

## The Law's Power to Prevent Transactions

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**Abstract:** As a crucial institution for maintaining social order and justice, the law possesses much power to set rules. However, the limitation of its power in regards to its relation with transactions that manifest with the consent between two primary parties would be closely examined and evaluated in the essay below. By analysing four separate facets of this problem: the validity of the transaction, existing legal regulations, and the case of the OTC market, and at last, the undesirable legal consequences of the transaction, the essay draws conclusion that the law does have power to prevent transactions if they are invalid, illegal or lead to undesirable consequences.

### 1. Introduction

Transactions are defined as: "... acts, performed with the intention to bring about changes in the world of law..." (Hage, 2013). They are a fundamental way in which individuals exercise their rights in private law. Legal transactions are classified as a type of constitutive act that is effective only if its inflicted change in the world of law corresponds with its "propositional content," that is, when the initial idea of the transaction is realized by the parties involved in the physical or social world (this is called a world-to-word direction of fit).

Therefore, transactions are one of the most common ways for individuals to change their or other people's legal status. For example: when an individual hires another person with wages in exchange for his/her labor-making them employer and employee; or when a homeowner lends his/her house to a buyer in exchange for monthly payment -making them landlord and tenant... However, with this freedom comes its corresponding obligations, which, unfortunately, means that the law must intervene when these duties are failed to be completed.

This essay will examine and discuss the two scenarios in which the force of the law should prevent a transaction using its coercive nature, even though it was entered freely between two competent and consenting adults. In the first part, we will discuss the validity of a transaction, while in the second part, we will focus on the undesirable legal consequences which make a transaction unjustifiable.

### 2. Validity of a Transaction

As mentioned above, a transaction is a constitutive act with a world-to-word direction of fit, and thus, for a transaction to be successful, it first has to be effective in fulfilling its propositional content in the real world. In order to do so, three conditions must be met:

- 1) There is an offer and an acceptance;
- 2). The parties involved have enough power to carry out the transaction;
- 3). The transactions must be carried out according to existing laws.

In this case, condition one is met since the transaction "entered freely" between two parties that are "consenting," we can deduce that involves an offer and acceptance. Then the conditions in question are 2 and 3. In the following section, these two conditions will be analyzed separately.

Condition 2: although both parties are "competent, consenting adults," that does not necessarily mean that they have the power to complete the transaction. It only means that the individuals have the

mental, physical and legal capacities to carry out the transaction initially. As the environment changes, the capacities of the parties can be altered too. A good example occurred in China during the coronavirus pandemic when the Chinese government nullified the transactions between citizens planning to visit another country and travel agencies because of disease control. In this instance, the citizens no longer have the legal capacity to travel abroad, so they would suffer financial loss if the transaction isn't prevented. In order to protect the benefits of both parties involved in the transactions, the government refunded all the plane and train ticket costs for the buyers and compensated the travel agencies through tax cuts (Chen, 2020). Apart from changes in the party's physical and legal capacities to fulfill its obligations in the transaction, its power could also be lost through mental capacities. A breach of contract proves this point: when a party becomes unwilling to complete the transaction through stalling or refusing to perform part of the initially agreed duties. When this occurs, the court must go through complicated processes in order to identify the level of the extremity of the breach, then terminate the contract with mitigation of loss; the court will then determine the amount of compensation based on "what is reasonably deserved" or *quantum meruit*. (Foman v. Davis, 1962)

Condition 3: On the other hand, there must also be existing law that permits such activity to be legally binding. For example, in some countries, an agreement must be in written form before it is acknowledged as a legitimate contract. Moreover, while last wills and IOUs are common practices of legal transactions, other forms might not be accepted as legally binding. Therefore, the legal transaction must be initiated according to existing rules, or else the force of law can terminate informal transactions because they are not legally binding. For instance, in many regions, an oral agreement is not enough to serve as proof for a transaction, and a precise process must take place before a transaction is settled. Other than the institutive act of creating a transaction, the transaction itself could be illegal based on existing law. For example, unregistered trading of firearms, human trafficking, and many activities are deemed criminal or prohibited in nature; thus, the law has the authority to intervene and prevent such transactions. However, it should be noted that this scenario suffers from some inconsistency as the legal landscape changes based on the social landscape too. For example, privacy law did not form a part as constitutional doctrine until 1961, which means that the supreme court did not consider transactions involving infringements of privacy during the rulings before that time.

