SHS Web of Conferences **148**, 03047 (2022) https://doi.org/10.1051/shsconf/202214803047
ICPRSS 2022

Analysis of the Introduction of Non-denominated shares

Nan Duan*

Peking University Law School

Abstract. With the enactment of the Company Law (Amendment) Act 2021 and the public consultation, the authorized capital system began to be accepted by our company law. Closely related to it, the system of non-denominated shares was also confirmed in the draft. For a long time, China has been practicing the par value share system, which undoubtedly played a role in safeguarding the equal capital contribution relationship among shareholders, preventing the company from improperly distributing dividends, protecting the company's continuous operation and being solvent under the framework of the early company law theory. However, with the development of the market and corporate governance, the actual function of the par value share system seems to be gradually deviated from the original purpose of its establishment. The purpose of this paper is to demonstrate the advantages of implementing a system of non-denominated shares, and also to suggest some supporting institutional arrangements after the introduction of non-denominated shares.

1 Introduction

According to United States Securities and Exchange Commission (SEC) regulations, a non-denominated share is a stock that does not contain a dollar amount on the face of the stock, but only the number of shares or the percentage of the total share capital. They are denoted as "1 share", "10 shares" or "10,000 shares". The value of a share varies according to the net worth of the issuing company and increases when the net worth of the issuing company increases and decreases when the net worth of the issuing company increases. The issue price per share is multiplied by the number of shares issued, which is the total amount of the issue.

The denomination of shares is the basic unit of the company's capital, so this is the starting point to see the change and development of the company's capital system from traditional to modern. The denomination of shares was initially considered to be a measure of the adequacy of the company's capital, the fairness of the share consideration, and the appropriateness of the dividend distribution. In the course of the company's development, the denomination shares also initially assumed the important function of creditor protection.

As the system and practice of corporate capital evolved, discounted issues were no longer prohibited by law across the board, and low-denomination shares, or even no-denomination shares, became an alternative arrangement. The system of issuing shares without par value originally originated in the U.S. In the early 20th century, as the role of the market became increasingly prominent in economic development, market autonomy, freedom of corporate operations, ease of financing, and maximization of efficiency became increasingly sought after by companies. In response to these market changes, and guided by the judicial spirit of experience over logic, the state of New York was the first to pass a law in 1912 allowing the issuance of par value stock, and in 1979, the Model Corporation Act (RMBCA) was amended to abandon concepts such as par value and legal capital. In 1923, 24 states in the United States already allowed the issuance of non-denominated shares. Later, other states in the U.S. and some countries, including Germany and Japan, followed this system. The function of the traditional denomination system is constantly being questioned and challenged, while the denomination-free system has been increasingly accepted by countries as a new way of thinking about corporate finance and an innovative move in financing channels.

In contrast to the trend toward a faceless system, there are many countries in the world where corporate law does not permit the issuance of faceless shares. This of course has the consideration of the company capital maintenance system; but at the same time, it has also caused some obstacles to the company financing. How to reform the system of stock par value, so that it is in line with the basic idea of reforming China's corporate capital system from capital credit to asset credit and from authorized capital to authorized capital, has become an issue that needs to be explored.

Since the system of non-denominated shares originally began in the United States, the author begins his discussion of the emergence and development of the stock denomination system with the development of the U.S. corporate system as the center of his discussion of early corporate law theory.

* duannan525@pku.edu.cn

2 Stock Denomination System Under the Early Corporate Law Theory

Under the corporate system, there is often an antagonistic relationship between the interests of creditors and shareholders of the company. This dichotomy is reflected in the fact that, on the one hand, the company's creditors want the company to have large assets and not to create new claims on its limited assets; that the shareholders cannot receive any return on their investment until they are paid; and that they want to be protected in all aspects of their property against the shareholders. On the other hand, the shareholder of the company wants to invest as little as possible in the company's assets and to incur more liabilities in order to obtain leverage; to be paid for the period while the company is profitable; to be given more freedom in terms of distribution. At the same time, for other shareholders, he wants every other shareholder to invest in the company in relation to the shares he has acquired.

