REFORM AND INCENTIVE MECHANISM ON EQUITY STRUCTURE OF FAMILY ENTERPRISES

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Abstract: From the perspective of realizing "everlasting business", how the founders of family enterprises in China can promote the reform on the ownership structure of the enterprises and establish an inclusive incentive mechanism, so as to take into account the inheritance of family wealth, to improve the technological innovation ability and the valuation (market value) of enterprises, is an economic and legal issue that is well fit for the current demand of China's economic situation, and is also related to the long-term development of China's economy. Its legal practice is worthy of in-depth study by Chinese legal scholars. This article reviews the transformation and development process of the ownership structure of family enterprises since China's "Reform and Opening-up", through interviews with the founders of family enterprises and field research in Fujian Province, a representative area of China's family business economy. The article pays special attention to the practice under the current on-going "business succession period" between the first-generation entrepreneurs and the second-generation leaders. The article collects the relevant legal and economic issues in the internal corporate governance mechanism, and explores the relationship between properly coordinating and optimizing the ownership structure of family enterprises, incentive mechanism and maintaining the allocation of wealth resources under the tradition in Chinese family society.

Keywords: Family Business; Ownership/Equity Structure; Equity Incentives; Corporate Governance

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Equity structure serves as the cornerstone of corporate governance, and plays a significant role in internal governance mechanism, operation and development of enterprise. Such significance is in particular highlighted in the enterprises that already evolve into bigger and stronger size depending on the equity structure, which usually determines the development direction and performance of the enterprise.

The reform and optimization of equity structure are conducted in several aspects including equity allocation, assignment, acquisition and merger, and additional issuance. Generally, the reform to corporate equity structure is critical to enterprise development and destiny. Effective incentive produced by the reform is decisive to the future of the enterprise. In modern enterprises, the setting of equity structure and incentive mechanism are evolving from time to time on the condition of developing market economy and diversified environment requirements for relevant industries. Essentially, the development history of modern market economy equals the history of corporate governance system driven by equity structure subject to continuous change.

Family enterprise is one of the enterprise forms in the modern market economy that is known for its longest history. During the history of reform and opening-up in China, the family enterprise which is an integral part of the private sector, splendidly pushes forward the economic development. In the current stage and after the ups and downs for more than four decades, the family enterprises that have already obtained achievements enter the period of criticality embarking on the power transfer from the Generation Create. Challenged with the transformation-oriented development centering on power transfer, the fulfillment of good corporate governance structure and adaption to the steady enterprise development based on the optimization design of equity structure and equity incentive will not only produce huge influence on these family enterprises, but also have significance to sustainable economic development and industry upgrading in China. Ownership can be separated from managerial authority by means of equity structure reform and incentive mechanism design performed by these family enterprises and considering the actuality of involved enterprises and families. A shift will be triggered from consanguinity management to management by professional team. Henceforth, the family enterprises will not be dominated by private capital, but grow into the public enterprises that accept market supervision. Stemming from the perspective of practice, it is more than a study on economic incentive mechanism, but a law-related research.

I. RESEARCH BACKGROUND

A. Raised Concerns

It is of great historical significance for the equity structure reform and incentive mechanism study of China's family enterprises. At present, the research on this topic is the necessity of the times. China has implemented the reform and opening-up policy for almost 45 years. In the time of China's economic development, apart from the state-owned company, foreign investment companies and IT companies which are generated by technicians after the 1990s, the family business which evolved from the original township enterprises and family workshops in the 1980s is an important force for China's economy. Especially in some regions with developed industries, the family businesses which have accumulated for decades are an important carrier for China's profession dedication, specification and innovation, as well as the potential champions in near future. There are also plenty of family businesses in other major industries, such as real estate, household appliances and consumer products. Most of them were from "Gen Generation (1st Entrepreneurial Generation) ". After 20 to 40 years' effort, they are gradually out of the stage, but facing their business handover problem which become a common topic among them. How to achieve the optimized design of equity structure and equity incentive in the transformation and development during the business handover time is of core significance to these enterprises, and also plays an important guidance role in the sustainable development of China's economy.

The author was born in Quanzhou city, which owns the most proactive private economy and the most centralized family businesses in Fujian Province, and therefore, is more than close to realize the urgency and necessity of this study. As early as more than ten years ago, there was a case that the family enterprise Xin Hua Du Group hired Tang Jun, a professional manager, to be in charge of the company, but it was unsuccessful in the end. Some well-known local founded companies in Quanzhou such as ANTA and HENG'AN, also invite foreign professional managers and innovative teams in recent years, some are successful, while some failed. Therefore, it is a problem that Chinese family businesses tend to face sooner or later.

