

Nature Determination of “Nominal Stock Rights-actual Creditor’s Rights”

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Abstract

“Nominal stock Rights-actual creditor’s rights” is a kind of innovative mode of company financing at present. Issues on the nature determination of this kind of trade mode are widely disputed in the context where stock rights and creditor’s rights are divided into two different parts in China’s written laws. There are three viewpoints about this nature determination—the stock right theory; the creditor’s right theory; and the individual case determination theory, among which the individual case determination theory is relatively more reasonable. In the process of determining the nature of the contract of “nominal stock Rights-actual creditor’s rights”, the court should take the content and actual performance situation of contracts as basis, explore the party’s true declaration of will, make it clear that only bona fide transaction counterparties can be protected in the situation involved the third party’s interests, and cautiously apply the Commercial Rechtschein Theorie.

Keywords

Equity; Nominal Stock Rights-actual Creditor’s Rights; Stock Right; Creditor's Right; True Declaration of Will; Rechtschein Theorie.

1. Introduction

Along with the deep integration of finance and the real economy, the financial innovation and the financing mode innovation of the company financing have presented a rich non-typical modality, and “nominal stock Rights-actual creditor’s rights” is one of them. [1] As a new type of the financing transaction mode, regulations on “nominal stock Rights-actual creditor’s rights” in current management rules are relatively chaotic, supporting legal norms are not perfect, and the dispute on whether its nature is “stock right financing” or “creditor’s right financing” still generally exists in both theoretical research field and judicial practice. In this paper, the author tried to sort out the determination idea of the nature of “nominal stock Rights-actual creditor’s rights” by method of combining the theoretical discussion with case analysis.

2. The Concept of “Nominal Stock Rights-actual Creditor’s Rights”

“Nominal stock Rights-actual creditor’s rights” is not a strict legal concept, and substantially a generic term used in practice for a certain type of innovative investment mode. There is not a legal definition with specific nature determination for “nominal stock Rights-actual creditor’s rights” in China at present, and the current definitions of “nominal stock Rights-actual creditor’s rights” are mostly scattered in the normative documents issued by competent authorities of various industries. Tax authorities define it as “investment business with a dual characteristic of both stock rights and creditor's rights”, [2] and the Banking and Insurance Regulatory Commission defines it as “stock right financing with repurchase clauses”. [3] The China Fund Association argues that “nominal stock Rights-actual creditor’s rights” refers to an investment way—the return of investment is not linked to the business performance of the enterprise invested, nor distributed according to the investment income or loss of the enterprise; the

investor is provided with a capital preservation income commitment and payed fixed income at regular intervals as agreed; the enterprise invested will redeem the stock right or repay the principal and interest after meeting some specific conditions.[4] Though “nominal stock Rights-actual creditor’s rights” is regularly manifested in this mode, the situation is ever-changing in practice, and it is uncertain whether the investment way which meets this transaction mode is “nominal stock Rights-actual creditor’s rights”, for instance, valuation adjustment mechanism (VAM). The valuation adjustment mechanism is usually applied in the initial stage of investment. In order to avoid endless arguments about the current value of the enterprise invested, parties of both investment and financing set a certain business objectives together, the value of assessment of the enterprise and the stock right ratio of both parties are adjusted by the actual performance of the enterprise operation, and conditions such as stock right repurchase, capital compensation, and management personnel changes will be triggered when the financing party fails to achieve the agreed target. [5] The starting point of the establishment of “nominal stock Rights-actual creditor’s rights” is to reduce the risk of lending money. The stock right repurchase has nothing to do with the business performance of the company launching the financing, and it will certainly happen at maturity. The purpose of the establishment of the valuation adjustment mechanism is to invest with stock rights, obtain stockholder status, participate in the operation and management of the company, and buck for the appreciation of stock rights. It is related to the achievement of the business objectives agreed by both parties whether the repurchase will be triggered.

