Manipulation by the Company

The announcement effect draws huge investment attention, which is an incentive to the company's share price. Thus, the company can achieve a stealthy manipulation of its share price, but this argument is still controversial [3]. If the terms limit the percentage of employees who can receive the guarantees, the company can yield much more than the guarantor's personal compensation by the manipulation. Employees who respond to the guarantee can be compensated by the guarantor if they suffer losses, but other investors are left to bear their own losses.

3.2 Risk of Shareholding Reduction by Majority Shareholders

Fallback Share-raising is a positive announcement, but the rapid rise of the share price after the announcement can hardly indicate the actual value increase of the company. When executives who are majority shareholders believe that the company's value is overestimated and that the performance of the company is declining, they tend to reduce their holdings of the company [4]. They can do so after the announcement, especially when the share price continues to rise because negative information that was released can be masked. The executives often learn more about internal management and future strategy of the company, so there is a large information asymmetry between inside executives and outside investors, and the interests of minority shareholders, especially the investors who are not guaranteed, are more likely to be harmed [5].

3.3 Risk of Being Beguiled by the Company's Chairperson

The company's employees are relatively inexperienced in investing compared to the outside investors, and they tend to think that Fallback Share-raising is a "risk-free investment". Consequently, they tend to respond positively to the chairperson's call to increase their shares of the company. However, if the company is at risk already or will encounter difficulties, its share price will probably fall, then the employees' investment returns will be low, and they may even suffer great losses because the promises can be hard to fulfill, or the company is delisted.

4 Analysis on C&S Paper Company's Fallback Share-Raising

4.1 Case Overview of C&S Paper Company

C&S Paper Co., Ltd. is a leading manufacturer and distributor of middle to high-end household paper. It is the first and only A-share listed company in its industry in China. Pulp, the raw material of its products, is mostly imported and its price fluctuates periodically which increases the company's operating costs in 2021. By the end of 2021, the company's performance has seen a substantial decline in the net profit falling by about 36% compared to the last year, which is the first in nearly seven years.

Under this background, Deng Yingzhong, the company's chairman and actual controller, announced on May 9, 2021, which is not a trade date, that any employee who bought not less than 1,000 shares of the company's stock between May 10th and May 31st, and held them until May 30th without leaving the job, would be guaranteed. He also promised not to reduce or pledge his entire holdings of the company's shares. However, two months later, its share price plummeted by about 50%, and by November 2022, more than 70%. Before and after the announcement, several executives resigned, and the chairman stepped down. On June 2, 2022, Deng announced that he had compensated the employees, so the employees' interests were protected, but many other investors were not. According to the company's quarterly reports, there were more than 80 thousand new shareholders in the third quarter, adding up to about 160 thousand shareholders. The number of new and total shareholders reached a record high. Many investors are trapped in the stock market and are left to bear their own losses.

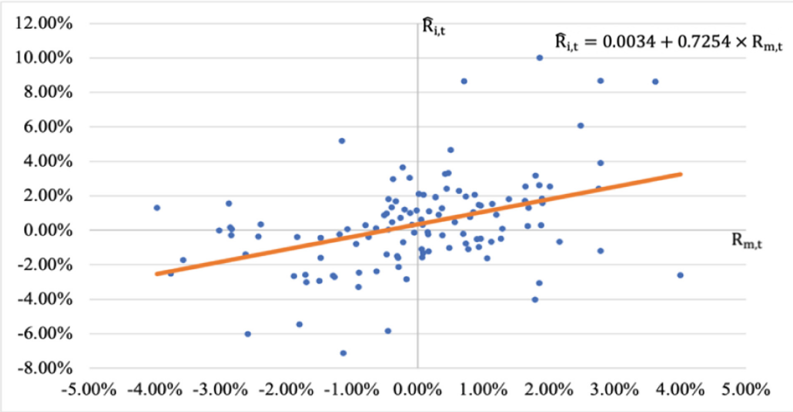

Fig. 1. Regression fit plot [self-drawn]

4.2 Analysis on the Impact of Fallback Share-Raising

To measure the market effect of the announcements of listed companies, many studies use the event study methodology, which can quantify the impact of the event on the company's share price. This research takes the same way to examine the impact of Fallback Share-raising on minority shareholders' interests.

Trading day May 10, 2021, one day after the announcement date, is selected as the event date, that is day 0. [−5, 9] is selected as the event window in which no other significant events happen. [−125, −6] is used as the estimation window, and it is for fitting the regression Eq. (1) using market model.

