

# Legal Issues on the Asset Restructuring of Listed Companies

## QUESTIONS JURIDIQUES SUR LA RESTRUCTURATION DES ACTIFS DES SOCIÉTÉS COTÉES EN BOURSE

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**Abstract:** Based on the theoretical research on the asset restructuring of listed company, including the comparison of asset restructuring with other concepts, types and modes of asset restructuring of listed company, this paper examines the legal nature of asset replacement, legal issues on debt-equity swap, the protection of creditors, and cross-ownership. By evaluating the current legislation on asset restructuring of listed company in China, the author suggest relevant measures to promote current legal systems on main system, public information system, and Responsibility system.

**Key words:** Asset restructuring; Asset replacement; Debt-to-equity swap

**Résumé:** Basé sur des recherches théoriques sur la restructuration des actifs des sociétés cotées en Bourse, y compris la comparaison avec d'autres concepts, d'autres types et modes de la restructuration des actifs des sociétés cotées en Bourse, cet article examine la nature juridique du remplacement des actifs, questions juridiques sur la conversion de la dette en actions, sur la protection de crédateurs et sur l'actionnariat croisé. En faisant des évaluations sur la législation de la restructuration des actifs des sociétés cotées en Bourse en Chine, l'auteur suggère des mesures pertinentes pour promouvoir les systèmes légaux actuels de notre système principal, du système d'information publique et du système de responsabilité.

**Mots-Clés:** Restructuration des actifs; Remplacement des actifs; Transformation actions-créances

Listed companies play a critical role in the whole financial market, with the fifth wave of corporate mergers in the world, asset restructuring of listed companies also set off a new round storm in China, but without systematic legislation on asset restructuring, there are a lot of problems in the process of restructuring asset, such as asset replacement, transferring debt to shares, staff participation, the protection of creditors, internal control and so on. We will discuss the asset restructuring of listed companies on several aspects, though which we try to found out an ideal way to improve the current legal system in China.

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## **1. THEORIES ON ASSET RESTRUCTURING OF LISTED COMPANIES**

### **1.1 Comparison of asset restructuring with other relevant concepts**

Asset restructuring is dependent concept that exists during the process of state-owned enterprise reform. After many years of development, there has been rich fruit of studies on asset restructuring, but different people have different point of views about the concept of asset restructuring, the question finally settled in 2008. The application scope of Management on Significant Asset Restructuring of Listed Company, which was formulated by Securities Regulatory Commission on March 24, 2008, came to effect on May 18, 2008. From this administrative legislation, we can definite the concept of asset restructuring, that is, asset restructuring means enterprise trade asset by the way of buying, selling and other ways outside daily business, which lead to the change of main business, asset and income.<sup>3</sup> The definition of asset restructuring can help us separate asset restructuring from related concept.

#### **1.1.1 Asset restructuring and capital operation**

The practice of capital operation originated in the west world, especially from the developed market economy countries such as USA, UK etc. Nevertheless, the just concept of asset restructuring was born formally in China. What is so-called operation is to achieve capital appreciation by arrangement asset artificially by the way of investment and financing, asset restructuring and property right trades and so on. Therefore, capital operation have larger scope than asset restructuring, asset restructuring is just one of means of capital operation. However, asset restructuring is the most important means of capital operation, so asset restructuring and capital operation often mix.

#### **1.1.2 Asset restructuring and corporate restructuring**

Corporate restructuring is to change structure of enterprise, leading to asset restructuring and finally realizing optimal allocation of resources and efficiency growth by the way of merger, separation, bankruptcy, acquisition and joint through property right flows among corporations. Essentially, corporate restructuring is strategic restructuring, asset restructuring is tactical restructuring, that is, corporate restructuring is one of economic means and process(WEI, 2004), while asset restructuring is the by-product of this economic means and process, and they are bound to be one-way and necessary relationship.

### **1.2 Types and Means of Asset Restructuring of Listed Company**

#### **1.2.1 Types of Asset Restructuring of Listed Company**

According to the effect of asset restructuring on corporate scale, it can be divided to tightening, expanding and inner changing restructuring.

