

Discussion on Creditor Protection of Subsidiary Corporation in China Affiliated Transaction under Deep-Rock Doctrine

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Abstract: As the continuous development and expansion of Chinese corporations, the affiliated transactions between controlling corporations and subsidiary corporations are more and more frequent, and the unfair tendency of transactions is more and more obvious. Unfair affiliated transaction not only brings profit loss to the subsidiary company, but also directly affects the interest of its external creditors. In terms of the protection of external creditors of Subsidiary Corporation, the Deep-Rock Doctrine, with its characteristic gentleness, solves the interest conflicts between creditors and controlling corporation and its controlling shareholders by adjusting the repayment order of creditor's rights, which guarantees the interests of external creditors, partly sacrificing the superior position of shareholders with posterior treatment. Although the Supreme Court published 'Shagang Case' as one of the typical cases in 2015, affirming the reference significance of this principle to the case, the application of this principle in China is still unclear. Based on the meaning and development status of deep-rock doctrine, analyzing the difficulties faced by adopting deep-rock doctrine in China to protect creditor and making the solution can better protect the interests of subsidiary corporations' creditor.

1. Introduction

1.1 Meaning of Deep-Rock Doctrine

Deep-rock doctrine also called Equitable Subordination Rule, which is established during the trial of Taylor v. Standard Gas & Electric Co. Case, as the United States Court made the controlling corporation namely standard corporation posterior after other creditors. In this case, the Supreme Court of the United States held that the Deep Rock Corporation was subject to the standard corporation and was instructed by the standard corporation to enter into an apparently unequal contract with the Deep Rock Oil Smelting Corporation, and also the operation of the Deep Rock Corporation was seriously interfered by the standard corporation. As the result, when it fails to pay, its controlling corporation, namely standard corporation, should be ranked next to other preferred shareholders. As the case gets richer and richer and the Deep-Rock Doctrine gets revised continually, we can define it as, in the affiliated enterprises with controlling and subsidiary relation, based on the controlling behavior whether the corporation shareholders violate the fairness principle, the original repayment order is adjusted and sorted to determine whether the creditor's right of controlling shareholders should be inferior to that of the external creditors of the subsidiary corporation when the subsidiary company cannot make payment, and such payment cannot be caused by the controlling corporation's control over the affiliated transactions. The core of it is that the judge can make the decision of controlling the shareholders' creditor's right subordination settlement and redistributing the conflicting interests through the definition and judgment of unfair behaviors, so as to achieve the purpose of coordination, which can protect the interests of the external creditors of the subsidiary corporation, and effectively prevent the controlling corporation shareholders from taking advantage of the subsidiary corporation to gain improper interests through related transactions, so as to promote the fairness of the transaction.

1.2 Deep-Rock Doctrine and Affiliated Transaction

Affiliated transaction is an economic phenomenon with complicated transaction relationship and it develops along with the trend of enterprise centralization and close connection between various stakeholders. As can be seen from the legislation of other countries and regions and the provisions of China, affiliated transaction refers to the transaction reached between the company and its affiliated persons, while related person refers to the person who has control right or significant influence over the company's operating decisions, besides, the controlling company or a third party that deals with a subordinate company at the direction of the controlling corporation is the affiliated person of a subsidiary corporation. It should be recognized that the affiliated corporation and affiliated transactions are originally in the neutral category, and their existence conforms to the needs of China's corporate system reform and the development of market economy, which has its positive effect. For example, the capital structure can be optimized through the redistribution of resources between related parties, so that both parties can give play to their advantages in production and operation, apart from that, the direct interaction between related parties can reduce opportunity cost, optimize capital structure and improve production efficiency. However, the affiliated transaction is a transaction made under the condition of non-competition, different from the general free competition transaction, so it is easy to deviate from the normal trading track. About the affiliated corporations, the real status of two corporations is unequal. The subsidiary corporation becomes controlling corporation's tool of profit-making and its solvency is reduced, while it is still an independent company in form, it loses its independence and also its economic benefits are scattered and transferred and then endangers the realization of external debt.