The equity structure reform including incentive mechanism to the Chinese family enterprises is also of far-reaching significance for promoting national development and pooling resources. After the explosive economic development from the 19th century to the early 20th century, the USA also experienced the similar period and was relatively successful when its first or second entrepreneur generation retired. Some well-known families, such as Rockefeller family, have finished the transformation successively, providing the initial capital source for various funds in the USA, enriching and improving gradually the economic system structure. In addition to the inheritance of the common values, the Rockefeller family is also good at dealing with a variety of financial instruments. For example, family trust is one of the methods that plays an important role, which could be referenced by the enterprise's equity structure reform to a large extent. That is, the family will customize a trust for each descendant member or each small family according to the actual needs, which will be handed over to the same trustee for management. From a legal point of view, the properties will be converted into trust property after the trustor transfers the properties to the family trust. Afterwards, the trustor does not have the ownership of these properties, while the beneficiaries are entitled to benefits produced by the trust property. Through this mechanism, the modern family that founded the enterprise will avoid the fate of the natural dissolution of the land property based on the feudal lord in the previous days of modern civilization with the equal distribution of properties by multiple heirs, and promote the ultimate separation of management from ownership of the enterprise at the level of family wealth, so as to ensure that the family wealth can be centrally managed and used. This model fulfilling the ultimate separation of management from ownership (founder group) has been also practiced in the wealth management of new technology companies and their founder families (e.g. information technology companies, including HP, Microsoft and Google, which are not only listed and publicly traded at the enterprise level, but also have established various forms of legal entities such as funds and foundations at the level of founder's wealth management). Thus, this is a proposition with universal value.

B. Research Direction

At present, due to the reason that the China's academic arena copies the current study themes of the USA[1], for family businesses in different industries, based on its internal driving

[1] For how to promote innovation on Intellectual Property laws through bonus and tax incentive, and relevant studies on how Company Law and Security Law support US capital market, refers to Michael Abramowicz, Perfecting Patent Prizes, 56 Vanderbilt Law Review 115 (2003); Nick Bloom et al., Do R&D Tax Credits

force, it is also worthy of studying whether to focus on discussing technological breakthroughs or exploring equity reform. In addition, we need to consider lessons learned from the dismissed founding team due to improper balance on equity incentives. Compared with foreign countries, in regards of balancing the interests of new and senior employees inside and outside the family business, the market environment and relevant systems are not fully matured, thus it is necessary to improve the system construction, strengthen market supervision. The article aims to do relevant research on promoting the equity incentive mechanism for achieving the best result, protecting small and medium-sized investors, and balancing the needs of different interest with the precondition of promoting a long-term development of family business.

However, the necessity and common needs of the equity structure reform of family enterprises receive less attention in both academia and industrial fields. And the systematic studies on the internal profit-driven motivation behind the equity structure reform in the long-term development of family enterprises are performed by members of family enterprises in few cases. What's more, Generation Create and its family may be expelled from the enterprise due to the improper design of the equity structure reform mechanism, and it is taken as the instructive precedent. From then on, most of the enterprises are on the decline. Therefore, it is the direction that we need to think about. From the perspective of practical operation, and compared with foreign countries, there are no matured market environment and legal system to balance the interests between the new and the old employees inside and outside the family enterprises, which necessitate the reinforcement of market supervision and the system construction improvement. It is necessary to promote the reform of relevant equity structure and the setting of incentive mechanism to achieve the best incentive effect on the premise of promoting the enterprise development in the long run, as well as protecting small and medium-sized investors, and balancing the needs of different stakeholders.

II. ANALYSIS ON FAMILY ENTERPRISE

A. Nature of Family Enterprise

Both at home and abroad, most of the enterprises are spontaneously incorporated by a large family or a combination of individual families (e.g. two partners from different families). Up to this date, family business remains a common form of business organization and a mainstay of the world economy, which provides jobs and maintains communities and environment.[2] In fact, the globalization of the last 30 years contributed to a large number of emerging enterprises in developing countries. In addition to the technology-based companies relying on venture capital, which are the major concern of media, there are a variety of family businesses in the real economy. As revealed by research and expert prediction of McKinsey & Company, the share of family businesses in the global Fortune Top 500 has increased from 15% in 2005 to 19% in 2013 owing to the rapid growth of the emerging new businesses. By 2025, family businesses will account for 40% of the world's large enterprises, higher than the figure

Work? Evidence from a Panel of Countries 1979-1997, 85 Journal of Public Economics 1 (2002); Brian Broughman & Jesse M. Fried, Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups, 98 Cornell Law Review 1319 (2013).

[2] Tharawat Magazine, The Economic Impact Of Family Business, Issue 22, May 2014, source：https://www.tharawat-magazine.com/magazine/issue-22-economic-impact-family-business/, visit on May 2, 2022.

of about 15% in 2010.[3]

The perspective of "family business" connotation that, the family retains control over the enterprise, while their generations are involved in the business operation,[4] from American scholars Astrachan and Shanker, shows that, the character of family is a high concentration of control and equity over the enterprise by family members and their generations. This is in line with the rules of many enterprises in the early development of USA, or most American's manufactures, furthermore it shows high consistency with the transformation of Chinese township enterprises and family business developed based on family workshops. This is a transformation into a modern enterprise, it is a comprehensive topic, which involves not only related (enterprise side) management and incentive mechanism, but also family inter-generational inheritance, role positioning and how to preserve, inherit and withdraw from the family equity for wealth management. According to the Corporate Governance Gap of Prof. Kastiel and Prof. Nili, the proportion of family enterprises that sticks to good governance disappoints the assumption of the public.[5] Apart from the unevenness in distribution, the development of these family enterprises also encounters various influences and challenges, including the periodicity in economy and industry, induction from external investors and other business agents, as well as problems related to society, academia, environment and social ethics. Under this circumstance, most of the family enterprises will undoubtedly transform to be modern enterprises for the purpose of long-term existence and development. At the same time, it is a proposition comprehensively and systematic work practically, which not only involves the management mechanism and incentives on the level of enterprises, but also affects the inter-generational transfer on the level of families, and the role definitions of Generation Create families and enterprises. Even the keeping and inheritance of family wealth are also included in this case. It further determines the separation of the families from the enterprises in the long run (e.g. separation of Ford families from Ford Auto). Family wealth management and evolution are also considered.

