

The Determination of the Effect of Company's Ultra Vires Guarantee --About the Effect Determination Regulated in Article 16 of Company Law

Yuhan Zhang

*Department of Civil and Commercial Law, Northwest University of Political Science and Law
 Xi'an, 710119, China*

ABSTRACT

The academic circle has always maintained a dispute about the effect of company's ultra vires guarantee regulated in article 16 of Company Law. Firstly, the paper will introduce the main theories regulated by article 16 of Company Law and then will discuss about the nature of Company Law. It will deeply discuss the determination of the nature and function of article 16 of Company Law, that is, the internal decision-making mechanism. At last, it will analyze the company ultra vires guarantee trailed by Supreme Court based on article 16 of Company Law so as to study the effect determination of company ultra vires guarantee.

Keywords: *Article 16 of Company Law, internal decision-making mechanism of the company, ultra vires guarantee*

1.The Normative Purpose of Article 16 of Company Law and Implicated Problems of Company Guarantee

1.1. The normative purpose of article 16 of Company Law

Analyzing from the nature aspect, Company Law is the law about company management and business operation. It is aimed to regulate and standardize the company management, including the power distribution among company participants, decision-making procedures and accountability mechanism. It belongs to the internal legal relationship. The civil laws like Contract Law and Guarantee Law are oriented to the functional transaction laws and are established based on relative transaction. It can be seen that although item 2 of article 134 of General Provisions of Civil Law provides basic principles for legal acts, the company resolution problem cannot be solved if the civil acts are completely applied. The reason is very simple. Company resolution is a behavior conducted by a group and company shareholders belong to a community of interest whose management aim is how to coordinate the common interest demands and interest of all company participants. However, the rules of civil legal acts are the systems established based on relative transactions.

Article 16 of Company Law regulates the affairs about company management and it is the procedural regulation of the company internal power ownership and the power exercise legitimacy. While analyzing from the perspective

of company legal representative and corporate body, this article is aimed to regulate the formation of company's own will, including the formation of resolution organization and resolution procedure. The legal effect of this article is only applicable to company internal staff who participate in the decision-making or who truly make decision, including shareholders, directors and so on. However, it is not applicable to external third parties. Therefore, article 16 of Company Law only regulates the resolution mechanism of company guarantee, but the effect of guarantee contract cannot be determined directly based on this article.

1.2. Article 16 of Company Law regulates the implicated problems of company guarantee

Although article 16 of Company Law regulates company's internal behavior and is not applicable to external third parties, the external affairs will be involved when the company exercises power based on the article, that is the external influence affairs will be caused by company behavior.

1.2.1. Company resolution is invalid or revoked

The company resolution may be declared as invalid or be revoked because of essential or procedural defects, which will lead to the violation of article 16 of Company Law. As the effect of guarantee contract will be affected under this situation, Contract Law and Guarantee Law shall be applied. If a company violates article 16 of Company Law and related regulations, it needs to check whether the

guarantee resolution is really invalid or revoked (based on judicial trial) and then it needs to check the effect of the guarantee contract signed by the company based on this resolution. However, in accordance with the opinion of China Supreme Court, even if this resolution is declared as invalid or is revoked, the guarantee contract shall not be inevitably judged as invalid. The effect of guarantee contract shall be determined based on whether the opposite party is out of good faith. If yes, the contract shall be valid and the company shall continue to fulfill the guarantee contract. If the opposite party is out of bad faith, which means they already know or shall know the company signs guarantee contract under the condition of violating article 16 of Company Law, the guarantee contract shall be determined as invalid.

1.2.2. Ultra vires guarantee

The Company Law does not clearly regulate the authority of legal representative. It only regulates that company legal representative represents the company externally and conduct company business internally but does not clearly define the boundary. Item 3 of article 61 of General Principles of Civil Law regulates two aspects: Firstly, the representation authority of company legal representative is only limited by corporate constitution or the power institution of the company. Secondly, in principle, this restriction only has internal binding force but will not cause external effect. This means that the power of legal representative is limited to irresistible bona fide third party. This force binding is applicable to the internal company. If legal representative has disputes with the third party and the third party is out of good faith, the company shall shoulder related external liabilities and then shall investigate related responsibility internally.

