

Reflection and Improvement Path of the Regulation on Actual Controllers of Listed Companies in China

Shudi Hu^{1,a,*}

¹North China Electric Power University, Baoding, 071000, Hebei, China

^a782477575@qq.com

*Corresponding Author

Keywords: effective controller, connected transactions, disclosure, corporate personality

Abstract: As a major category in the *Company Law* and the *Securities Law*, the actual controller of a company is the subject that exercises real power over the operation of a company without being subject to the original regulations. From this perspective, the actual controller occupies the core of corporate governance structure compared with other major shareholders who have control over the company, so the regulation on it has become an important issue. In practice, the actual controller of an enterprise abuses the power of enterprise and destroys its independent personality repeatedly. However, the existing regulations on it are narrow in scope and missing in content. On this basis, the paper analyzed the status and problems of the strict regulation system of actual controllers in China's legislation and the main points of modern judicial practice in such cases according to classic judicial precedents, based on which summarized the status and perfection of the system in China's legislation.

1. Introduction

The beneficial owners of listed companies in China are mainly regulated based on the *Company Law*, the *Securities Law*, and relevant regulatory documents of governmental supervisory departments such as the Securities Regulatory Commission. China adopts the model of independent regulation of beneficial owners, i.e., the direct regulation of beneficial owners. The entire regulatory system mainly includes the affiliated transaction system, the information disclosure system, and the responsibility to creditors. However, in practice, it is common that the actual controller infringes on the independent personality of an enterprise, damages the interests of creditors, or uses affiliated transactions to violate the rights and interests of the enterprise, and so do the narrow scope of voting rights exclusion, incomplete information disclosure, and the lack of information disclosure of continuing affiliated transactions. At present, a sound system of corporate civil liability has not been established for the civil liability of actual controllers of enterprises. As can be found in the provisions of the *Company Law*, the actual controller is only liable to the enterprise itself, which will lead to the difficulties of internal shareholders and external creditors in relief [1].

The Article 20 of the *Company Law* only regulates the joint and several liabilities of the majority shareholder for the infringement of corporate personality and the damage to the interests of creditors and does not take the actual controller of the company into consideration, which undoubtedly increases the possibility of abuse of rights by the actual controller for personal interests. As to the actual controller against the interests of the company and creditors, the parties often sue by way of tort and contract. However, as a loss of control shareholders and external creditors, it is difficult to obtain information about the company's internal transactions, procedural law barriers, and practical difficulties.

We should improve the actual controller connected transactions and information disclosure mechanism, further establish the liability mechanism for actual controllers, strengthen regulation of certain channels proposed in the tort and contract, and further strengthen the regulations of the *Company Law* on the liability of actual controllers. Meanwhile, the cases that touch on the actual controller to infringe on the personality of a company to mix with the personality of affiliated

companies or the interests of the company's creditors can apply the corporate personality denial system to protect the legitimate rights and interests of shareholders and creditors of the company.

2. The Sorting-out and Reflection of the Current Situation of the Regulation on Actual Controllers of Listed Companies in China

2.1 The sorting-out of the current situation of the regulation on actual controllers of listed companies in China's legislation

2.1.1 The status of regulation on the actual controller of listed companies in China's legislation

(1) Affiliated transaction system

First of all, according to the Article 21 of the *Company Law*, it is clear that when the actual controller of a company uses the affiliation to violate the rights and interests of the company, the enterprise needs to bear the liability. At this time, shareholders can protect the interests of the company and their interests through the application of the system in respect of shareholder-derived litigation. Secondly, in a series of legal and regulatory documents of securities market such as the "*Measures for the Administration of Initial Public Offering and Listing of Stocks*", restrictive acts against the actual managers of enterprises are enumerated, including operating monopoly acts of transferring or possessing funds, assets or other resources of SMEs in different forms, carrying out activities of participation in SMEs through participating in the purchase of service products or marketing channels or using related transactions, benefit-sharing, asset restructuring, external financing, making guarantees, and other methods to infringe on the legitimate rights and interests of listed companies or other social creditors, etc. Thirdly, in the regulatory documents of China Securities Regulatory Commission and the Stock Exchange, the mechanism for the exclusion of voting rights of actual managers of enterprises is regulated. It is required that shareholders of relevant enterprises must circumvent the voting rights when voting on affiliated transactions is implemented in the special general meeting of an enterprise. It is also stated in the Article 16 of the *Company Law* that the provision of guarantees by the company for its shareholders or beneficial owners must be resolved by the shareholders' meeting or a general meeting, but for this vote, shareholders at the disposal of beneficial owner are not allowed to participate in [2].