B. Problems in Development of Family Enterprises

Generally, the founder of the enterprise is entitled to the ownership and control over the enterprise in the early stage of the family enterprise, which make sure that the interests of the enterprise are consistent with those of the founder. And the corporate governance is not taken as a major concern since the company itself is not subject to any conflicts and contradictions. Business expansion receives most of the attentions.[6] However, the demands for scientific management are increasing during the expansion of the enterprise. The centralization of power existing in the internal structure of family enterprise prevents the enterprise from further development. More and more family enterprises employ professional managers for the purpose of professional management which has become the trend of corporate governance. Governance and reform of the family enterprises center on the adjustment of equity structure. In addition to the reform of excessive centralization of equities and control, and to improve the stability of the human resources on the higher level, it is also suggested to invite investors, import employee equity incentive mechanism and be listed abroad so as to fulfill further management

[3] Åsa Björnberg, Ana Karina Dias & Heinz-Peter Elstrodt: Fine-tuning family businesses for a new era, source：https://www.mckinsey.com/business-functions/people-and-organizational-performance/our-insights/fine-tuning-family-businesses-for-a-new-era, visit on May 2, 2022.

[4] Joseph H. Astrachan & Melissa Carey Shanker, Family Businesses' Contribution to the U.S. Economy: A Closer Look, Family Business Review 16.3 (2003), p.211-212.

[5] Kobi Kastiel & Yaron Nili, The Corporate Governance Gap, 131 Yale Law Journal, p.787.

[6] Elizabeth Pollman, Startup Governance,University of Pennsylvania Law Review 2019, Vol. 168: 1, p.196-197.

for the equity structure. Regarding the practices carried out in China over previous years, the reform of equity structure is beset with difficulties in the developed regions densely located with family enterprises such as Shandong, Zhejiang, Jiangsu, Fujian and Guangdong due to the characteristics of Chinese family enterprises and insurmountable problems existing in the resources distribution inside the family enterprises, including the benefits transfer caused by nepotism during the expansion of the family enterprises.

During the research on family businesses, one of the most important existing topics is, how to balance the three aspects of interests from the entrepreneur's perspective, including family wealth inheritance, improving the enterprise's technological innovation, and further to improve the enterprise's valuation (market value). The author has experienced many specifics and challenging questions. For example, how can the first family generation leaders improve the corporate governance structure and ensure its control power when setting up funds for future generations? Whether the regulatory rules and institutions guarantee the establishment of a double equity structure to achieve the organized purpose and institutional arrangements are perfect? Is equity incentive an effective mechanism for all industries and interest groups? It is not surprising of these findings, because the balance and trade-off between the positive and negative benefits of the equity structure reform of family businesses have not yet been deeply studied.

These are crucial topics, because the answers not only relate to the scope of equity structure reform, benefit distribution and the internal logic of corporate governance, but also allow us to understand better on the evolution of equity structure reform in a transitional economy with a booming private economy such as China. Since the reform and opening-up, the private economy has had 360 degree changes. However, with the promotion of economic reform, the rapid transformation of the ownership structure and incentive methods of family business has also showed problems. In order to resolve these open topics, the Chinese people urgently need a well-designed system that keeps pace with the times.

C. Relationship between Family Enterprises and Existing Legal Mechanism and Significance of Mutual Enhancement and Co-evolution

This is not only an economic incentive mechanism study, but also related to law research. *The Company Law* is one of the most important laws for the economy. It has a potential impact on promoting the equity structure reform being built by family businesses. First of all, *The Company Law* influences the corporate governance structure and mechanism, the responsibilities of Board members and high management, affiliated transactions and the protection of the interests of shareholders, especially minority shareholders. Secondly, the ownership structure plan may affect the economic and political stability by affecting the creation of wealth and the distribution of interests. Thirdly, under the protection of the legal system, a reasonable equity incentive system can better balance the needs from various interests via the control rights' distribution. Therefore, it is not hard to understand why private enterprises, especially family business, need to establish a clear equity structure to optimize resource allocation under the institutional guarantee of full *Company Law*. The research on the equity structure reform and equity incentive mechanism that provides consideration to the family wealth inheritance will certainly stimulate the establishment of legal framework in China as well as relevant legal research.

It is recommended to stem from the benefits of the stakeholders and break down the equity structure reform of the family enterprises, which could be highlighted through the following aspects: to define the benefits or demands that need protection; to determine the incentive measures for personnel who are potentially trained to be in charge of enterprise operation, to encourage or prevent the actions of relevant personnel. These measures will contribute to the basic formation of the complete equity structure reform plan for family enterprises.