The legal capital system of the American corporation in the 19th century was created to deal with this conflicting set of problems. Of course, although the original intention, but with the development of history, its function has also produced some changes, and has not been adhered to in the subsequent judicial and legislative process. The author will discuss its abandonment and development later.

2.1 The three main functions of the early denomination stock system

2.1.1 Protecting the company's continuous operation and solvency.

The par value of the stock was considered to be the protection of the solvency of the company. For this reason, early corporate legislation strictly prohibited the issuance of shares at a discount, and in 1892 Lord Halsbury, the British Lord Chancellor, stated in his judgment that the law should not allow external issues below par value per share because, first, every creditor of a company has the right to consider the definite and unchanging amount of capital as its security; second, a company misleading potential shareholders and creditors about the true amount of its capital should not be allowed. Second, it is impermissible for a company to mislead potential shareholders and creditors about the true amount of its capital.1. When the par value of the shares is clearly stated on the face of the certificate, all shares have been issued and fully paid up, creditors can have good reason to believe that the stated capital of the company is the sum of the par value of its outstanding certificates. In this sense, the stated capital of the company serves as a reliable guarantee for the company's creditors and holders of senior securities, which allows creditors to rationally judge the risk of borrowing.2

[1] Eilis Ferran: Company Law and Corporate Finance, Oxford University Press, 1999, at 355-372.

2.1.2 The yardstick for judging the fairness of the consideration of capital contribution among shareholders.

When a company is first established, shareholders will use different types of property to make their contributions. This makes it a difficult issue to compare the fairness of different types of property contributions. The stock denomination system that emerged from this is a fairer reflection of the fairness of contributions among shareholders: the stock denomination is used as a measuring stick, and contributions are considered fair as long as the final contribution is the same, regardless of the form of contribution. Under a strict par value system, any payment of consideration below the par value of the shares is considered a fraud on the company's external creditors, senior security holders and other shareholders, and the shares received by the shareholder are considered to be "watered down", thus triggering the shareholder's liability for compensation or damages.

2.1.3 Prevent improper distribution of dividends by the company.

Early corporate law theory held that external creditors and holders of senior securities of the company could rely on the capital of the initial investment, which is the capital that invested by the company’s funder. And they could reasonably rely on the fact that the company could not make distributions to shareholders unless there were profits in excess of the company's share capital, which would trigger an improper outflow of corporate funds and erode the interests of the company's creditors. Therefore, the sum of the par value of all shares issued by the company can be used as a yardstick to prevent the outflow of the company's capital.

As the above discussion progresses, we can understand that the expected function of stock denomination was an unquestionable concept in the early 19th century corporate law theory. However, with the development of modern business society, the modern credit investigation and remedy mechanisms, the need for efficiency in corporate financing, the questioning of the function of minimum corporate capital, and the change of concepts and rules from capital credit to asset credit, the three major functions of par value shares introduced above have been defeated one by one.

2.2 Deviation from the function of the denomination stock system in the development of practice

2.2.1 Gradual deviation of the function of the denomination system.

The three reasons for the choice of the denomination system in early corporate law were explored above, but with the creation of modern economic mechanisms such

[2] Liu Lian Yu, "Research on the Theory and Judgment of Company Law", Law Press, 2002, pp. 170-171.

as modern credit and relief mechanisms, these three functions are no longer important and have even become alienated.

1. Creditor protection function: weakening.

Modern credit investigation and remedy mechanisms have been improved, and credit investigation methods in the modern business world have improved the initial, simplistic, static equity-as-trust model for corporate creditors to assess the creditworthiness of counterparties. It allows creditors to focus more on the company's assets rather than its capital. This is because the initial capital credit system has continuously shown its limitations and drawbacks.

The core of the capital credit system lies in the three principles of "capital certainty, capital maintenance and capital invariance". Under these three principles, mandatory capital arrangements have become the norm. The original purpose of denominated shares was to determine the total amount of capital a company had, so that creditors could decide whether to borrow from the company. However, the capital of a company is an abstract number derived by multiplying the number of shares issued by the par value of each share, not the actual assets owned by the company. Only under the original model we discussed above can a company's capital and assets be equated - but only for a moment; once the company is in business, it is difficult to establish this relationship again.