### **3. Legal Regulation of Related Party Transactions**

#### **3.1 Conflict between Form and Substance**

In China's substantial economic system and complex financial market, companies widely use related party transactions in practical operations because of their advantages, such as saving company costs and reducing intermediate links. However, it is precisely because related party transactions widely exist in China's corporate governance links that the regulation of related party transactions poses a severe challenge to China's laws, including laws and regulations such as company law, securities law, tax law, and accounting law, as well as industry norms related to related party transactions in the securities market. Even if it is a legitimate related party transaction, it is conducted through proper procedures and legal decision-making links in form, and it seems to be fair and reasonable in the process of shareholders' voting and approval. However, due to the differences in the size of shareholders, even if the related party transactions are conducted legally, it will inevitably harm the interests of small and medium shareholders. Different laws have different judgment standards and regulation methods for related party transactions. At present, there is no unified regulation on related party transactions. The company law mainly involves related party transactions in the process of corporate governance, while the securities law focuses on whether the whole related party transaction process is fully disclosed in the related party transactions of listed companies. Because the transactions of superior companies will affect the legitimate rights and interests of small and medium shareholders, the actual capital problems

of listed companies cannot be covered up by related party transactions, which damages the legitimate rights and interests of small and medium shareholders.

The principle of equality and voluntariness will face significant challenges under the conditions of related party transactions. Under the typical conditions of related party transactions, contracts are often arranged by the controlling shareholders and other related parties, and even the legal representatives of both parties may be the same person. However, in this case, due to the particularity of the connected transaction contract, it is difficult to apply the fraud and coercion rules in the contract law. Although the affiliated transaction is conducted through due process, its particularity makes such transaction more like a subject's own pursuit of interests. The conflict between formal fairness and equality and substantive fairness and equality is evident in related party transactions. Tax law mainly focuses on whether related party transactions have tax evasion besides reasonable tax avoidance, while accounting law aims at the fact that companies use related party transactions to whitewash their financial reports and cover up their actual operating conditions. Criminal law punishes the responsible subjects who commit economic crimes in the related transactions of enterprises. On the other hand, although each law has its respective emphasis on related party transactions, all laws are not unrelated, and they are integrated to form a system of laws and regulations governing related party transactions of Chinese companies.

### **3.2 Conflicts of Interest between Different Subjects**

For the company, in order to achieve the maximum profit with the lowest cost, a large number of related transactions exist in the management of the company. The key to the fairness of related party transactions depends on the comprehensive information disclosure of related party transactions of the company. In fact, conflicts of interest always exist in the process of human social interaction. Conflicts of interest are typically manifested in two forms in company law, one is the conflict between owners and managers, and the other is the conflict of interest between controlling shareholders and non-controlling shareholders. The related information disclosure specifications of listed companies are widely distributed, but on the whole, each specification often goes its own way, and the information disclosure of related transactions is not systematic and specific. Because of this, listed companies take advantage of the low connection between these regulations to conduct related party transactions, thus exploiting legal loopholes.

Moreover, the information disclosure of listed companies can not be done quickly and quickly, leading to the problem of information lag in the control of information disclosure of related party transactions. In connected transactions, controlling shareholders often use their more voting rights to restrict the rights of minority shareholders or obtain more benefits by trading themselves and paying more wages than the market level. For limited liability companies and joint-stock companies, there is no mandatory information disclosure in China. Therefore, China has not paid enough attention to the information disclosure of non-listed companies. For corporate creditors, the company's competitiveness is reduced, and the interests of small and medium shareholders are damaged due to related transactions, which will inevitably affect the solvency of the company and eventually affect the interests of creditors. In China's current economic model, the critical information disclosure system plays a vital role in monitoring the company's business activities and ensuring the company's legal operation, whether for listed companies or non-listed companies.

## **4. Legal Regulation of Otc Market**

In the modern financial market, there are two ways for enterprises to finance funds, namely, direct financing and indirect financing. From the perspective of indirect financing, when commercial banks provide loans to enterprises, security is the primary factor to be considered, and the scale, strength, management and repayment ability of loan objects are often strictly examined. Therefore, commercial

banks usually tend to lend to mature and stable large enterprises. Compared with stock exchanges, the remarkable features of the OTC market are colossal market capacity and low market access conditions. The construction of a multi-level OTC market model is conducive to meeting enterprises' financing needs of different types, scales, and growth stages. With the deepening of China's securities market reform, it is only a matter of time before the opening of the capital market, which is also the inevitable requirement of China's integration into the world economy. Objectively speaking, with the sustained growth of China's economy and the accelerated pace of reform of state-owned enterprises, the financing needs of small and medium-sized enterprises, high-tech enterprises and enterprises, after restructuring are constantly expanding. It is the general trend to develop multi-level capital markets. Subjectively speaking, investors' investment preferences are diversified.