The protection of external creditors of Subsidiary Corporation involves the security of the whole market transactions and if the behavior of infringing corporation creditors does not get restriction, the order of market transactions will be threatened. External creditors have no control right over the corporation, do not participate in the internal operation of the corporation, lack a full understanding of the actual situation of the corporation, and are not clear on the summary of business transactions and the understanding of the risk of creditor's rights and debts, as the result, the people in control of the company are easy to manipulate the company to infringe on the rights and interests of creditors. If there is no regulation and adjustment, the trading market will be out of order. The Deep-Rock Doctrine can adjust this disorder situation at this time, that is when the creditor's right of the controlling shareholder and the external creditor confront each other, the creditor's right of shareholders will be in the posterior place and ensure that the external creditor can be repaid before the controlling shareholder. In order to avoid their creditor's rights inferior to other ordinary creditors to be distributed, shareholders must reasonably exercise their controlling right in advance to avoid unfair related transactions on their control of subsidiaries.

1.3 Development of Deep-Rock Doctrine

In the United States, the deep-rock doctrine was established in Taylor case and developed in the subsequent cases such as Pepper v. Litton and Comstock v. Group of Institutional Investors. In Taylor case, the court held that the management misconduct of the holding company led to the insufficient investment in Subsidiary Corporation, so it supported the demoting of the creditor's right of the subsidiary corporation held by the holding company. In Litton case, the court held that the creditor's right of the controlling shareholder should be dealt with in posterior form, because the controlling shareholder, in order to make the creditor of the subsidiary corporation unable to get the settlement, purposely transfers the property of the subsidiary corporation to another corporation through the order of priority creditor's right set by themselves. Litton case enriched the application form of deep-rock doctrine, that is, shareholders abuse their control right to set up creditor's rights, trying to advance their claim to be compensated, so that the external creditors can not be repaid, in which case, shareholder's rights should be dealt with in posterior form.

In the following case of Comstock v. Group of Institutional Investors, the court extended the doctrine of complete subordination, which puts that generally, it is believed that the creditor's right of the malpractice can be dealt with in posterior form by dividing the controlling corporation's

behavior, while when the behavior of the controlling corporation is too complex to be separated, the creditor's right of the controlling corporation will be completely subordinated. As that, the deep-rock doctrine was explicitly stipulated in the American bankruptcy law in specific articles, stipulating that the court can decide whether to dispose of the creditor's rights or not according to the actual control situation of the shareholders.

Germany is even stricter about the behavior of controlling shareholders, and its laws do not take shareholders' subjective fault or whether they are damaged into consideration. In order to ensure the subordinate company creditors getting fair settlement, the revised Germany Corporation Law in 2008 established a direct rule that is as long as the shareholders provide loans for subsidiary corporation, then no need to tell the details of the loans reason, background and the loans will be automatically placed in the bottom of creditor's rights liquidation order in bankruptcy procedure. This rule is usually called automatic subordination rule academically. The reason is that, in practice, shareholders do not invest the corporation normally, but send the investment to the corporation in the form of loan, so they become both creditors and shareholders of the corporation with a dual role, which provides the shareholders with the priority of compensation and avoids the shareholders' obligations and risks that they should bear. When the corporation fails to pay, the automatic subordination rule directly adopts the posterior treatment at the expense of the compensation order interests of shareholders, which reduces creditors' burden of proof and protects their rights and interests to the greatest extent. However, that behavior also makes shareholders give up the transaction with the corporation as unwilling to accept the consequences of the normal transaction with the company, and inhibits investors' investing desire and normal trading activities, which is not conducive to economic development.