Tightening restructuring is that corporate sell and spin-off its sub company, production line and core business , that is not in line with long-term business strategy, bad performance and have not performance prospect, reduce the scale of corporate and focus attention on core business and advantage product intensively. Expanding restructuring is just the opposite. It is to expand the scale of corporate by the way

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<sup>3</sup> Article 2 of Management on Significant Asset Restructuring of Listed Company provides that this regulation applies to that enterprise trade asset to a certain degree by the way of buying, selling and other ways outside daily business, which lead to the significant change of main business, asset and income.

of merger, acquisition, joint and combining and so on. Inner changing restructuring is to optimize the structure of corporate managing and allocate asset reasonably by the way of renting, contracting and trusting and so on in the situation that corporate scale does not change. Expanding and inner changing restructuring are both means of capital operation, which both realize optimal allocation of resources and efficiency optimization. If they are used reasonably, the result is the same; therefore the three do not have merits.

According to the degree of opening, it is divided to closed and opening restructuring.

Closed restructuring usually buys shares and bones that are not in circulation, merger and control target enterprise to expand corporate scale. Opening restructuring generally takes the form of buying shares of listed company, purchase and control listed company to realize interest optimization in our country, because of restriction on financial derivatives, most asset restructuring belong to closed restructuring.

### **1.2.2 Means of Asset Restructuring of Listed Company**

The main means of asset restructuring is to peel off bad asset, list partially, swap debt-equity and clear and so on.

Peeling off bad asset is to sell part of asset to other enterprise. The asset can be fixed asset, current asset or all sub and affiliate company. The purpose of peeling off bad asset is to make listed company thin to guarantee core business development of listed company. What is the key is to find suitable buyer, because asset sell to competitors, which no doubt impact on listed company, therefore, non-related enterprise may be the right buyer. LENOVO improve its market share by the way of peeling of f bad asset. In 2003, LENOVO sells 50% shares of motherboard factory to Memory Company in Shenzhen, which is a joint venture that is set up by cooperating with Gigabyte Motherboard Company of Taiwan. In 2004, LENOVO sold 50% of LENOVO cyber to its parent company- LENOVO holding (MU, 2005).

To list partially is that listed company lists its part business or sub company separately, and income belongs to parent company. To list partially do not change the ownership, and parent company have absolute right of control. When corporate come into the situation that is non-economic scale, to list partially is an ideal choice in order to make corporate thin. In 2000, Qingdao Huanyu spun off from Qingdao bridge to list in Hong Kong, in 2000 Tongren science and technology spun from Tongrentang, in 2001 Tuopu science and technology spun from Tuopu software.

Debt-equity swap is that debt of listed company can be changed to shares, which is also known bones of equity. Most country do not forbid asset restructuring through debt-equity swap, but debt-equity swap may damage the interest of creditors, therefore it is necessary to introduce appropriate judicial rules to regulate on December 25, 1998.

Liquidation of listed company can be divided to voluntary and non-voluntary liquidation. Voluntary liquidation is to liquidate company according to shareholders` agreement as the company is in bad performance in long time. Non-voluntary is usually linked to bankruptcy which is also one of legal procedure during listed company bankruptcy. In capital market of China, asset restructuring can bring extra profit, so it is difficult to understand that liquidation belong to asset restructuring. Therefore, it is necessary to correct the opinion that high profit brought by liquidation of listed company, which is abnormal phenomenon is the result of unsound of capital market. Liquidation of listed company can control loss of creditors within a certain level. On December 25, 1998, Big East Sea Tourism Center Group which is the largest shareholders of Big East Sea Tourism Center Co. ltd sell 96,320,000 original shares on the price of 1.41\$ per share to Sanya branch of agricultural bank of China in order to compensate the debt of 1.36 billion.

## **2. PROBLEMS EXISTING IN ASSET RESTRUCTURING OF LISTED COMPANY**

### **2.1 The legal nature of asset replacement**

Asset replacement is one of the important ways of asset restructuring of listed companies, but also makes a lot of legal problems. Asset replacement is to sell the entire company asset, to replace the control of shareholders and directors. Then is it a new company after the asset of listed company is replaced, is it a new company, or is the act to operate capital or just a policy? These problems are not regulated clearly in Chinese law. The author believes that asset replacement also belongs to significant behavior of a company; to change the main business after asset replacement actually makes the concept of company re-listed (JI and BAI, 2000). Therefore it is necessary to regulate asset replacement in the premise of protecting freedom and security of trading between companies. Both corporate and security law do not regulate re-listing issues after asset replacement, but corporate law regulates the conditions on how a company list specifically, as a result, we should conform to security law to judge if the company whose asset is replaced is a listed company, reject the notion that the new company after asset replacement is sure to be a listed company and make sure to what degree asset replacement belongs to company trading and to what degree asset replacement belongs to listing in disguise. As an important role in financial market, to regulate listed companies can guard against financial risks and maintain financial stability and order.