Investors' risk tolerance varies from high to low, and there are also differences in the access channels, completeness and authenticity of information access of investment enterprises. Different investors have different abilities to analyze and judge the exact information of an investment enterprise, and investors have different requirements for the liquidity and profitability of their investment funds. At present, it is urgent to build an OTC market, so the law should have a positive response to the OTC market. In addition, the dual market structure of China's over-the-counter market has been formed, but the development of the over-the-counter market is quite different. The transactions of stock exchanges account for the vast majority of the capital market, and their supervision system is relatively perfect. However, the development of the over-the-counter market has not been smooth, and even suffered setbacks frequently. One of the important reasons is that the Securities Law, as one of the fundamental laws of the capital market, has no clear regulations on the over-the-counter market. The exit channels of venture capital are diversified, including repurchase, sale, listing and liquidation. Among them, the listing is considered the best exit channel for venture capital because it not only provides a better financing platform for enterprises but also enables investors to obtain high returns through listing transactions. Therefore, building a multi-level OTC market and accommodating more small and medium-sized enterprises to be listed on the market will help provide more efficient and convenient exit channels for venture capital and promote the continuous development of venture capital in China.

In recent years, China's capital market intermediaries, such as securities companies, law firms, and accounting firms, have made a qualitative leap in scale, quantity, and business scope, providing relatively perfect intermediary services for investors and financiers trade in the over-the-counter market. Because there are many government entities or government departments involved in formulating relevant laws, regulations and policies, each entity or department has issued regulations and policies for its own interests according to its own standards, and lacks unified laws and regulations. One of the meanings of clarifying the legal status of the OTC market lies in ending the chaotic and inefficient situation of laws and regulations governing the OTC market, and establishing a unified and efficient legal system and supervision system to provide a guarantee for the efficient and orderly operation of OTC market. Establishing a supervision basis means strengthening and perfecting legislation to provide a legal basis for the supervision of the OTC market, which is an inevitable requirement for adequate supervision of the OTC market. Effective supervision includes the formulation and implementation of standards beforehand and the inspection and punishment of violations afterwards. These two aspects should complement each other. Effective supervision beforehand can significantly reduce the occurrence of supervision afterwards, and the implementation of supervision afterwards can enlighten people and make people more consciously abide by the standards formulated beforehand. For the issuance system of the listed entities in the OTC market, it is suggested to introduce a sponsor system similar to the IPO of listed companies. The specific system design can refer to the sponsor system in the U.K. market and the sponsor system in the OTC market in Taiwan Province. After clarifying the legal status of the OTC market, it has laid a legal basis for the legitimacy of the OTC market on a macro level. Then, it is necessary to establish and improve basic systems and make some achievements on a micro level, because these systems are not only the criteria for entering the OTC market, but also

the basis for regulators to exercise their supervisory functions. Therefore, we should establish and improve the legal norms of supervision in law, which mainly include the following aspects: trading subject and issuing system, trading place system, trading system and information disclosure system.

## **5. Undesirable Legal Consequences**

In the section above, we discussed the scenarios in which a transaction can become invalid so that the force of law has the right to take measures to prevent them from happening. In the following section, we will instead focus on transactions that must be nullified in order to avoid legal consequences.

Usually, these consequences cause harm or infringement of rights to an unrelated third party. In many transactions, its consequences affect not only the people involved but also the public at large. Before the 1990s, there was much less regulation for insider trading in the United States, which meant that stocks of a public company and other securities could be sold based on material, nonpublic information of the company (Bhattacharya & Daouk, 2002). The consequence is that the parties involved gain an unfair advantage to the investors who do not have the knowledge, reaping colossal profit in the process. These practices not only harm other investors and also the public, and it is exploitative. In order to prevent these consequences, enforcement of insider trading law emerged in the 1990s and is standard practice today.

For obvious reasons, this method of thinking raises the question of inconsistency: it would be unrealistic for the court to analyze the legal consequences of every transaction, not to mention if it has the power and time to examine every potential outcome. Therefore, the sensible approach would be to consider various factors: the intention of the transaction, its risks, and whether it has the consent of an unrelated party that might be involved in their transaction.

“Cozy open fires and wood-burning stoves are at the heart of many homes up and down the country,” said Environment Secretary George Eustice. “But the use of certain fuels means that they are also the biggest source of the most harmful pollutant that is affecting people in the U.K.” Therefore, starting from February 2021, the sale of bagged traditional coal and wet wood would be gradually banned in England. The government's reason for this action is to slow down the increase of air pollution caused by the fine particular matter (PM 2.5) from the burning of wet wood and traditional coal, protecting the innocent unrelated party (the public, in this case) from the harm caused by such transactions. (Department for Environment, Food & Rural Affairs & Pow, 2021)

## **6. Conclusion**

Transactions allow individuals to bring change to the real world with their legal rights, but in many cases, the law has to intervene for justice and protection of rights. Through this essay, two scenarios in which the force of the law should intervene are presented and thoroughly discussed: the former being the transaction's validity and the latter being the undesirable legal consequences of the transaction. In this way, the law uses its power to ensure maximum protection of the rights of its participants, as well as giving them the freedom to make changes reliably and effectively, safeguarding the smooth function of society.

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