So, in this sense, we can understand the capital credit system as a definite, static description of the company's capital, but in fact the disconnect between the company's assets and capital is a constant state. What creditors are really concerned about is the real assets owned by the company, not the abstract number of capitals.

Thus, from a dynamic point of view, the capital credit system that underpins the denominated stock system is actually becoming less and less protective of creditors; unfortunately, it is running completely counter to the original purpose for which it arose.

2. Equal protection function of shareholders' capital contribution: lack of substantial guarantee.

Another function of the denomination system is to reconcile the equal contribution relationship between shareholders. However, in Handley v. Stuts, described above, the U.S. Supreme Court has in fact rejected a strict par value system for stock. This attitude has been upheld in subsequent U.S. legislation and practice. In fact, the existence of a par value of stock not only does not provide a substantial guarantee of equal treatment to shareholders, but also gives a misleading illusion of equal treatment to shareholders and potential investors.

The development of the modern business reality society has made it increasingly thirsty for the efficiency of corporate financing. The problem brought by the efficiency of the company is that the premium issue becomes a popular way of financing; at the same time, the discount issue becomes an exceptional channel for loss-making companies thirsting for financing. Both premium and discount offerings break through the mechanism of the original coupon rule. In both cases, the shareholders receive different share consideration among themselves, so there is still a need for a path to unfair damage remedy against this purchase price in fact, in addition to the coupon system itself.

At the same time, the setting of the minimum capital contribution does not serve the function of efficient protection of equal capital contribution of shareholders of the company as desired by the early company law theory. Under the denominated share system out of prudence of the company's capital, the law mostly stipulates the minimum amount of capital for company formation. The minimum capital system was originally arranged to respond to the limited liability company shareholders limited liability and raised the issue of externalities. However, in practice, the minimum amount of capital required for the establishment of a company, although it can play a role in providing protection for creditors, but otherwise this system is not useful; this system is even the least efficient system to protect creditors.

3. Function to prevent improper dividend distribution: difficult to use as a useful yardstick.

In the early conception of corporate law, the total face value of the external shares issued by the company was able to guard against the outflow of funds triggered by the distribution of dividends in other forms3 .

In principle, the share capital of the company, which is formed by the par value, is hardly a useful yardstick for the distribution of the company. This is because the so-called "capital credit" has been gradually replaced by the concept and rules of "asset credit". It has become clear that it is not the static equity or equity premium account figures on the right side of the balance sheet that provide protection to shareholders or creditors, but the ability of the company to service its debts. The solvency of the company has also become the yardstick for measuring the reasonableness of the company's distribution.

This concept is also found in the practice of some legislation: the California State Corporation Law in the United States amended the corporate distribution scale, using the "dual scale of assets and liabilities and solvency" judgment, the legislator is more concerned about the ability of the enterprise to readily liquidate funds to repay.

From this point of view, the par value is not even a consideration for the equity premium, and therefore in principle cannot serve as a useful yardstick for corporate distributions, let alone be able to prevent improper distributions of corporate dividends.

[3] Fu Dou, "The Debate of Stock Denomination Trade-off", Comparative Law Research, No. 6, 2004.

2.3 Advantages of the non-denominated share system

2.3.1 Flexibility in issue pricing: protection of shareholders' equal rights and interests in capital contribution.

In discussing this section, our question is whether, in contrast to denominated shares, non-denominated shares can serve to protect the equal interests of shareholders? The answer is yes. The following section will focus on this question.

1. Are the interests of shareholders really equal under the par value share system?.

The shareholder interest shown on a par value share is only a formal equality. It reflects the number of shareholders who have invested the amount of money stated on the par value for the company. However, it does not take into account the fluidity and changeability of corporate governance. That is, in the process of corporate governance there is always a need for financing of one kind or another, and the floating of the market does not allow the stock price to be the same when the company has a need for financing as when it was issued. This undoubtedly brings pressure on the company's financing, when the company has no new investors, and the company's operation is difficult to continue, so also insist on the equality of the ticket, the interests of shareholders and the company are harmed.