Neither the legal provision nor the judicial interpretation regulates the determination of guarantee effect for the ultra vires guarantee. It only prescribes that if the company guarantees for company shareholders or actual company controllers, it shall be decided by the shareholder's meeting or shareholder meeting resolution. Under this situation, the guarantee contract is not completely invalid. If the company representative who gives guarantee is authorized by articles of association, board of directors or the general meeting of shareholders, the guarantee contract is valid. If the company representative who gives guarantee is not authorized but the opposite party is out of good faith, it may constitute apparent authority and the guarantee contract is valid. This situation is beyond of the regulation of article 16 of Company Law. In conclusion, article 16 of Company Law is not the direct basis for the determining of the guarantee contract effectiveness.

2. The General Introduction of Different Theories About Company Extra Vires Guarantee Effect Determination

2.1. Foreign countries opinions about company ultra vires guarantee effect determination

After the ultra vires principle is established in England in 1875, it has brought a far-reaching influence on different countries and regions. Since then, the articles of association in different countries and regions will inevitably add the term of company purpose scope. This ultra vires principle is established to prevent the company executives or shareholders abusing rights so as to avoid the damaging of company interest. It brings certain effect when it is just established. However, it also causes the problem that the company interprets its ultra vires act as an individual behavior so as to evade related responsibility, which threatens the transaction safety and the legal interest of shareholders and participants.

2.1.1. Ultra vires act identification of common law countries

Based on the early British company law, ultra vires act will be determined as invalid, which greatly decreases the efficiency and security of the transaction conducted by company legal representative. This regulation is aimed to protect the so-called interest of shareholders, but actually ultra vires act may not bring disadvantages for company and shareholders. Now, the current British company law has completely abolished this regulation and articles of association has restricted this regulation to a proper extent. However, if the occurrence of this act has created certain effect and brought certain legal effect, the court can not deny the validity of this act. This provision changes the characteristics that ultra vires act is certainly invalid, and this provision confirms the validity of ultra vires. Now the Company Law approves the company to guarantee for company directors or related stakeholders, but the company shall get the approval from company shareholders and company resolution.

American law is deeply influenced by British law and it regulates that all businesses conducted beyond the regulation of articles of association are invalid. Now, the American legal system about ultra vires is no longer as strict as before. As early as 1896, it was proposed that company can engage in the transactions that were affiliated to or were ancillary to the company main businesses. In the subsequent reform, among British and American law systems, America has become a country that conducts the most thorough modification of Company Law. In Amendment of The Model Business Corporation Act, it regulates that the company can engage in any legal act and the lack of right is not the necessary condition to decide whether the company's act is legal and effective or not.

Thus, American law basically has not put forward any restrictions on company's ultra vires guarantee.

2.1.2. The ultra vires act identification of civil law countries

Based on the Germany law, the legal representative can be classified as public legal representative and private legal representative. The public legal representative can only exercise rights and fulfill liabilities within the frame of related laws. If they exercise rights or fulfill liabilities beyond the law frame, it is regarded that the act of public legal representative does not have legal effect. For the rights and power of private legal representative, article 82 of Stock Companies Act of 1965 regulates that "the representation right of the board of directors shall not be restricted". This provision also breaks the restrictions on the representation right of the board of directors regulated by articles of association. The article 36 of Limited Liability Company Act of 1992 regulates that "The company's business executors shall exercise the company's right and shoulder the company's liability no matter whether the act is conducted in the name of the company or whether the executor thinks that the act is conducted in the name of the company or not". As company guarantee is the right of private legal representative, Germany law holds a free attitude toward the company's external guarantee. It only requires that when company provides guarantee or loan for company executives or their relatives, it shall be cautious and shall get approval of board of supervisors.