(2) Information disclosure system

The Article 80, 84, and 85 of the *Securities Law* regulate the special circumstances, under which the actual controller of a company shall fulfill the obligation of information disclosure and bear the liability for its violation of the obligation. The specific content and format standards for the release of information system of an enterprise offering shares to the public include No. 1 "Contents of Prospectus", No. 2 "Specific Content and Format of Annual Statement", and a series of normative texts issued by China's Securities Market Supervision and Administration Commission, which also regulate the information disclosure system of enterprise. In general, that is, an enterprise undertakes the obligation from the beginning of its listing to every change in its controlling shareholders of the company. The Article 56 of "*Guidelines on the Articles of Association of Listed Companies*" formulated in 2006 also states that when the shareholders' meeting intends to study the nomination of the president and supervisor, it must reveal whether there is a relationship between them and the actual controller of the company.

(3) Liability of the beneficial owner to creditors

The Article 21 of the *Company Law* regulates the liability of the actual controller of a company that the actual controller cannot use his or her affiliation to infringe upon the rights and interests of the company. Those who disclose information in violation of the law and cause economic loss to the company are required to bear the liability for compensation. The Article 24 of the *Securities and Exchange Act* expressly provides that the beneficial owner in the violation of the above-mentioned statutory requirements and legal procedures, or failing to offer the company's shares shall be canceled, who is also jointly and severally liable with the issuer. The Article 84 and 85 also provide joint and several liabilities for the breach of information disclosure obligation by the beneficial

owner. Meanwhile, the universal rules of the Tort and Contract Sections of the *Civil Code* also regulate the actions of beneficial owner to protect the interests of creditors [3].

2.1.2 Jurisprudence on the regulation of actual controllers of listed companies in China in judicial practice

In current judicial practice, cases that the actual controller of an enterprise abuses the control of the company and undermines the independence of its personality are often resolved in the suing of tort or contract and his/her bearing of joint and several liabilities according to Article 20 of the *Company Law*. For example, in the case of "Luo Shumei's Infringement of the Rights and Interests of Urumqi Xinyuan Coal Mining Co., Ltd", the enterprise sued for the infringement of its rights and interests because Luo Shumei reached an agreement with the enterprise to sell the mine and acted as its de facto controlling person, but no operating funds were remitted to the enterprise during the business period. However, we believe that the company, as a civil legal entity with its legal property rights, has legal protection against the infringement of its legitimate rights and interests, while its actual controller needs to fulfill its liability for compensation for its infringement of the rights and interests of the company. Luo Shumei was the actual controller of property disposal without the relevant consideration on the company's account, which is sufficient to determine that Luo Shumei significantly infringed on the corporate property rights and interests of Xinyuan Group in fact, and needed to bear certain liability for compensation, That is based on the Article 20 of *Company Law*, but the provisions of this article for corporate shareholders to abuse the status of a company's independent personality and their limited liability for the evasion of debts seriously damage the interests of the company's creditors, for which the company shall be jointly and severally liable for the debts. The Article 21 is only involved in restrictions on beneficial owners and restrictions and related transactions against the rights and interests of enterprises, which shows that the existing *Company Law* does not have specific legal restrictions on the beneficial owner to infringe on the company's corporate power [4].

When the personality of affiliated enterprise is mixed, the creditor still files a lawsuit for damages in tort, which will further increase the difficulty in procedure and practice. At this point, the application of legal personality denial will become the key to the case. For example, in the case of "Loan Cooperation Dispute between Sichuan Tailai Decoration and Construction Engineering Co., Ltd. and Chengdu Office of China Xinda Asset Management Company", the actual controllers of the decoration enterprises, real estate companies, entertainment enterprises, etc. used their control over each enterprise, completely ignoring the independence of the personality of enterprise and transferring and disposing of property and debts between each enterprise, which caused confusion of the personality of relevant companies and greatly infringed on the rights and interests of those companies. As a result, the company completely lost its ability to repay the debt, and claimed that the enterprise was exempted from liability because the interests and character of the enterprise were separate, so it was fully responsible for its debt, making it impossible for the debtor's interests to obtain legal remedies. Finally, the court applied the legal personality denial to the case because it violated the basic concept of building a socialist legal person democratic system and infringed on the principles of honesty, credit, and equality. This is a breakthrough in the protection of creditors' interests.