2. No denomination shares and low denomination shares.

A denomination-free stock is one in which the face of the stock states the proportion of the company's assets represented by the shares represented by the stock rather than the denomination of the stock. For purely non-denominated shares, the company's articles of incorporation do not specify the issue price of the company's shares, truly making the shares non-denominated and non-current. The determination of the par value price of the stock is authorized by the company's bylaws to be determined by the company's board of directors in accordance with market conditions and the company's own financing needs.

Although the United States affirmed the existence of non-denominated shares by legislation as early as the beginning of the twentieth century, whether or not to issue non-denominated shares is a business judgment of the company and is not mandatory in legislation. In fact, no-denomination shares have not gained an overwhelming advantage in this area, and denominated shares remain the more dominant choice, with lower denomination shares always occupying a more dominant position.

Meanwhile, let's return to the Handley v. Stuts case discussed above. If the par value of the stock had been set very low from the beginning, wouldn't the case have gone so far as to have the court determine a so-called "pass"?

At the same time, in the case of shareholders' contributions in kind or in money, it is easy to issue shares at a price lower than the minimum price or par value set in the articles of incorporation, also known as a "discounted issue". Although a discounted issue can attract a significant number of investors in a short period of time, from a long-term perspective, a low issue price often means that the company's business situation is not optimistic, making the company's capital is not sufficient, which leads to the circulation of the issued shares on the market price decline, to the detriment of the interests of the original shareholders.

The discounted issue makes the company's paid-in capital less than the issued capital, and is therefore also called "watered down shares". The "watering down" of the company's capital can easily cause misunderstanding between potential investors and creditors of the company, and is not conducive to the protection of the company's creditors. Therefore, the issuance of low-denomination shares can prevent stock "watering", that is, the amount of shares is very low, so that the sale price of the shares will be much higher than the face value of the shares, the face amount of the shares is much lower than the true market price per share, so as to prevent the purpose of watering. This, in fact, coincides with the function of the no-denomination stock system.

3. Non-denominated shares can reconcile the interests of shareholders.

As early as the early 20th century U.S. scholars had reached some basic consensus on the advantages of non-denominated shares over denominated shares. No-par was not an instrument of fraud, and par was in fact irrelevant to the value of the company. At the same time, they argued that there were several advantages of no-par shares.

First, in law, the essence of equity is actually a proportional interest; in the valuation of the company, it should return to the essence of the company's profitability. While the value of the non-denominated shares changes with the profitability of the company, the issuance of non-denominated shares can prompt investors and creditors of the company to give the laws of the market and not just the par value to make investment judgments.

Second, the hypothesis that the denomination of shares weakens the role of the denomination and that the share capital no longer has a protective function for creditors and shareholders is proven to be unfounded by the denomination of shares. In particular, they play an important role in the reconciliation of relations between shareholders: not only do they not give rise to shareholder fraud, but they also make it possible to achieve substantial equality in shareholder contributions because of the flexibility of their issuance.

The biggest challenge to the no-money shares is undoubtedly that they will encourage the legalization of "watered-down shares", which will lead to inequality of rights among shareholders and fraud among shareholders. However, this argument is not tenable.

First, the definition of a watered-down share. It means that there is no actual consideration paid for some shares at the time of the shareholder's contribution. For this "actual full consideration" how to identify, there are different standards: par value standard, that is, when the advanced or other property paid to the company does not reach the par value of the shares, the shares are considered "watered down;" equity standard, that is, watered down shares means that the company's books show The capital of the company is higher than the total value of the company's contribution actually received; the issue price standard, that is, not all of the consideration paid, even if it has exceeded the par value is considered watered down; non-cash contribution for the price standard, that is, non-cash contribution for the price standard. Therefore, if it is said that the non-denominated shares have legalized the adulterated shares, then it is considered that the criterion for determining the adulterated shares is the "par value criterion", and this conclusion is only valid on the par value criterion; therefore, it is not valid to say that it causes fraud among shareholders.

Moreover, there is a unique flexibility in the issuance of non-denominated shares. This flexibility is reflected in the fact that the price of the issue of non-denominated shares is generally determined by the directors of the company; although shareholders are not required to contribute a fixed minimum amount of capital, they are still required to contribute the same type of consideration for the value of the denominated shares. In this sense, each contributor's contribution is still equal. When non-denominated shares are issued at different prices, subscribers and holders of the same class and different classes of shares can participate equally in equity swaps and dividend distributions, and in this sense, the rights of each shareholder are also equal.