3. Nature Determination of “Nominal Stock Rights-actual Creditor’s Rights ”

3.1. Distinctions and Relations between the Stock Right and the Creditor’S Right

For a long time, discussions on the nature of stock rights always keep active in the academic circle, mainly including the ownership theory, the membership right theory, and the independent right theory, but the stock right has its own clear meaning in the context of corporate finance. The distinction between stock rights and creditor’s rights is relatively clear: (1). From the perspective of property attribute, the stock right is a kind of right enjoyed by the investor to the enterprise property, and the enterprise does not need to repay the principal and pay the interest for the capital which is gained by the enterprise based on the stock right arrangement. The creditor’s right is a kind of right to request the enterprise to repay the principal and the pay the interest, which is enjoyed by the right holder based on the assignment of the right of use capital.(2). From the perspective of risk taking, the creditor can participate in the distribution of company property in advance of stockholders in the corporate liquidation, which means that the stockholder takes more risk of company failure than creditors. (3). From the perspective of the exercise of right, the creditor’s right is mainly property right, and the creditor does not participate in the internal operation and management of the enterprise, and does not enjoy the identity right. The stock right includes the identity right, such as the right to vote, the right to elect, etc. [6]

Though there are obvious differences between stock rights and creditor’s rights, they are not completely isolated concepts, and the phenomenon of blend of stock rights and creditor’s rights widely exists in practice. For example, the “convertible bonds” system, and the corporate bond attached with the reservation right of new stocks that is provided in the “Company Law of Japan”. [7] Even under the legal principle and logic of the British and American law system, the commonality between the stock right and the creditor’s right is greater than the difference. In the USA, where the capital market is highly developed, stock right itself has been reformed and innovated for a long time. As early as the case *Stron V. Blackhawk Holding Corp*, the court

deemed that the management and control rights in the stock right could be separated from the right to share assets and the right to share profit, and these rights are not necessarily complete and symmetric. [8]

3.2. Different Viewpoints about the Nature Determination of “Nominal Stock Rights-actual Creditor’s Rights”

As a new type of financing tool, in terms of investment mode, “nominal stock Rights-actual creditor’s rights” is different from both the creditor’s right investment and the stock right investment in a pure sense, and possesses the dual attribute of both stock rights and creditor’s rights. The so-called nature determination of “nominal stock Rights-actual creditor’s rights” refers to the issue whether this transaction mode should be determined as a creditor’s investment in law.

The first viewpoint is the creditor’s right theory, which believes that the investor’s true purpose is not to acquire the stock right, but to lend money, though the investment mode of the two parties is manifested in the form of stock right transfer or additional share, and intents of stock right transfer and additional share are all false declaration of will. The second viewpoint is the stock right theory, which believes that the investor will obtain the shareholder qualification if the investor is recorded as a shareholder in the register of shareholders and signs and seals the articles of association, and the industrial and commercial registration of changes has been completed. So this type of investment mode should be determined as stock right investment. The third viewpoint is individual case determination theory, which argues that the nature determination of transaction mode should be respectively determined in individual cases according to factors such as the parties’ transaction purposes, rights and obligations.

Examples of results of judgments and rulings in juridical practice. 1. Sentences that determined it as creditor’s rights. In the case “Meishijie Wallpaper Manufacturing Company V Longhua Industrial Corporation, Dispute over Private Lending”, the court deemed that there was content such as minimum-guarantee clauses, deadline for performance and clause without taking operating risks in the Agreement signed by both parties. In addition, both parties failed to go to the industrial and commercial administrative departments to go through the stock right change registration procedures. The rights and obligations stipulated in the agreement above showed that the relationship between both parties was nominally contractual relationship of stock right transfer, but actually contractual relationship of loan. [9] 2. Sentences that determined it as stock rights. In the contract dispute case between Pan Zuyi and Sichuan Trust, the court deemed that this kind of transaction mode met both parties’ transaction purposes and demands and the performance result of the agreement was pursued by all parties. In addition, the performance act of Sichuan Trust also further proved that the signing of the “Stock Rights Acquisition and Transfer Agreement” involved in this case was not an act aiming at hiding the true declaration of will by false act conspired in advance. Therefore, in this case, the relationship between both parties was determined as stock right investment relationship.[10]