In view of these objectives, the optimization of the corresponding legal framework and the application of appropriate legal tools are crucial for the development of family enterprises in the long run. In current stage, China's relevant legal system usually takes ambiguous and tentative positions on and in respect of issues related to regulating the equity structure of family enterprises, leading to confusion and uncertainty in practice and also producing various disputes. This situation must be changed. Meanwhile, the tradition of Chinese society still needs to be considered in the relevant legal practice of Chinese family enterprises. This tradition as mentioned here is more prominent in the field of family enterprise management, which inevitably involves people having power. China often needs to compromise the reality in the process of reform and opening-up due to the pragmatism tradition prevailing in the Chinese society. In the historical operation of Chinese family enterprises, various principles which are socially recognized are inevitably adopted. For example, many major issues related to the development of enterprises and the distribution of interests are handled morally or under the table, resulting in the formation of the situation in the current stage that cause conflicts with laws in realistic and practical cases, or the situation that is adverse to assuring the benefits and interests of the core founder of the family enterprise. It is worthy of in-depth study by legal professionals under the topic of family enterprise reform on how to properly coordinate the relationship between the current situation and the legal system, how to not only optimize the equity structure, ensure family inheritance, maintain the allocation of wealth resources in China, but also encourage the reform of modern enterprise system, cultivate new enterprise talents (especially the talent groups outside the family) generation by generation, and transform the enterprise development to the technological innovation led by talents, so as to improve and share the enterprise value with the whole society. This research will definitely be beneficial to the systematic optimization and reconstruction of China's legal system which still awaits improvement in many aspects.

III. ARRANGEMENT OF EQUITY STRUCTURE REFORM OF FAMILY ENTERPRISES

A. Separation of Ownership from Operation at the Level of Enterprise

1. Introduction of Manager System

As the operation scope and size expand gradually, the operation capital and involved transactions are increasing. It is a new type of corporate governance that the managerial right will be assigned to any other individuals or entities, and the ownership enjoyed by the owner of production goods remains unchanged when the company systems have developed to a certain stage and extent. The business and operation size of the joint-stock firms necessitate the professional knowledge and capabilities in scientific planning and operation obtained by the operators. For instance, the land lord may lease his or her lands to peasants for farming, or the BOD may entrust CEO to be responsible for business operation.

This reform is seemingly justified by theories. However, it is hard to be implemented in practice. The reason is that major changes in the power of enterprises are involved, especially for Chinese family enterprises that strongly rely on operation by people having power. The assignment or the transfer of important positions, is of vital importance for two consecutive generations of Chinese family enterprises, even for brothers and sisters of the same age, let alone “outsiders”. Especially in the environment of Chinese family enterprises in the private sector, a realistic problem shall not be neglected with a great many of managers having the background of training by foreign enterprises “to be introduced at a fixed price” in the market. Therefore, days since the beginning of 21st century have witnessed many classic cases that the majority of Chinese family enterprises have failed in the introduction of managers, and successful cases are rarely found. Even some of the state-owned enterprises cannot escape from the curse when they recruit talents and professionals out of the government or state-owned systems. The curse that the rise and fall of Chinese enterprises depend on one generation still awaits a systematic resolution.

2. Optimization and Adjustment of Equity Structure Inside Families

Establishment of a “family-holding platform entity” is a proposition raised here, which serves as a carrier for the survival and development of family wealth, and further realizes control of the enterprise through the investment platform. Under this entity, the equity inheritance or equity division is merely limited to the family members, which could prevent the family enterprises from equity confusion at the enterprise level (e.g. it directly specified that each family member straightly holds a certain proportion of the shares of the operating company in the early stage). The setting of the family platform entity is conducive to the internal interests’ distribution among family members, e.g. by redeeming the shares of family members who held shares of business operation in the early stage, but withdrew from business operation already.

Here is another solution that is adopted by Chinese family enterprises. In the context of family enterprise inheritance, the founder may take into account dividing the business of the family business into multiple sub-businesses (Chinese family enterprises usually involved in multiple industries, e.g. the common combination in some economically developed cities such as being engaged in both the manufacturing industry that could produce wealth and local real estate industry, and also making minor investments). Each enterprise needs to also consider the cross-shareholding among multiple family members to balance the interests of family members without prejudice to the family wealth inheritance. For example, the family business is divided into several different types of sub-businesses, which are respectively handed over to the successor who is interested in such sub-business. However, the presiding successor of each sub-business only holds part of the equity of the business company, while the remained is shared equally by other successors. The aforesaid measures will enable the successor to be in charge of each sub-business to have absolute control over the enterprises under his or her operation, and have a high degree of independence and self-motivation, so as to avoid costs and internal conflicts aroused from negotiation with other brothers and sisters.