In Eq. (1), $R_{i,t}$ refers to the actual return of company i on trading day t. α_i and β_i are coefficients. $R_{m,t}$ refers to the market return on trading day t, and $R_{m,t}$ can be replaced by 399005 SMB (Small and Medium Enterprise Board) index in this research. $\varepsilon_{i,t}$ refers to the residuals, which can be neglected. After regression fitting, the estimated coefficients $\widehat{\alpha}_i = 0.0034$, $\widehat{\beta}_i = 0.7254$. The coefficients are brought into Eq. (1), and Eq. (2) is obtained. The regression fit plot is shown as Fig. 1.

$$R_{i,t} = \alpha_i + \beta_i \times R_{m,t} + \varepsilon_{i,t} \tag{1}$$

$$\widehat{R}_{i,t} = 0.0034 + 0.7254 \times R_{m,t} \tag{2}$$

Next, the daily market return $R_{m,t}$ in the event window [-5,9] is brought into Eq. (2) to calculate the company's daily expected return $\widehat{R}_{i,t}$. The daily abnormal return $AR_{i,t}$, which is also called unexpected return, is then calculated as is shown in Eq. (3). This equation explains that the unexpected return is the actual return excluding the expected return. Finally, the cumulative abnormal return $CAR_i(t_1, t_2)$ over the event window [−5,9] is calculated by adding up daily abnormal return $AR_{i,t}$, as is shown in Eq. (4).

$$AR_{i,t} = R_{i,t} - \widehat{R}_{i,t} \tag{3}$$

Table 1. Calculated data in the event window [self-drawn]

Trade date	Dif	$R_{i,t}$ (%)	$R_{m,t}$ (%)	$\widehat{R}_{i,t}$ (%)	AR (%)	CAR (%)
2021/4/28	−5	−1.70	0.68	0.84	−2.54	−2.54
2021/4/29	−4	3.73	0.50	0.71	3.02	0.49
2021/4/30	−3	0.72	−0.27	0.15	0.57	1.06
2021/5/6	−2	1.07	−1.59	−0.81	1.88	2.94
2021/5/7	−1	−3.11	−1.61	−0.83	−2.28	0.66
2021/5/10	0	7.12	−0.67	−0.14	7.26	7.92
2021/5/11	1	3.52	0.01	0.35	3.17	11.09
2021/5/12	2	−1.13	0.66	0.82	−1.95	9.14
2021/5/13	3	−2.36	−1.11	−0.47	−1.89	7.25
2021/5/14	4	−1.58	1.53	1.45	−3.03	4.22
2021/5/17	5	4.18	2.07	1.84	2.33	6.55
2021/5/18	6	−2.78	0.15	0.45	−3.23	3.32
2021/5/19	7	−2.92	0.55	0.74	−3.66	−0.33
2021/5/20	8	1.92	0.49	0.70	1.22	0.89
2021/5/21	9	−0.13	−0.77	−0.22	0.09	0.98

$$CAR_i(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_{i,t} \tag{4}$$

CARs in the event window [−5,9] are shown in Table 1 as follows. Dif stands for differential value. Table 1 shows that within a short period of time after the event date (Dif = 0), the actual returns of C&S Paper Company's share were significantly above the SMB Index, which enhanced the investors' confidence. The announcement of Fallback Share-raising conveyed a positive message because shortly after the event date, the company's CAR increased significantly to 11.09%. However, this effect was not sustained and did not protect the interests of minority shareholders in the long term because on the 7th trading day after the event date, CAR dropped back to -0.33% and maintained previous levels. It can be seen that $R_{i,t}$ fell to -1.13% just on the 2nd trading day after the event date and was frequently lower than the SMB Index ($R_{m,t}$) thereafter, which lowered investors' confidence in investing.

Figure 2 is drawn based on ARs and CARs in Table 1. It can be clearly noted that AR showed a substantial increase right on the event date, but are frequently below 0% thereafter, which indicates that although the market response to Fallback Share-raising is highly optimistic within a short period of time, such response is prone to decline. The company's future share price is more uncertain and more susceptible to shocks coupled with the stepwise decline in the company's financial performance and internal management chaos, which means the interests of minority shareholders can be damaged. What is worse, small investors might suffer severe losses due to the ongoing downturn.

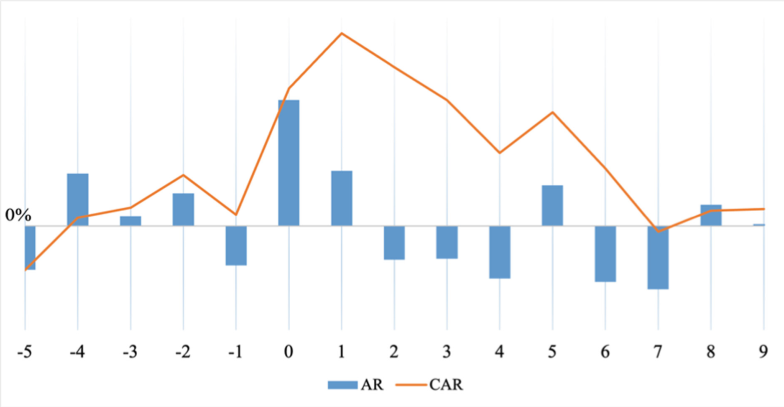

Fig. 2. Trend plot of AR and CAR [self-drawn]

5 Conclusions

From the perspective of corporate risk, the example above shows that it is difficult for the interests of minority shareholders to be guaranteed. When the company is also facing operational and management risks, they are more likely to be harmed.

