

Study on the Right Boundary of Preferred Stock Contract from the Perspective of Fiduciary Duty

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Abstract: The characteristics of the integration of equity and creditor's rights in the Preferred Stock Contract Make The Interest Conflict Between The Preferred Stock shareholders and common ones more complicated. In these conflict, how to define the right boundary of the preferred stock contract in a rational way is particularly important. In order to define the above issue, this paper studies the right boundary of preferred stock contract from the perspective of fiduciary duty. Based on the angle of fiduciary duty, some actions like establishing the judicial review standard of fiduciary duty, paying attention to the important role of procedural justice, and pursuing procedural justice at the same time, as well as taking substantive justice as the standard to determine the right boundary of preferred stock can effectively define the right boundary of preferred stock contract.

1. Introduction

Although the *Guiding Opinions on the Pilot Development of Preferred Stock* issued in 2013 made the preferred stock system formally enter into the practical operation stage in China, as a contract signed between strategic investors and companies, the preferred stock contract has been widely used in a long time before its issuance. Preferred stock contract refers to a special investment contract signed between the preferred shareholders and their enterprise, which determines a special form of equity similar to the preferred stock equity, so as to ensure that investors can obtain the priority in dividend distribution, residual value claim and other aspects. There are many forms of preferred stock contract, not only in its original name, for all the contracts that have determined similar to the preferred stock rights can be equaled with them. As a contract form to meet the personalized financing needs of the company and investment needs of investors, the preferred shares determined by the contract transcend the attributes of creditor's rights and stock rights, resulting in a complex interest struggle between the preferred shareholders and the common ones. How to define the right boundary of preferred stock contract reasonably has become an important condition to solve the complex interest disputes between preferred stock and common stock shareholders.

2. Summary of the Fiduciary Duty Theory

Fiduciary duty is the loyal duty at most, which comes from the Anglo-American law system and becomes an important principle to deal with the complicated interest disputes between company's management and shareholders. According to the fiduciary duty, trustor as the beneficiary, should give trustee the necessary trust, so that they can handle the affairs entrusted by the trustor with integrity and sincerity, and be loyal to the trustee and act selflessly for the benefit of the trustee. From the perspective of economics, the fiduciary duty holds that the trustee should care about the preference of their client, and act in accordance with it, be devoted to his duties, and not harm the interests of the client. The fiduciary duty is not only widely used to deal with the interest disputes between the company's management and shareholders, but also between lawyers and customers and in dealing with trust relations. Moreover, it has been successfully applied in Europe and America in dealing with preferred stock contract boundary, and formed a relatively complete judicial review procedure.

3. Main Problems in Defining the Right Boundary of Preferred Stock Contract

The biggest characteristic of the preferred shares established by the contract of its own is the integration of creditor's rights and stock rights. As for integrating creditor's rights, the holders of the preferred shares have the priority of dividend distribution right. No matter whether the company is profitable or not, they need to distribute dividends to the preferred shareholders, which makes the preferred shares have the characteristics of creditor's rights. In terms of the characteristics of equity integration, some of the preferred shares that can be converted into common shares and some of the preferred shares that have the right to vote or send directors have the characteristics of equity. Because of the characteristics of combining equity and creditor's rights, the preferred stock contract has a complex relationship with its company, which brings a great challenge to define the right boundary of preferred stock contract.

On the one hand, it is practically severe that the contract rights established by the preferred stock contract have been usurped by the organization. The preferred stock shareholders not only lose the right of preferential dividend distribution and other rights determined by the contract, but also suffer huge losses when that happens. Especially in the current legal framework of our country, when the preferred shareholders and common shareholders have interest disputes and enter into the judicial process, it is the characteristic of equity of the preferred shares that often be recognized as equity by the judicial authorities rather than as creditor's rights, which makes the preferred shareholders lose the right to receive dividends according to the rights determined in the contract. Within the context, the contractual rights determined by preferred stock contract give way to the organic law, which makes it difficult to be exercised.