It can be seen from the sentence of the above cases that the investment of “nominal stock Rights-actual director’s rights” has diversity and complexity, and there is not an absolutely consistent trading mode in practice. Hence, the nature determination of investment of “nominal stock Rights-actual creditor’s rights” needs to be determined comprehensively according to specific details of a case and combining with factors such as contents of the agreement, the actual performance situation of both parties, and rights and obligations. It is thus clear that the individual case determination theory is relatively more reasonable, in which the judge will not have to classify financing agreements as some sort of named contract, and not be limited to the dualistic “nominal-factual” thought. They should persist in focusing on the nature of the transaction, pay attention to the business arrangements behind the contract, then judge the attribute of “stock right or creditor’s right” through these factors.[11]

4. Consideration Factors in Specific Cases

It depends on the true declaration of will of the parties to judge whether the investor of investment of “nominal stock Rights-actual creditor’s rights” enjoy the stock right or the creditor's right. The court can not determine it only according to the contract name involved, but should make a thorough inquiry combining aspects such as the transaction purpose, the content of the contract and the performance situation of the contract. These following factors generally will be reviewed by the court in judicial practice.

4.1. Whether the Investor's Income Will be Impacted by the Company'S Operating Performance

The income of stock right investment mainly comes from the bonus distributed by the enterprise invested and the proceed from stock right transfer after implementing project exit, which means that it is closely related to the company's operating performance whether investors can profit. Repaying capital with interest is the obligation of the debtor. In the case of creditor's right investment, agreements like the investor is not responsible for the profit and loss of the company after becoming a stockholder or the profit and loss of the target company does not affect the investment return of the investor commonly exist in the investment contract.

4.2. Whether the Investor Participates in the Operating Management of the Company

In the creditor's right investment, the purpose of the investor is to withdraw the principal and interest at maturity, who will generally not participate in the operating management of the company. But in the relationship of stock right investment, the purpose of the investor also includes obtaining shareholder status, exercising the right to elect and vote, and so on. As a result, if an investor obtains the stockholder status and exercises the stockholder's rights, the investment will generally be determined as stock right investment.

4.3. Whether an Exit Mechanism is Agreed

It is another essential factor of the nature determination of “nominal stock Rights-actual creditor’s rights” whether an appointment has been agreed on gaining fixed income and exiting the investment when this investment is due or some specific conditions are triggered. [12] Viewing from the current referees, a conditional repurchase may be determined as stock right investment, [13] and an unconditional repurchase at maturity may more likely be determined as creditor's right investment.[14] However, it can not be determined simply according to whether conditional or not, and the degree of difficulty triggering the conditions attached should also be judged carefully. If the condition is very easy to trigger, it will generally be determined as creditor's right investment. There are also some other viewpoints—even if the agreement involved has agreed clear appointments on the fixed income, year by year exit, and due repurchase, the relationship of both parties may also be determined as stock right investment relationship as long as certain personalized arrangements of rights and obligations made by both parties exceed the legal relationship content of “the borrower borrows money from the lender, and returns the loan and pays interest when maturity”.[15]

4.4. Whether the Price of Transferring Stock Rights is Reasonable

first viewpoint believes that in the contract of stock right transfer, the price of transferring stock rights should be clear and specific. If the agreed price of transferring stock rights is excessive low, not clear, or has no direct relationship with the value of stock right, or does not make an appointment on the transaction consideration , or does not in line with the feature of the contract of stock right transfer, it can be deemed that both parties do not have the intention to make a stock right transaction, and the “Contract of Stock Right Transfer” involved will be

regarded as merely a document for industrial and commercial records, or a contract of “nominal stock Rights-actual creditor’s rights”. The other viewpoint believes that the price of transferring stock rights has no impact on the nature and validity of the original contract, and the level of the price of transferring stock rights should be judged comprehensively by various internal and external factors of the company during the transaction.[16]

5. Nature Determination of “Nominal Stock Rights-actual Creditor’s Rights” that Involves the Third Party

After the dispute case of the confirmation of bankruptcy claims of “Xinhua Trust V Gangcheng House Purchasing”, the viewpoint of distinguishing the internal and external relationships has gradually become the mainstream in the judicial adjudication field. This viewpoint believes that the agreement of “nominal stock Rights-actual creditor’s rights” made by the parties on the purpose of debit and credit should be internally determined as creditor’s investment when it involves the third party’s interest, [17] and externally determined as stock right investment according to the commercial rechtsschein theorie, to protect the reasonable reliance of the bona fides third party (creditors outside the case). [18] This viewpoint will be discussed next.