According to the Company Law of Taiwan of China, if the controlling corporation makes the subsidiary corporation in the situation of 'non-routine or other unprofitable operation', then the controlling corporation cannot claim to offset the liability for damages against the subsidiary corporation just because it has creditor's right against the subsidiary corporation, furthermore, the creditor's right should be secondary to the other creditor's right of subsidiary corporation. Taiwan sets up the prohibition offset system and posterior liquidation system against the abuse of control power by the controlling company, besides, clearly stipulates that the posterior scope of the controlling company's creditor's right will be assigned after any other creditor's right, which is a reference to the experience of the United States. Taiwan's laws and regulations put forward a new behavior reference, that is, analyze, from the entity level, whether the company's behavior is contrary to the business practices and whether belongs to the range of unprofitable operation according to the daily business transactions. Transactions between shareholders and the company are not strictly prohibited, if that are subject to the scope of normal business operations. In addition, its laws stipulate the measures for the inversion of burden of proof, which provides convenience for protecting the interests of subsidiary corporation and creditors.

2. Introducing of Deep-Rock Doctrine in China

China's laws do not exclude affiliated transactions, which greatly increases the possibility of damages to the interests of external creditors, whose interests are of great significance to market security and transaction order. The deep-rock doctrine has its own advantages in protecting creditors, which is worth discussing and introducing in China.

2.1 Weak Position of Creditors in Subsidiary Corporation

In the rapid development stage of affiliated companies in China, the phenomenon is that the affiliated transactions between controlling corporation and subsidiary companies increase constantly, and a large number of affiliated transactions attract people's attention, however, the relevant discussions mainly focus on how to protect the interests of minority shareholders and other issues, and the protection of creditors, especially external creditors of subsidiary corporations, has not attracted much attention.¹² For the affiliated companies, the creditor information and identification ability are in a weak position, they are often the most vulnerable to the infringement of rights and

interests. The law's lacking of the necessary requirements for the formation and decision-making of affiliated transactions, not perfect internal governance system of enterprises, and few provisions on the disclosure and report of affiliated transactions¹³ lead to the imbalance of different subject positions, the creditor's not being able to grasp the relevant information, and difficult right protection after right being infringed.

In 2013, the amendment of Company Law of China abolished the restriction on the minimum amount and paid-in amount of company's registered capital, which caused some problems in practice. Shareholders become the creditors of the company by borrowing to finance the company, thereby reducing the registered capital amount of the company in exchange for limited liability protection. In addition, the controlling corporation shareholders can also make use of their controlling position to set up security for the creditor's rights, so that their creditor's rights to the company can be repaid in priority. Apart from that, the shareholders' own rights can be protected through their internal operations, while the creditor's rights are ignored.

2.2 Advantages of Deep-Rock Doctrine on the Protection of Creditor

Compared with the Disregard of Corporation Personality System, the deep-rock doctrine is not limited by the abuse, insufficient capital contribution and prior establishment of creditor's rights etc. in terms of applicable conditions. For the result, it only changes the settlement order of credit right but not denies the existence of controlling shareholder's credit right. The judgment made by court is based on company's capital and the obligation, good faith of the controlling shareholders, besides, stipulates that the precondition for shareholders to be compensated is to ensure that external creditors can be compensated first, which is more mild than the Disregard of Corporation Personality System. The denial of corporate personality is to deny the independent personality of the company and the limited liability of the shareholders in terms of specific facts. Compared with the deep-rock doctrine, the denial of corporate personality is more thorough in terms of results. After denying the independent personality of the company, the shareholders are directly responsible not only for the creditors, but also for the public interests related to the company. The Disregard of Corporation Personality System is generally difficult to be invoked if the unfair behavior does not affect the personality independence of the subsidiary corporation, at this time, the deep-rock doctrine can be applied not only to protect the interests of other creditors of the company, also take into account the rationality of the creditor's rights of the controlling shareholders.

For the bankruptcy cancellation system, creditors are able to indirectly exercise their claim right of settlement with the help of bankruptcy administrator, and their rights are often not guaranteed in the end. However, with the deep-rock doctrine it is no need to ask for help from the bankruptcy administrator and the creditor can execute the right directly. Article 510 (c) of the Bankruptcy Law of the United States stipulates that the security right is invalid, and the shareholder's right of credit becomes an unsecured right of credit inferior to the external right of credit, furthermore, Germany, the United Kingdom and Taiwan all stipulate that the secured shareholders' right of credit are inferior to the external right of credit, which is a strong guarantee for the rights of external creditors in the case of secured shareholders' right of credit.

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