On the other hand, in the dispute of rights and interests between some preferred shareholders and common ones, organization order is greatly invaded by the contract of preferred shares, and even the rights of the contract of preferred shares are considerably expanded in the organization, which eventually causes the interests of the company to be damaged by the investors of preferred shares. In contrast to the erosion of the contractual rights of preferred shares, the shareholders of preferred shares make full use of the contractual rights established in the contract of preferred shares and let the organizational order give way to the contractual rights in this case. In the preferred stock contract, the preferred stock contract not only establishes the priority right of dividend distribution, but also the terms of forcing the company or the common stock shareholders to buy back the preferred stock or the liquidation of company. When the preferred stock shareholders claim these specific priority rights for their own interests in the case that it is not conducive to the company or the common stock shareholders, which will often cause great harm on the company and its common shareholders.

4. Solutions to Define the Right Boundary of Preferred Stock Contract from the Perspective of Fiduciary Duty

To a large extent, the definition of the right boundary of the preferred stock contract is the division of labor between the contract law and the organization law. That is to say, when facing with the dispute over the preferred stock contract, it is the issue whether put it under the framework of the contract law or the organization law. If the preferred stock contract disputes are brought into the framework of contract law, a serious encroachment of organizational rights by contractual rights will happen. But at the same time, using the organizational law framework simply will make the interests of preferred stock investors easily damaged. However, the principle of fiduciary duty, which has been used for a long time in the Anglo-Saxon law system in dealing with the right boundary of preferred stock contract, has a positive reference for defining it and properly dealing with the following disputes. From the perspective of fiduciary duty, the definition of right boundary of preferred stock contract could be tackled from the following two perspectives.

First one is to establish the judicial review standard of fiduciary duty and attach importance to the procedural justice. The fiduciary duty puts the preferred stock contract disputes under the framework of organization law, at the same time, emphasizes the importance of procedural justice,

and then the judicial review standard of benefit distribution through the procedure is established. In the way of paying attention to the important role of procedural justice, the directors of the company are required to make decisions according to specific decision-making procedures firstly. When meeting with preferred stock contract disputes, the judicial organ firstly needs to conduct judicial review on the procedural rationality of the directors' decision-making, which will be supported when it conforms to the legal procedures.

Second, substantive fairness is taken as the standard to determine the right boundary of preferred stock under the premise of pursuing procedural justice. Procedural justice is not necessarily able to deal with the interest disputes between the common shareholders and the preferred ones reasonably. In order to deal with the disputes between them or among the company more fairly, both procedural and substantive justice should be paid attention to equally. Particularly in dealing with the compulsory buyback required by the preferred shareholders, the disputing parties should also be given the right to prove that the relevant transaction conforms to the substantive fairness. Generally, when the decision-making of directors or company is in accordance with the legal procedures, it is the preferred shareholder who claim the rights that shall provide evidence to prove that the relevant transaction is not in conformity with the substantive justice. Otherwise, the relevant directors or the company shall provide evidence to prove the conformity.

5. Conclusion

The research shows that when determining the right boundary of the preferred stock contract, it is not only faced with the problem that the contract rights are usurped by the organization and the preferred stock investors suffer losses, but also the organization order is invaded by the contract and the company interests are damaged by the investors, which makes it difficult to make a reasonable distinction between the right boundary of the preferred stock contract. Based on the angle of fiduciary duty, especially the judicial practice in Europe and the United States, some actions like establishing the judicial review standard of fiduciary duty, paying attention to the important role of procedural justice, and pursuing procedural justice at the same time, as well as taking substantive justice as the standard to determine the right boundary of preferred stock can effectively define the right boundary of preferred stock contract. Therefore, in order to solve the problem of defining the right boundary of preferred stock contract, the company law of our country can introduce the judicial review standard of fiduciary duty according to the characteristics of the disputes of preferred stock contract.

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