2.2 Reflection on the current status of actual controller regulation

First of all, China's connected transaction system is not perfect at present. Firstly, the prohibited acts of actual controllers are enumerated, while the forms of connected transactions are diverse and extensive, and the situation of actual controllers obtaining personal benefits through improper and illegal connected transactions cannot be fully covered. Secondly, the exclusion of voting rights for the actual controller of a company can only be applied to related party guarantees, so the scope is narrow. Thirdly, according to the provisions of the *Company Law*, enterprises can directly finance other companies, but in the case of joint enterprises, the law also lacks effective regulations on their related transactions, which is easy to lead to the damage to the interests of the company and creditors [5].

Secondly, the information disclosure system of actual controllers is also not perfect. Firstly, there are ambiguous expressions regarding the basic circumstances and methods for disclosure. For

example, when a significant change in the controlling shareholder of an enterprise is found to have occurred during the reporting period, the enterprise needs to disclose the basic status of the controlling shareholder and the actual controller after the significant change, which should be clearly expressed. Secondly, for the disclosure of continuous connected transaction information, the current regulations only require overall disclosure in the prospectus or periodic report, which makes this kind of connected transaction often receive less attention, causing the oversight of regulation. Thirdly, there is no timeliness and accuracy in the control of information disclosure activities of listed companies and in the supervision of their actual controllers, and the penalties mostly rely on the reputation penalty method, which fails to produce effective control over their activities.

Finally, according to the Article 21 of the Company Law, it is clear that beneficial owners are liable to a company itself rather than its creditors. As to the trustee or director of a company who has a fiduciary duty to the company, the law carries out several liability mechanisms for the breach of the duty. When the control of a company falls to the actual controller, or the control of the company is abused, or the interests of the company's creditors are violated, according to the rules of the *Company Law* and the independence of corporate legal personality, the actual controller is responsible for the civil liability of the company. Therefore, the creditors shall be held responsible for the breach of contract of the actual controller, according to the rules of the subrogation and tort of the company on the contract. However, as the external debtor of the company, there are problems such as the abuse of shareholder personality by the actual controller, the direct damage to the rights and interests of shareholders, the indirect damage to the interests of creditors, and barriers and practical difficulties of access to the procedural law, which causes that the interests of creditors cannot be effectively protected [6].

3. The Improvement Path of the Regulation on Actual Controllers of Listed Companies in China

3.1 The improvement of connected transaction system of actual controllers

First of all, the scope of prohibited acts of actual controllers should be further clarified in the legal provisions, such as illegal guarantees to related parties. Secondly, the scope of the exclusion of the voting system of beneficial owners should be expanded, and it should be clarified that when the representative meeting of related shareholders is held to consider a matter concerning connected transactions, neither the company that has an influential relationship with the matter nor one dominated by the beneficial owner that has an influential relationship with the matter can participate in the voting on the matters stipulated in the preceding paragraph. Finally, for the situation of corporate mutual shareholding, mutual shareholding voting rights limit system can be established. In this aspect, China's *Company Law* can learn from Germany and Taiwan on the restrictive provision of mutual shareholding voting rights, that is, set a proportion: voting rights of a mutual shareholding company shall not exceed the proportion regulated in order to protect the rights and interests of the company and creditors.

3.2 The improvement of the information disclosure system of actual controllers

In response to the ambiguous description in the regulations of corporate information disclosure, it can be clarified that when there is a significant change in the controlling shareholder of an enterprise during the reporting period, the enterprise needs to disclose the basic status of the controlling shareholder or the beneficial owner after the change. Secondly, it should also improve the system of information disclosure on continuing connected transactions of listed companies while strengthening the existing information disclosure system. A listed company is required to disclose all positive measures and negative inaction taken according to the instructions or for the benefit of its controlling company on a case-by-case basis, in addition to all legal acts performed by the company, the controlling company or other affiliated companies in the previous year. Finally, the government can strengthen the supervision of beneficial owners and increase the punishment for internal violations of law in listed companies [7]. According to the above-mentioned regulation of the top management of listed companies in the U.S., the actual controller of a company will be severely held responsible for the

violation of the law. Furthermore, Article 180 of the *Criminal Law* will be applied to those who refuse to fulfill the disclosure, and the act of "fabricating and disseminating false information affecting securities trading" will be restricted. Meanwhile, with the *Company Law* as the basis and core, the securities law, accounting law, corporate taxation, financial law, and laws of other sectors will be further promoted. It will further promote the system of information disclosure based on all the above laws as the main part, the regulations of the Securities Regulatory Commission and other regulatory departments as the key content, and the normative text of the stock exchange as the guide.