3. Decreasing Family’s Shareholding Proportion in the Enterprise and Introducing Equity Incentive and Employee Shareholding Plan

For a long-term perspective, the family enterprises need to bring in a lot of new members and share the development achievements and created values with the employees (including senior officers and critical staff). Since the excessively high percentage of the family shareholders among the entire shareholders is improper, it is recommended to introduce employees that are allowed to hold shares to a certain extent so that the employees and the enterprise will have plenty of skin in the game by means of diversified equities and new distribution mechanism. According to *No.6 Guidance on Supervision of Non-listed Public Company - Supervision Requirements for Equity Incentive and Employee Stock Ownership*

Plan (Trial), the participants of the Employees Stock Ownership Plan consist of the employees that have entered into the labor contracts, including those from the leadership. Employees participating in the Stock Ownership Plan are entitled to have equal equities with any other investors and independently liable for their profits and loss, and risks.[7] It is permitted to provide the employees to be in charge of operation and management by means of incentive systems, including issuing shares to the managers that perform excellently in the performance assessment. Take the family enterprise groups in Quanzhou for example. Local listed companies such as ANTA and HENG’AN (these listed companies being defined as the family enterprises from their culture attributes) issue shares to thousands of grantees depending on the stock incentive plan.[8]

4. Introduction of External Strategic Investors

The introduction of strategic investors to balance the company’s internal governance structure depending on the company’s development needs will contribute to improving the control onto the enterprise exposed by the leadership so as to ensure that a series of enterprise development measures formulated by the leadership can be effectively implemented. Enterprises may consider those enterprises that have transactions of significance and stable business relations with themselves and being engaged in the same industry chain during selection of strategic investors. Financial investors however are also imported in combination with various purposes, e.g. Gree’s introduction of Hillhouse in recent years. There is an economic reality worthy of objective consideration in China. Central enterprises, local platform state-owned enterprises and other entities have tight control over financial resources after the year of 2010. By contrast, involvement especially in the industrial field of competitive market was seldom seen at the level of industry. Surprisingly, China’s national policies prefer to support the real economy since 2020, and many of the real economy in the competitive market are Chinese family enterprises, such as those incorporated in Zhejiang and Fujian Province. It is a topic worthy of study that whether central enterprises and other state-owned platform companies of all kinds can find the access to family enterprises as appropriate external strategic investors and fulfill co-existence. For example, Billion Industrial Holdings Ltd. (2299.HK) in Quanzhou City introduced the state-owned China Energy Conservation Group with a large proportion of additional shares in 2012, and established a harmonious relationship, which result in the rapid growth of Billion Holdings in the era of 2010.

B. Legal Form of Equities of Founding Families - Financial Instruments (Family Trust) and Setting of Two-tier Equity Structure

1. Family Trusts, Family Investment Offices, Family Foundations and Other Financial Instruments

Compared with the aforesaid enterprise-level business focusing more on the restructuring of corporate equity, the flexibility of wealth management corresponding to equities controlled by the family will be more diversified and realistic.

Firstly, equity may be diluted or acquired maliciously during inheritance. Therefore, the establishment of legal and financial instruments such as credit, insurance and fund for

[7] No.6 Guidance on Supervision of Non-listed Public Company - Supervision Requirements for Equity Incentive and Employee Stock Ownership Plan (Trial), p.9.
[8] Announcement on Granting of Incentive Shares by ANTA Based on Stocks Incentive Plan (November 5, 2019); Announcement on Granting of Incentive Shares Based on Stocks Incentive Plan and Issuing of New Shares Based on General Authorization Made in 2021 by ANTA (April, 4, 2022).

family members and future generations will support to prevent equity from being diversification. The enterprise can stipulate in the relevant articles of association that the majority shareholders of the family in the credit should be designated as the subject with actual control power, and implement the independent voting rights so as to prevent the family heirs from losing control power of the family wealth in case of any disputes due to the separation of ownership and management rights.

Secondly, the equity wealth controlled by the family can be transformed into various legal terms. In recent years, there are some foundations and other organizations, which are usually applicable to enterprises with large scale and good reputation, and which also serve as one of the ways for the country to achieve the 3rd wealth distribution and fulfill common prosperity. For example, Mr. Cao Dewang, who founded Fuyao Glass, implemented this method when he initiated Heren Charitable Foundation, and the founding team of HNA Group also launched the Cihang Charity Foundation. These foundations are generally established in the way of cash investment, and then the controller donates the equity to the foundation to achieve asset separation and equity structure optimization.[9] Before setting up the foundation, the sponsors need to sort out their total assets, determine the share of assets donated to the foundation on the basis of retaining sufficient assets required by family members, and ensure the working capital required for the subsequent operation of the enterprise.

The existence of these foundations is of great significance. For example, Mr. Cao Dewang has initiated Fuyao University of Science and Technology, and Heren Charitable Foundation played a critical role during the process (a contributor in legal sense). Over recent years, the new emerging private universities in China are all initiated by some renowned enterprise celebrities, relying on the practice of foundations in most cases. It highlights the incentive effects produced from enterprise creating and sharing wealth with the society by means of talents education and training. This effort will play a more important role in China in the future.

2. Two-tier Equity Structure (Duality Ownership Structure) Establishment

From the perspective of initiating social funds, some family enterprises tend to perform “de-familiarization” in share proportion, and gradually move towards professional management and modernization. In addition to the fund establishment, the establishment of “Two-tier equity structure” (Duality equity structure, or equity structure with different voting rights) also has the impact on optimizing the governance of family enterprises. The two-tier equity structure is equipped with the institutional advantages of “meeting the different needs of shareholders, promoting the company’s long-term goals, avoiding hostile acquisitions, and enhancing the efficiency of decision-making”.[10] The *Company Law* of China applicable for the time treats the effect of two-tier equity structure differently based on the company strategies. In regards of the limited liability companies, the companies are allowed to modify the voting rights allocation through the Articles of Association pursuant to the *Company Law*.[11] From literality of the provisions, the two-tier equity structure should be permitted. As for the stock corporations, the *Company Law* prohibits any other form of voting rights’ allocation depending on different equity ratios.[12] “As revealed by the difference, the *Company Law* tries to reach a

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9 Problems to be Concerned before Initiating a Foundation, source: https://www.sohu.com/a/405321016_100244361, visit on May 4, 2022.