Influenced by the ultra vires principle regulated by early common law system, Japan did not recognize the effect of ultra vires guarantee. But later, affected by the criticism and resist of the academic circles, the Japan Supreme Court began to reinterpret and amend some terms and then the restrictions on the effect of ultra vires act gradually became loose. At first, only the behavior that can meet the business scope regulated by the purpose of the articles of association is recognized. Later, it is amended that the company purpose scope shall not be limited to the purpose regulated by the articles of association. Instead, all acts that can directly or indirectly meet operation purpose shall be regarded as meeting the purpose scope regulated by the articles of association. Japan regulates that the necessary legal procedures shall be performed only when the company is providing guarantee for directors or shareholders and the related legal procedures do not need to be performed when the company provides guarantee for other staff, but the third party out of bad faith is excluded

2.2. The domestic theories about company ultra vires guarantee effect

Most scholars have different understanding and great

disputes of the effect of extra virus guarantee conducted by Chinese companies. Meanwhile, there is also a great difference in judicial practice, which causes greatly different judgment results. Now, there are three theories that can bring great influence, that are the theory of legal norm attribute, the theory of legal authority restriction and the theory of internal management norm.

2.2.1. The theory of legal norm attribute

The theory of legal norm attribute directly adopts the effect compulsory norms and administration compulsory norms distinguish method regulated by Contract Law and its interpretations. This distinguish method is sourced from item 5 of article 52 of Contract Law and article 14 of Judicial interpretation of contract law II. In accordance with article 14 of Judicial interpretation of contract law II, the "mandatory provisions regulated by laws and administrative regulations" can be divided into administration compulsory provision and effect compulsory provision and these provisions are directly used to judge whether the guarantee contract that violates article 16 of Company Law is valid is not. If the guarantee contract meets the condition regulated by the first provision (effect compulsory provision), the guarantee contract is invalid. If the contract meets the situation regulated by the second provision (administration compulsory provision), the guarantee contract is valid. Generally speaking, the conclusion of this kind of theory is that after the article 16 is the management compulsory provision, the involved guarantee contract shall be determined as valid based on the reason that the management compulsory provision can not be used to determine the contract as invalid contract.

2.2.2. The theory of legal authority restriction

In accordance with the theory of legal authority restriction, article 16 of Company Law determines the rights of company legal representative and then furtherly determines whether the act of company legal representative belongs to authorized representation or unauthorized representation. If the unauthorized representation is constituted, the article 50 of Contract Law shall be applied, and then it needs to judge whether the opposite party is out of good faith. If the opposite party is out of good faith, the representative's act constitutes apparent representation and the guarantee contract shall be valid and the guarantee company shall shoulder the guarantee related liability. If the opposite party is out of bad faith, it can not constitute the apparent representation and the guarantee contract shall be invalid. Under the precondition that the opposite party fulfills related inspection liability, subjectively the opposite party is out of good faith and the legal representative's act constitutes apparent representation. Under this situation, the company shall shoulder related guarantee liabilities for the opposite party. If the opposite party does not fulfill

inspection obligation, it shall be determined that the opposite party has subjective fault and the opposite party shall shoulder related adverse consequences. Now, this recognition method has become the leading trend. However, article 16 of Company Law does not restrict the authority of company representative, so it is difficult to directly apply this article to restrict the authority of company representative.

2.2.3. The theory of internal management norm

According to the theory of internal management norm, article 16 of Company Law is to adjust the company internal decision-making in the legal way and it does not have effect on the external part. Compared with the above mentioned two theories, this theory is more consistent with the normative purpose of article 16 of Company Law and it judges whether the company shall shoulder related liabilities by directly distinguishing the internal relationship and the external relationship of the company. Based on this theory, article 16 belongs to the procedural provision used to regulate internal relationship, so it can not be used to bind the third party of the transaction and the opposite party shall not shoulder inspection obligation. However, this kind of theory still has some disadvantages and it is intended to solve the guarantee contract effect issue directly. Essentially, this method still belongs to the theory of legal norm attribute and it fails to break the limit of the theory of legal norm attribute.

2.3. Related judicial practice in China

The theory of legal authority restriction is the most feasible theory to determine company's ultra vires guarantee. Actually, the theory of legal authority restriction is widely applied in China's judicial practice.

