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An Analysis on the Problems Related to Security Interests on Publicly Traded Shares as Security for Corporate Bonds Issuance

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Because the publicly traded shares of listed companies carry the features of continuous price fluctuation and free circulation in the securities market, when putting up publicly traded shares as security for corporate bonds, it is necessary to recognize the various legal problems involved and design a more comprehensive transaction structure. The aim of this article is to briefly analyze the forms of security interests available for securing the bonds issued by a listed company (the "Issuer") — specifically, the creation of a security interest on the publicly traded shares the Issuer owns by pledging them as collateral for the issued bonds.

Creation of Pledge on the Shares

An issuer intending to secure its issued bonds by creating a security interest on the publicly traded shares it owns can do so by pledging those shares. According to Article 11 of *the Measures for Pilot Projects for the Offering of Corporate Bonds* (the "Measures"), the pledge shall guarantee the principal and interest payments of the bonds, liquidated damages, compensatory damages and expenses for realization of creditor's rights. Meanwhile, the Issuer must have free and clear ownership rights to the pledged shares. The parties shall enter into a written contract and the pledge rights will attach upon pledge registration by the securities registration and clearance institution pursuant to PRC property and security laws. Because the bondholders cannot be determined at the time of issuance, it is not practicable to provide every bondholder with pledge individually. Thus, the Issuer may sign a pledge contract with the bond trustee, register the pledge with the securities registration and clearance institution, and entrust the pledged shares to the seat or membership designated by the bond trustee prior to the pledge contract coming into effect. Only after the bond trustee obtains the documents evidencing the foregoing security interest can the Issuer proceed to issue the bonds.

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Designation of Trust Property

According to Article 25 of the Measures, if the Issuer creates a security interest for the bonds, the bond trust agreement shall specify that the secured property is property owned by trust. Two models may be used to entrusting the shares: (i) entrusting the collateral directly as trust property; or (ii) entrusting the security interest in the collateral as trust property.

Under the first model, the Issuer entrusts the pledged shares as trust property to the bond trustee. The bond trustee thus also acts as the trustee of the trust property (i.e. the pledged shares) and must manage the trust property for the beneficiary. The terms under the trust documents are usually structured so that the bondholders are the preferred beneficiaries and the Issuer is the secondary beneficiary. Also, one of the requirements under the Measures for the issuance of corporate bonds is that the aggregate balance of corporate bonds after the contemplated offering cannot exceed 40% of net assets at the end of the most recent period. Thus, there is concern that the designation of the pledged shares as trust property might cause a reduction in the Issuer's net assets, which might cause the Issuer to fall below the foregoing threshold. The Accounting Methods for Trust Business provides that the risks and benefits in connection with the trust property must have been substantially transferred for the property to be derecognized from the Issuer's balance sheet. Therefore, the accounting of the entrustment deserves special attention so as to ensure that the foregoing statutory requirement is satisfied.

The second model involves entrusting the security interest as trust property. In this situation, the bondholders entrust the security interest on the pledged property to the bond trustee, who then manages and exercises the security interest on behalf of the bondholders. If the Issuer makes principal and interest payments of the bonds according to the prospectus, the trust property is extinguished and the trust relationship terminates. However, if the Issuer fails to perform its principal repayment and interest obligations, or is late in performing such obligations, the bond trustee should exercise the security interest, and use the proceeds obtained from the auction of the collateral (i.e. the pledged shares) to satisfy the corporate debts.

Disposal of the Pledged Shares during the Term of Pledge

Generally, the price of the publicly traded shares tends to continuously fluctuate and the maturity periods of corporate bonds are relatively long. Therefore, to protect the legitimate interests of the bondholders and the Issuer, an arrangement which permits the Issuer to sell the pledged shares in the secondary market depending on market conditions, and the price, performance and other factors of the pledged shares, could be considered when creating the pledge.

Because the pledge (a security interest) must be extinguished before the pledged shares can be sold, to protect the interests of the bondholders, the Issuer could promise the bond trustee that (i) it would not transfer the trust in the course of extinguishing the pledge; (ii) the shares, the pledge on which is going to be released, shall be set as trust property; and (iii) the proceeds obtained by selling the pledged shares shall be deposited to a special account.

The proceeds obtained by the Issuer through the sale of the pledged shares shall be deposited to a special bank account. The Issuer and an appointee appointed by the bond trustee shall together oversee the deposit of the proceeds and ensure that the proceeds obtained during each trading day are transferred to the special account in a timely manner.

The Issuer and the bond trustee may agree that the proceeds obtained via disposal of the pledged shares constitute trust property for the purpose of securing payments under the corporate bonds. However, if the amount under the special account exceeds the balance of principal and interest of the corporate bonds, the residual amount after deducting the balance of the principal, interest and the reasonable expenses for the realization of creditor's rights shall not be considered as trust property. Hence, the Issuer could manage and dispose of the residual amount at will.

In order to protect the legitimate interests of the bondholders, if the Issuer does not sell off all the shares on which the security interest was extinguished for the abovementioned purpose, the Issuer should inform the bond trustee immediately after the expiration of the sale period and re-sign a new share pledge contract with the bond trustee to reinstate and re-register the pledge on those unsold shares.

Realization of Pledge Rights

If the Issuer fails to perform the bonds' obligations to make principal and interest payments according to the prospectus, the bond trustee is entitled to require the Issuer to dispose of the pledged shares corresponding to the scope of its breach liability and satisfy the due but unpaid principal and interest, liquidated damages, compensatory damages and other payable expenses.

Release of Pledge

If the Issuer completes repayment of the principal and interest of the bonds in accordance with the terms stipulated under the prospectus, and any due liquidated damages, compensatory damages and other payable expenses, the Issuer and the bond trustee should immediately extinguish the pledge on the publicly traded shares with the securities registration and clearance institution.

Structuring a bonds issuance by collateralizing publicly traded shares owned by the Issuer is rare in practice, so other legal issues may arise during its execution. This kind of security structure opens a path to securing financial instruments. Therefore, further legal development on the relevant issues and questions is of great practical value to the field of corporate finance.

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