### **2.2 Legal issues on Debt-equity swap**

Debt-equity swap is also known as bonds of equity, whose essence is bonds of property. Though people do not have consensus about the nature of stock, there is no gap which can not be transcended between claims and equity (FENG, 2000). To allow listed companies to asset reorganization by the way of debt-equity may cause issues as follows:

First, it will jeopardize the principle of capital adequacy. Listed companies are co-fund companies, capital is the only material security, and therefore listed companies must maintain capital reality and adequacy. If debt-equity swap is allowed, it may affect capital adequacy because of reality and achievability of claims. Object fund is to be assessed rigorously, while false claims are difficult to be guarded against in practice.

Secondly, companies issue stocks to accumulate fund in order to accomplish a degree of business plan, if debt-equity swap is allowed, the company may not attain adequate fund, which can affect business plan. Then the purpose of issuing stocks may not come true.

Thirdly, after the company is in the process of restructuring, if debt-equity is allowed, creditors who subscribe for new shares can be paid off previously, which is unfair to other creditors.

Fourthly, debt-equity, especially the way that offset by a desire may be taken use of by company directors and major shareholders, which may cause many disadvantages. Though Anglo-American countries do not prohibit the act of debt-equity swap, in practice they take use of piercing corporate veil and other judicial rules in order to strengthen the protection of the interest of creditors.

### **2.3 The protection of creditors**

According to agency theory, the relationship between creditors and directors can be regarded as agent and agentee (CHEN, 1998). Though listed companies have the obligation of continuous information disclosure, creditors can not understand insider information of asset restructuring. In the condition that both parties have asymmetric information, the act that creditors require corporate directors to take upon

moral risk is different form that corporate buy raw material and equipment, produce and sell products, and adjust staff、fund and material (SUN, 2003). Asset restructuring is a strategic reform of corporate, the information related is more complex, and therefore it is more difficult to guard against moral risks.

## **2.4 Cross-ownership**

In practice, there exists how to ascertain the problem that listed companies hold control and equity participation of subsidiary companies, then spin-off to list by control subsidiary companies listed. It was a popular problem that corporate and enterprises are cross-ownership when corporate law was enacted. In 1994, enterprise's structure is relatively simple, but with the large numbers of asset restructuring in 1998, cross-ownership is increasing used as means of asset restructuring. We believe that comprehensive cross-ownership prohibition is to totally deny the companies' right to invest and it is not in line with corporate law, however, if there is no limitation on cross-ownership, many problems that exist in China can not be solved such as false-funded, inadequacy-funded and so on. Combined shares ownership because of cross-ownership, registered fund overlap and capacity of paying debt off weakening may be harmful in the background of current legal culture and economic reform. At the present, in order to protect the creditors' interest and trading security, legislation should both give limitation on cross-ownership between corporate and enterprise and specifically regulates vote rights of subsidiary companies that hold shares of mother-companies, which is good for making sure the amount of companies' asset, protecting creditors' interest and determining market objects correctly.

## **3. DESCRIPTIONS AND EVALUATION ON RELEVANT LEGISLATIONS**

### **3.1 Descriptions about legislations on recent asset restructuring**

There have been some specialized legislations on asset restructuring of listed company such as "On the Merger of the Interim Measures" (1989) by State Commission for Restructuring the Economy, "On the Sale of Small State-owned Enterprise Property Rights of the Provisional Measures" (1989) by the State Council, "Notice on the City Piloted to Optimize the Capital Structure" (1996) by the State Council, "Deepening the Large-scale Enterprise Group's Work" (1997) by the State Council, "The State-owned Large and Medium-sized Enterprises to Establish A Modern Enterprise System and Strengthen the Management of the Basic Norms (on a trial basis, 20) by State-owned Assets Supervision and Administration Commission, "Norms on the Work of the State-owned Enterprises" (2003), etc. "Management on Significant Asset Restructuring of Listed Company"(2008) by Securities Regulatory Commission, "Decision on Amending <Management on Purchasing Listed Company>63 item", "Management on Purchasing Listed Companies"(2008) by Securities Supervision and Management Committee, "Change in the Shareholding of A Listed Company to Disclose Information Management"(2002) by Securities Supervision and Management Committee, "Public Offering of Securities Companies to Disclose Information Content and Format Guidelines" (2002) by Securities Supervision and Management Committee, "Notice on Listed Company to Importantly Buy, Sell and Exchange Asset" (2001) by Securities Supervision and Management Committee.