10 Guo Li, Peng Yuchen: Reflections and References on International Regulatory Experience of Double-Level Equity Structure, published in Journal of Peking University (Philosophy and Social Sciences Edition), 2019 (2).

11 Article 42 of the Company Law of the People’s Republic of China.

12 Article 103 of Company Law of the People’s Republic of China.

balance between the ideas of shareholder autonomy and the ideas of investor protection. Of course, this balance is subject to change."[13]

IV. EQUITY-LIKE INCENTIVE AND EQUITY INCENTIVE MECHANISM UNDER THE EQUITY STRUCTURE REFORM OF FAMILY ENTERPRISES

In the context of the reform on the equity structure of family enterprises, the core of incentive mechanism is mainly designed around the equity or benefits thereof. From the realization perspective, there are mainly equity-like incentive (informal equity, such as virtual equity plan) and equity incentive.

A. Equity-like Incentive – Virtual Equity Plan

1. Introduction of Virtual Equity

When discussing virtual equity, it is firstly to ensure that the company's implementation plan targets to "specific group"[14] people and will not involve any illegal fund-raising. As an ancient and common crime, illegal fund-raising, includes the promise of a high rate of return on capital, defrauding the investment of any social public. And it is a deceptive behavior of using the consequent investment to repay the previous investors.[15] Even if the incentive investors are required to make capital investment, it cannot be handled according to the actual capital from shareholders, but only to be credited based on the external loans of enterprises. As per the advantages of this measure, the company can get some cash flow to alleviate the financial pressure of the project. Meanwhile, the disadvantages are also obvious that part of the incentive from the company is the usage funds, which will greatly reduce the incentive motivation. In order to keep the core employees, the virtual equity held by employees can be transferred into actual equity via certain proportion under certain conditions so that employees can become real shareholders through capital increase and share expansion or equity transfer.

In practice, this situation occurs at the level of specific project in most cases, which is, to incentivize the key people at the project level rather than company level. Although listed companies can achieve equity incentives by issuing shares, at the same time, there are top management who are only in charge of a specific project rather than the entire listed company, especially where the business is mainly based on project. It frequently occurs in real estate project, and also adopts virtual equity design method. There is a so-called "co-investment system" for real estate projects. The top management involved in the system must invest to specific projects in order to obtain the project dividend. Then types of issues come. For example, should it be regarded as a special debtor-creditor relationship if the project company is given virtual equity? Any methodology of contracting requires answers from 2 questions: what risks the parties must face and what management methods the parties can use to eliminate or reduce these risks.[16] As long as the rights and responsibilities of both parties that are involved, a proper

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[13] Guo Li, Peng Yuchen: Reflections and References on International Regulatory Experience of Double-Level Equity Structure, published in Journal of Peking University (Philosophy and Social Sciences Edition), 2019 (2).

[14] The first paragraph of Article 2 of the Measures for the Supervision and Administration of Unlisted Public Companies stipulates that an unlisted public company refers to a joint stock limited company whose shares are not listed and traded on the stock exchange under one of the following circumstances: (I) the issuance or transfer of shares to specific objects results in a total of more than 200 shareholders; （II） Public transfer of shares.

[15] Wang Kaiyuan, Shi Dongyi and Luo Meiting: Empirical Study on Ponzi Schemes in China, Financial Law Forum, 2010 (80).

[16] Matthew Jennejohn, The Private Order of Innovation Networks, 68 Stanford Law Review 281 (2016), p.294.

legal framework is necessary to ensure the normal operation of the mechanism.

2. Cases Study on Shared Plan and Huawei's Virtual Equity

There is such practice in the family business group in Quanzhou. Some more powerful unlisted family businesses, invited professional institutions to make a sharing plan for the core top management and directors from non-family business members. The purpose of the sharing plan is to encourage the management in advance and sign the agreement with the employees in order to avoid the inconsistent interests between the core management and the company, which will further impact the listing. The agreement can only be saved by the company and no copy for employees. The employee can only assign three agents to lock the agreement in the locker. With the permission of the company, the three people can enter their own passwords and open it at the same time.

This sharing plan is a bonus incentive of "achievement and risk sharing" initiated by the shareholders as individual and face for key personnel. This plan has no relation with the legal representative of the company, but only takes the company's performance results as the incentive target and calculation basis. Participants shall receive the relevant share via actual capital investment. According to the share from the shared plan, participants can get the related bonus incentive income from shareholders when they achieved performance KPI as agreed with shareholders. At the same time, participants also have to bear if there were any financial losses. The methodology of profit distribution and loss bearing of the plan is to be decided by the shareholders. Regarding the system arrangement, the sharing plan participants shall focus on the common business objectives; they shall not only consider the short-term profit incentives, but also the long-term development of the company, support and cooperate together for the strategic direction and core business of the company. Regarding the capital investment and incentive policy, participants can enjoy the loan provided by shareholders to subscribe the shared plan shares, and receive the bonus provided by shareholders according to their share portion.