3.3 The application of corporate personality denial system

The corporate personality denial system refers to that when shareholders abuse the independent personality and limited liability of a company to avoid debts, creditors who control the company's legal personality can directly request to fulfill its legal obligations according to joint and several liability systems, the actual controller can be bound into the scope. In essence, the independence of company personality is the independence of company [8]. When the control of a company falls into the hands of the actual controller and is abused by him/her, the company has lost the essence of independence, which can no longer independently assume legal responsibility. At this time, the company has become the means and tools of actual controller to obtain private benefits, which can become not only the subject of a tort but also the subject of tort liability. Furthermore, the essence of corporate personality denial system is about who abuses the company personality, who has joint and several responsibilities for the repayment of the company's debts. In summary, the application of actual controllers and the corporate personality denial mechanism is conducive to the maintenance of the interests of creditors and the operation of actual controller liability mechanism.

4. Conclusion

The promulgation of the Company Law in 2005 announced the end of the era of legal regulation on beneficial owners. Subsequently, the Securities Law and the securities regulatory provisions formed the prototype of legal regulation system for beneficial owners. At present, China has adopted the model of independent regulation on beneficial owners and established a system of legal regulation on beneficial owners with connected transactions and information disclosure as the core, which appropriately regulates the liability of beneficial owners to creditors. As to the legal regulation of effective controllers in China, this paper summarizes the following deficiencies and proposes the path of improvement. Firstly, the system of connected transactions in the legal regulation of effective controllers is not perfect. That is mainly reflected in the voting right exclusion system and the protection for interests of creditors in connected transactions. Therefore, foreign and domestic regulators of effective controllers should expand the scope of application of voting right exclusion system to all connected transactions, and establish a maximum ratio of mutual shareholding. Secondly, the information disclosure system in the legal regulation of effective controllers is also not perfect. That is mainly showed in that it is not clear under which circumstances an actual controller should be disclosed, and there is no sound information disclosure system of continuing connected transactions for actual controllers of listed companies. Therefore, regulators should clarify the different circumstances under which an actual controller should and can be disclosed, and improve the information disclosure system of continuing connected transactions for actual controllers of listed companies. Finally, regarding the remedy system for the rights of the company, shareholders and creditors, the paper holds that the denial system of corporate personality can be appropriately introduced to pursue the responsibility of actual controllers.

In conclusion, the paper applies the methods of general description, horizontal comparison and judicial case analysis to fully analyze the current situation of regulation on actual controllers in China and summarize and outline the path to improve the legal regulation in China.

References

- [1] Yu Zhengping, Wang Zhaohui, Wu Feifei. On the Application of the Rule of Corporate Personality Denial to the Actual Controller. *Law Application*, no.02,pp.90-97,2021.
- [2] Xu Lai. *Research on the Legal System of Actual Controller*. Southwest University of Political Science and Law, 2011.
- [3] Liu Lin. *Research on the Legal Regulation of Corporate Effective Controllers*. Southwest University of Political Science and Law, 2011.
- [4] Li Xiaoqian. *On the Criteria for Identifying and Legally Regulating Effective Controllers*. Jilin University, 2010.
- [5] Xu Jianyu. *Research on the Legal Regulation of Corporate Effective Controllers*. China University of Political Science and Law, 2009.
- [6] Chen Rui. *Research on the Legal Liability of Corporate Effective Controllers*. China University of Political Science and Law, 2007.
- [7] Zhou Liang. On the Liability of the Abusive Corporate Personality of the Actual Controller to the Creditors of the Company--A Concurrent Review of Articles 20 and 21 of the Company Law of China. *Nanjing University Law Review*,no.Z1,pp.198-212,2007.
- [8] Li Lin. Suggestions for Improving the Regulation of Disclosure of Actual Controllers of Domestic Listed Companies. *Securities Market Herald*, no.04,pp.64-67,2005.