Asset restructuring of listed company is a systematic project, which refers to a lot of laws, including General Civil Law in Civil Legislations, Company Law, Enterprise Bankruptcy Law, Law against Unfair Competition, Anti-monopoly law in corporate legislations, Securities law in financial legislations. Furthermore, it may also refer to Land Administrative Law, Tax Law and so on.

### **3.2 Evaluation on relevant legislation**

Single legal thinking is not in line with the multi purpose of asset restructuring system, which is hard to

be up to requirement of interest balance. For example, corporate law regulates, corporate can not be merged and separated if it does not pay debt off or afford security, which affects the efficiency of asset restructuring seriously. The latter such as norms on buying back shares. To buy back shares may affect the principal of capital adequacy and interest of creditors (LIU, 2000, p.162). *Corporate Law and Stock Issue and Exchange Provisions* adopt a simple pattern of prohibiting that is just when corporate increases and decreases fund, buying back is legal, which affects self-adjustment of stated-owned shares and development of the reform of employee stock ownership.

Compared with the same legislation as in the developed economy market countries, there indeed still exists some legal gap. There is strange phenomenon in China that asset restructuring of listed company can increase price of shares. Evil and sham asset restructuring of listed company may happen for the sake of profit, but there are none legislations on it, therefore, there is no special penalty on evil and sham asset restructuring of listed company. Market administrators pay much attention on related transaction. However, they pay little attention on related restructuring, which is harmful to healthy and stable development of capital market.

## 4. LEGAL SUGGESTION ON IMPROVEMENT ON ASSET RESTRUCTURING

### 4.1 Subject system

The main subjects of asset restructuring of listed companies include government and enterprise. At the present, the asset restructuring of listed companies is driven by government, therefore, government should be empowered main status. However, asset restructuring is a marketing act, it is necessary to emphasize that government should intervene properly; otherwise, government should take upon obligation of antitrust in the process of asset restructuring.

### 4.2 Information Disclosure System

Listed companies have the obligation of continuous information disclosure, so, information on asset restructuring belongs to the scope of information disclosure. Regulations on information disclosure on takeover of listed companies previously once dominated in practice.

Regulations on the Takeover of Listed Companies regulates the content that have to be announced, other regulations can be seen in Notice of the China Securities Regulatory Commission on Several Issues Concerning Major Purchases, Sales and Exchanges of Assets by Listed Companies<sup>4</sup>, and Administration of Disclosure of Information on the Change of Shareholdings in Listed Companies Procedures<sup>5</sup> and so on. Securities Law regulates the requirement of public information on listed companies' takeover: investors holding five percent issued shares of a listed company or what investors hold has reached five percent, then, each addition or reduction five percent should be reported to the State Securities Regulatory Agencies and Stock Exchange and announce<sup>6</sup>. Takeover by the way of acquisition agreement should report and announce the agreement<sup>7</sup>. However, as mentioned above, at the present, asset restructuring in the law has not been studied in depth, the way of restructuring asset is various, it is possible to be expressed by the way of companies trading, Therefore, it is important to expand the scope of information disclosure.

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<sup>4</sup> promulgated in 2001, now invalid

<sup>5</sup> promulgated in 2003, now invalid

<sup>6</sup> Art.86 of Securities Law of P.R. China

<sup>7</sup> Art.94 of Securities Law of P.R. China

## 5. RESPONSIBILITY SYSTEM

As for the asset restructuring that is not driven by asset optimization such as buying shell in the disguise of shell, escaping debt by stripping high-quality asset and obtaining interest by restructuring and so on, the internal controller should bear the relevant liability for the damage caused by these action mentioned above, which can not only guard against shareholders' moral risks effectively, but also do good to the protection of the interest of creditors.

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