In similarity, every year, Huawei will nominate the outstanding employees and issue a contract with the specific shares that they can purchase from the company. After reviewing the contract, the employee will sign off, then submit, and the contract will be kept by the company. Although there is no copy and corresponding shareholding certificate, employees can check their shares hold via their internal account number. At the same time, the employee names will not be shown in the industrial and commercial registration certification, and the equity of the employees will be deputized by the Huawei labor union, essentially the contract proves the recognition of employees' equity. However, this recognition is partial, it mainly aligns via legal contract; this belongs to a virtual equity[17], rather than the ownership equity legally.

3. Potential Issues of Virtual Equity Plan

It should be noted that the top management purchase the virtual equity, but did not actually own the shareholder's rights and interests defined in the *Company Law*. If the company loses money, the principal of the virtual equity will also be lost. At this time, will the interests of the company or of the virtual equity investors be protected? How to define the nature of this investment, whether it belongs to shareholder's loan, company loan, or equity investment? If this money is used as a loan, whether it should be separated from the business operation? If so,

[17] Yang Jingyi: The Unique Role of Virtual Equity Incentive from Huawei's Experience, source: https://www.sohu.com/a/509078370_99901588, visit on May 6, 2022.

will it deviate from the original intention of signing a virtual equity plan to bind the interests of the company and employees? The answers were not found from the laws and regulations to above problems, which are urgently to be resolved from upper level management of China laws.

In addition, how to define the nature of the dividends from the virtual equity is yet a question. The first paragraph of Article 6 of *the Regulations for the Implementation of the Individual Income Tax Law* states that, "Income from wages and salaries refers to the wages, salaries, bonuses, year-end salary increases, labor dividends, allowances, subsidies and other income related to the employment relations."[18] Paragraph 6 states that, "Income from interest, dividends and bonuses refers to income from interest, dividends and bonuses get from individual creditor's rights and equity."[19]Therefore, the equity dividends to employees without actually holding of the company's equity are virtual equity dividends, which are not income from dividends and bonuses, and are not subject to personal income tax. At this time, if the virtual equity dividends to employees are regarded as their labor income, the individual income tax shall be calculated and paid accordingly. It is worth considering that if it is divided into bonuses, which is regarded as the reward for its labor protected by the Labor Law, is it not in line with the original intention of the company to let employees invest (become shareholders)? It is worth attention that in the case of higher income, the proportion of tax paid according to labor income is higher than that of dividend, which is obviously not a benefit to the effect of incentives. But if this dividend is defined as interest or shareholder dividend, when facing the disputes, should top management represent as creditors or equity holders?

B. Equity Incentives

1. Equity Incentive Overview

The Article 8 of *the Measures for the Administration of Equity Incentive of Listed Companies* regulates the objects of equity incentive. The objects can be BOM, directors, senior managers, core technicians or core businesspersons of listed companies, as well as other employees that the company believes to be encouraged or have a positive impact on the company's business performance and future development, but should not include independent BOM and supervisors. Foreign employees who are BOM, senior managers, core technicians or core business personnel of listed companies can become incentive targets.[20] Article 10 states that "If the incentive objects are BOM and senior managers, the listed company shall establish performance KPI as the conditions for the incentive objects to fulfill their rights and interests."[21]

Equity incentives are not only applicable to large enterprises, but also to small and medium-sized enterprises and family enterprises. When preparing the financial reports, the return on equity should be highlighted, which can help enterprises reduce debts, improve cash flow, increase production and improve shareholder returns. The salary plus equity benefits the transition and empowerment of family business power, reducing the cost of talent can alleviate the principal-agent problem and save cash flow. Let employees enjoy the return of rising stock price, and promote family enterprises development from small to large, and then to go public, can also benefit the unity of long-term and short-term incentives and the development of family

[18] Article 6 of the Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China.
[19] Article 6 of the Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China.
[20] Article 8 of the Administrative Measures for Equity Incentive of Listed Companies.
[21] Article 10 of the Administrative Measures for Equity Incentive of Listed Companies.

enterprise culture.

It is to be mentioned that, the equity incentive of family enterprises is not only a property rights system's innovation, but also a profound cultural change. The innovation has promoted the corporate culture reconstruction. For the decision maker, this is a change from family culture to corporate culture. The family culture has strong united power with its irreplaceable loyalty and team spirit together, which has enhanced the family business development. It ensures that the family enterprises adapt to the increasingly fierce market competition environment by attracting more talents for technological innovation, thus promotes the profits growth. For employees, this is a change from work culture to entrepreneurial culture. Employees are allowed to purchase shares, share dividends and return in profits. The incentive mechanism combines the interests between employees and family enterprises. The identity of employees has changed from outsiders to insiders, and from working for the company to working for themselves. They are willing to pay more attention to the long-term development of family enterprises, thus promoting the increase of relevant business income and equity income.