From the perspective of the motives of the guarantor, the real motives are mostly unclear, which disguises the investors and makes them suffer losses. Also, the restrictive terms such as the lock-up period and the minimum purchase limit set in the terms raise doubts as to whether the share-raising is for rescuing the company or for benefiting employees. This means employees can be trapped in an unfulfilled guarantee.

From the perspective of the vulnerability of minority shareholders, the fulfillment still depends on integrity and solvency of the guarantor. Accordingly, employees may also become victims if they respond to the initiation, while the losses of other investors who are not protected by the terms is most likely to be magnified by share price manipulations, shareholding reductions by major holders and market volatility.

In summary, Fallback Share-raising can cause a significant damage to the interests of minority shareholders, especially those who look for quick profits.

6 Suggestions on Protecting and Consolidating Minority Shareholders' Interests

6.1 Suggestions for Listed Companies

In the short term, listed companies can possibly achieve positive effects of lifting market expectations and increasing stock prices by announcing Fallback Share-raising. However, in the long run, the stock market tends to be rational due to the substantial gap between the company's financial performance, internal management, employee responses and market expectations. Also, investors' consistent expectations may cause a chain reaction of stock prices crashing in the market [6]. Therefore, listed companies can elevate their actual value instead of manipulating market value, which means listed companies should avoid taking advantages of investors who look for quick profits and stop controlling the market to disguise their actual motives. Plus, the guarantors and executives should consider increasing shareholdings of their own companies to share the risk with investors to consolidate their interests. With the increase, major shareholders under the pre-pressure of equity pledge can achieve better performances of the companies' future stock prices especially [7].

For employees, Fallback Share-raising only preserve their capital. There is no compensation for the time value of their capital, that is, the companies' behavior is equivalent to raising credit financing from employees without paying any interest. Companies tend to claim that Fallback Share-raising is good for employees, but employees lack judgment about the risks of accepting the terms, and the companies' outwardly charitable behavior may harm their interests instead. It would be better for companies to declare the risks to employees in advance and compensate them for the time value of their capital. If the share price falls successively, companies may consider permit employees to receive compensations for losses in advance.

6.2 Suggestions for Minority Shareholders

Fallback Share-raising is a positive announcement released by the company, but this kind of announcement is relatively more favorable to employees. Minority shareholders, especially general investors in the secondary market who are not guaranteed, are more likely to experience damage to their interests because they are not protected by the terms. It is difficult for minority shareholders to overcome the time lag and inadequacy of information, so they need to be more cautious when investing. They can make investment decisions by considering information on the company's governance structure, financial performance and status of equity pledge of the promisor. It is irrational for minority shareholders to expect short-term profits vainly. They may consider investing for a long term and choosing a reasonable portfolio to reduce the damage.

If permitted, they have the rights to require the companies to disclose information concerned with their interests, especially information on the adverse impact of management changes on the company's operation and internal management. They can also receive strong protection by requiring the companies they invest in to add protective provisions that enable them to veto specific company events [8].

6.3 Suggestions for Authorities

From the view of regulation, in China, it is not allowed for the major shareholders or directors and supervisors of listed companies to recommend their own shares to the investors [9]. Fallback Share-raising is precisely a kind of behavior of boasting, and such behavior is not strictly regulated. It is necessary to build a supervising system. Until now, China's Company Law, Securities Law and the notice issued by Shenzhen Stock Exchange have not imposed mandatory requirements about Fallback Share-raising on listed companies. Although companies need to comply with certain standards, the fulfillment of promises still depends on the competition in the industry, the proportion of equity pledged by the promisor, the ability of the promisor to fulfill and future financial performance of the company. Policymakers can require companies to regularly disclose information on the internal holders' reductions of shareholdings and guarantors' fulfillment progress of compensations to the employees. They can also limit the length of the lock-up period adopted by the companies.

To discern the real motives for announcing Fallback Share-raising, the initiators are advised to submit public and independent financial opinions explaining the reasons why they claim to have underestimated the companies' stock prices [10].

A series of mandatory policies are also needed to regulate the content of the terms of the announcement to consolidate the interests of minority shareholders. For example, the law can mandate that the initiator increase their shares of the company before the announcement and hold the shares until the lock-up period expires, and the shares should not be less than the sum of the employee's additional shares, and that the executives are not allowed to reduce their shares before the expiration of the lock-up period even if they resign.

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