Because of this, the issuance of non-denominated shares does not harm the equal interests among shareholders, but rather reconciles them based on market changes and corporate governance.

2.4 Truly reflect the value of the company and reduce misleading to investors.

Unmarked shares can truly reflect the value of the company and reduce misleading to investors. The reasons are as follows.

First, to some extent, no-denomination stocks can facilitate the financing of other portfolio capital and provide financing for companies in financial distress, which is the biggest difference between no-denomination stocks and par value stocks[4] . The "adoption of a par value system ......" can "keep the board of directors in check and restrict them from issuing shares at a discount ...... but, in the face of falling below par the locked-in lower limit on the par value of the stock becomes an obstacle and a bar to the company's external financing." [5]This facility was also confirmed by the U.S. courts in the Handley case mentioned above.

Second, shares have no nominal value, so investors will not be able to associate dividends with the nominal capital of the company, avoiding potential misunderstandings or misinformation. "The purpose of the reform to introduce denomination-free shares is not to seek to reveal which 'share' scale of value is more realistic, but rather to eliminate the misleading value of 'shares' from the current denomination. "[6]

Finally, the pricing mechanism of the non-denominated shares determines that their issue price is closer to the true market value of each company share they represent. This is because, in determining the price of a stock issue, the board of directors needs to make a decision based on specific rules of business judgment, which means that the board needs to take into account factors such as maximizing the company's interests and the liquidity of the stock. When the total value of the company's assets changes in response to market changes, operating profit and loss, etc., the stock price is able to change flexibly in response to changes in the actual price of the company, and the stock price changes more in line with the laws of the market and the true market value of the company.

3 Conclusion

From the history of the creation and development of the stock denomination system, the creation of the corporate capital system was initially based on the conflicting interests between the creditors and shareholders of the company. The choice of legal values in different legal systems has created different corporate capital systems, and they have evolved with the development of practice. Compared with the traditional authorized capital system, our legislation accepts the authorized capital system and the faceless share system, which can reflect the company's real assets dynamically and is more conducive to the company's financing, in line with the law of market economy development. However, there are certain shortcomings of the faceless shares themselves, and therefore need relevant institutional arrangements to resolve them.

References

1. Zhao Xudong: Corporate Law, Beijing: Higher Education Publishing House, 2012 edition.
2. Shi Tiantao, A Treatise on Corporate Law, Beijing: Law Publishing House, 2006 edition.
3. Wang Shujiang, et al., The Commercial Code of Japan, Beijing: China Legal Publishing House, 2000.
4. Fu Dou: Rethinking the Principles of Corporate Capitalism, Beijing: Law Press, 2004.
5. Wu Jianbin, "Latest Japanese Corporate Law", Beijing: Renmin University of China Press, 2003 edition.
6. Yu Zhengping, "Selected U.S. Corporate Regulations", Beijing: Commercial Press, 1st edition, 2004

[4] See note [2] above.
[5] W.Y. Wang and R.K. Lin, "A Study of the Corporate Capital System and the Denomination of Stock", Yueh-Dan Law Journal, No. 73.
[6] See note [5] above.

https://doi.org/10.1051/shsconf/202214803047

7. Zhao Xudong: "Research on the Reform of Corporate Capital System", Beijing: Law Publishing House, 2005 edition.
8. John J.Roche. No Par Value Stock [J].76Marquette Law Review 7(1923):76.
9. Zhao Xudong, "Legal Liability of Capital under the Change of Capital System - A Rational Interpretation of the Revision of the Company Law," Legal Studies, September 2014.
10. Lin, Kai, "Re-discussing the Function and Introduction of Denominationless Stocks," Times Jurisprudence, December 2021.
11. Tian Juying, "A Brief Analysis of the Issue of Stock Denomination," Journal of Adult Higher Education, No. 2, 2006.
12. Wan Qian Yi, "Corporate Capital System and Protection of Creditors' Interests", Master's Thesis, East China University of Political Science and Law.
13. Liu Ge, "Research on the stock denomination system", Master's thesis, Jilin University.