2. Issues in the Practice of Equity Incentive

Article 39 of the *Measures for the Administration of Equity Incentive of Listed Companies* also mentioned that, "Listed companies should hire law firms to issue legal opinions on equity incentive plans and provide professional opinions on the matters."[22] Since the major purpose of equity incentive is to link the interests of employees, enterprise development and shareholders to achieve a win-win situation, the incentive can fully work only by establishing a certain threshold of ownership conditions. If the price of the listed company shows strong deviation from the stock price, there shall be issues from the commercial rationality and interest collaboration. The regulatory authorities should further improve the equity incentive system, raise the price standard of granting equity incentive, by considering the market value of listed companies in the condition assessment, strictly review the rationality of the enterprise equity incentive plan, and well manage the interests of the responsible parties to avoid illegality.

However, in practice, it is found that the family's non-founder shareholders of listed family enterprises are difficult to deeply understand the actual business operation; The conflict will become more obvious after the founder's retirement. Within the time-limited equity incentive mechanism, as a short-term incentive plan for managers, it may potentially conflict

[22] Article 39 of the Measures for the Administration of Equity Incentive of Listed Companies regulates that, listed companies should hire law firms to issue legal opinions on the equity incentive plans, and at least give professional opinions on the following matters: (1) whether the listed company meets the conditions for the implementation of equity incentive stipulated in the Measures; （2） Whether the contents of the equity incentive plan comply with the provisions of the Measures; （3） Whether the procedures for the formulation, review and publicity of the equity incentive plan comply with the provisions of the Measures; （4） Whether the determination of equity incentive objects complies with the provisions of these Measures and relevant laws and regulations; （5） Whether the listed company has fulfilled the obligation of information disclosure in accordance with the relevant requirements of the CSRC; （6） Whether the listed company provides financial assistance to the incentive objects; （7） Whether the equity incentive plan has any situation that obviously damages the interests of the listed company and all shareholders and violates relevant laws and administrative regulations; （8） Whether the directors who are intended to be the incentive objects or the directors who are associated with them have evaded in accordance with the provisions of the Measures; （9） Other matters that should be explained.

with the shareholders' long-term expectation. For example, annual accounting can achieve the goal of reducing enterprise costs by adjusting financial statements and extending the machines' depreciation life. If the professional managers adjust the financial report data, it makes the founders and their families who have retired to the second-tier difficult to understand the real operation of the company from the data, thus leads the misjudgment on the manager's competence. Therefore, to discuss on how to take into account short-term personal interests and long-term value of enterprise development under the premise of employing professional managers to manage the business is a legal and economic topic.

3. Employee Shareholding Platform (Limited Partnership) and Compliance Check

In practice, the legal perspective of the employee stock ownership platform involved in equity incentive is basically limited partnership. This helps to further stabilize the equity structure of the target company and prevent the continuous change due to the employees' resignation. For tax payment, normally to split first and then to be taxed, and the individual tax is paid by the incentive individuals, rather than directly at the shareholding platform.

Before listing, few people paid attention to the compliance of equity incentives. However, as long as the enterprise starts to go public, regulators, brokers and other intermediaries, and even competitors and other parties will pay special attention to the enterprise's compliance issues, and the enterprise's information will be even disclosure. Therefore, as a long-term strategy, equity incentive must be strictly considered by the company before implementation. In order to judge whether the equity incentive is compliant, the aspects that can be considered include but not limited to whether the arrangement of the equity incentive system itself is legal or compliant; whether the implementation of each equity incentive plan is carried out in accordance with relevant laws and regulations; and whether the incentive individual are held on behalf of others. Only after thoughtful consideration of compliance issues (incl. tax), can family enterprises be officially listed.

CONCLUSION

The equity structure and corporate governance system by family enterprises in the early stage can only guarantee the development of the company at the time of establishment. However, while as long as the enterprises are growing, the development has been restricted by initially framework. From the development needs, the management system of enterprises should adapt to its development. The initial ownership structure and corresponding management system have led to the inevitable transformation of many enterprises, also the necessity for equity structure reform. Meanwhile practice has also proved that the long-term effective equity structure is rare to have, and the relevant reform of the system needs to keep updated with the times.

Regardless of whether the family enterprise decides to go public or go public successfully, the ownership structure will have a great impact on its business operation, and the ownership structure problem is also the core issue that cannot be avoided in developing. In order to go public, enterprise managers should adjust their equity structure according to the relevant policies issued by the CSRC, and should optimize the equity structure based on the development objectives of enterprises.

As China's economic development steps into a new era, either from the industrial upgrading perspective, which is the most important thing for the Chinese government, and constantly cultivating new talents from generation to generation (cultivating non-family business management teams and successors), or from the perspective of common prosperity, corporate wealth invest in social construction constructively, which benefits the people, and creates new sources of social productivity (such as private education), the reform on Chinese family enterprises' ownership structure and related derivative topics will become the highlights of China's economic, social life and regional development. To take initiative, and create institutional Chinese characteristics, to positively face the development issues which are widely concerned by public in the current drastic changes in the domestic and international situation, to resolve social contradictions, to eliminate confusion, to stimulate the vitality of Chinese civil society again, to constantly increase productive competence in the industry, to achieve common prosperity, so as to support the great rejuvenation of the Chinese nation in politics, are of great significance.