5.1. The Commercial Rechtsschein Theorie and its Application

Rechtsschein theorie, also known as apparent legal principle, right appearance or liability appearance, [19] is a legal principle theory generally accepted by commercial laws of various countries. Though written laws of various countries do not provide this concept as a general provision in the form of law article, it has been widely applied in the specific system of commercial laws of various countries, and even no field of private laws can exclude its application. [20] From the perspective of commercial trial, the Commercial Rechtsschein Theorie is a rule that should be followed when weighing the conflict of interest between the actual right holder and the external third party on a specific occasion. This rule requires to recognize the validity of a civil act which is made by a third party on the basis of the trust of the right exterior of the transaction counterparty, protecting the civil right that the external party obtains by this, but the actual right holder’s loss caused by this can be only solved in the internal relationship. [21]

Disputes over the nature of “nominal stock Rights-actual creditor’s rights” are merely disputes between investors and stockholders over the nature of the contract based on the contract agreement, which are civil disputes between equal subjects. This kind of dispute does not need to apply the commercial rechtsschein theorie, and just needs to adhere to the determination standard that essence is better than the form following the principle of declaration of will. In the situation involving the interest of external creditors or the company bankruptcy, due to the reasonable reliance that the third party has for the stock right investment, conflicts will arise between the debtor-creditor relationship claimed by the investor and the stockholder relationship reasonably trusted by the third party when the third party requires the investor to take the stockholder responsibility. In this situation, the mainstream viewpoint argues that the judge should make a choice between these two kinds of relationship applying the commercial rechtsschein theorie, to protect the interest of the third party.

5.2. Bona Fides Third Party is Merely Limited to the Third Party Involved in the Transaction Behavior

Under the principle of rechtsschein theorie, not all the external third parties can be protected. An external third party can not claim to apply the rechtsschein theorie and require the investor to take the stockholder responsibility if this external third party knows perfectly well that the real purpose of the investor and the target company is debit and credit, or should know this real purpose. In addition, due to the purpose of maintaining transaction security, the scope of

application of the rechtsschein theorie should be limited to the third party involved in the transaction behavior, and the so-called third party involved in the transaction behavior means that the existence of a third party identity is based upon the act of paying the consideration.[22] Therefore, when the creditor of the investor claims to enforce the "stock right" of investors, there is no room for the application of the principle of rechtsschein theorie, but the investment of both parties can not be determined as stock right investment by this. Because the creditor of the investor does not make the transaction aiming at the stock right in appearance of the investor, and searches investors' assets to pay debts merely for other debt disputes. Moreover, not all the creditors who have a debtor-creditor relationship with the target company in the daily operation of the company are third parties involved in transaction behaviour, and the application of the commercial rechtsschein theorie should be really cautious.

5.3. Brief Summary

The application of rechtsschein theorie principle may lead to the loss of the interest of a non-fault party. As a result, this principle should be cautiously applied when distinguishing internal and external relationships and determining the transaction nature of "nominal stock Rights-actual creditor's rights".

6. Summary

"Nominal stock Rights-actual creditor's rights" is not a strict legal concept, but a generic term for an innovative financing mode. In terms of the nature determination of "nominal stock Rights-actual creditor's rights", there are three viewpoints—stock right theory, creditor's right theory and individual determination theory. Due to the diversity and complexity of this kind of investment mode, individual determination theory is relatively more reasonable compared with other viewpoints. In specific individual cases, the judge usually review the true declaration of will of the parties through several factors, such as whether the operating performance of the target company affects the income of the investors, whether the investor participates in the operating management of the company, whether an exit mechanism is agreed by both parties, whether the price of transferring stock rights is reasonable, and then determines the nature of "nominal stock Rights-actual creditor's rights". In particular situations involving the third party, the determination method of distinguishing the internal and external relationships is adopted, the commercial rechtsschein theorie is applied cautiously, to protect the interest of the bona fide transaction counterparties.

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