2.3.1. Case analysis

2.3.1.1. Case 1

In the civil ruling paper of the retrial of equity transfer dispute between Chen Youzhong and Fujian NuoqiCo., Ltd, the judgment made based on article 16 of Company Law is as following: "In accordance with item 2, article 16 of Company Law of the People's Republic of China as well as the articles of association of the company, the guarantee shall be approved by resolution of shareholder's meeting and Mr Ding shall not vote in the meeting. However, in this case, there is no evidence to prove that other shareholders have reached resolution by meeting method for the guarantee issue mentioned in this case. In addition, no evidence can prove that the guarantee mentioned in this case is approved by the majority of other company shareholders. Therefore, the original trial court's

determination that the guarantee mentioned in the case is extra virus guarantee is made based on sufficient facts and legal evidences".

The fact part of the case is consistent with the provisions of company resolution procedure required for company guarantee regulated by article 16, Company Law. It means if the company provides guarantee for company shareholders or actual controllers, it shall be approved by shareholders' meeting or shareholders' general meeting. The civil ruling paper describes the trial consequence that "the original trial court's determination that the guarantee mentioned in the case is extra virus guarantee is made based on sufficient facts and legal evidences". It can be seen that as the guarantee violates the procedural provision of article 16 of Company Law, the court concludes that the guarantee is ultra vires guarantee. This is the typical ruling result made based on the theory of legal authority restriction.

2.3.1.2. Case 2

The civil judgment paper for the second trial of guarantee contract disputes between Shandong Zhongtong Science&Technology Development Co.,Ltd. and Zheshang Coal Trading Co., Ltd. regulates the issue that whether the guarantee contract is valid or not. In accordance with item 1, article 16 of Company Law of the People's Republic of China and article 11 of Interpretation of several issues concerning the application of the Guarantee Law of the People's Republic of China, it can be seen that only when the contract opposite party is out of good faith can the representation action be valid and can the guarantee act bring legal binding effect on the company.

In this case, the civil judgment paper firstly adopts article 16 of Company Law to explain that the legal representative signs the guarantee contract beyond the authorized power. Then, it adopts article 11 of Interpretation of several issues concerning the application of the Guarantee Law of the People's Republic of China to judge whether the opposite party is out of good faith. Therefore, it can be seen that this trial is also made based on the theory of legal authority restriction.

2.3.2. The latest provisions of Minutes of civil and commercial trial meeting

Article 17 of Minutes of civil and commercial trial meeting regulates the company's guarantee for others. In addition, its method to judge whether the company legal representative's guarantee is extra vires guarantee is same as the method mentioned in this paper. In addition, article 18 of Minutes of civil and commercial trial meeting regulates how to judge whether the opposite party is out of good faith in detail. Based on this regulation, the creditor's inspection on the resolution made by company decision-making institution is basically limited to the

formality inspection, so the creditor can be judged as out of good faith as long as they fulfill necessary obligations. It can be seen that China does not have a very strict judgment standard about whether the creditor is out of good faith. However, the book also regulates the situation that the creditor is not out of good faith. It means if the company has evidence to prove that the creditor already knows the resolution is faked or altered, the creditor shall be out of bad faith.

3. Conclusion

In conclusion, the paper adopts comparison method and case analysis method to analyze the nature of article 16 of Company Law of People's Republic of China, to analyze how to judge whether the guarantee contract is reached beyond authorization based on this article 16, and to study how to determine the effect of the confirmed extra vires contract. Now, China's academic circle prefers the theory of legal authority restriction. In the judicial practice in China, when trailing the cases that extra vires guarantee is constituted because of violating the article 16 of Company Law, firstly it needs to judge whether the guarantee act is conducted with the approval of the resolution of shareholder's meeting or board of directors. If the legal representative provides guarantee for others without authorization, it constitutes the extra vires guarantee. Once the company extra vires guarantee is confirmed, it needs to judge whether the creditor signs the contract out of good faith based on article 50 of Contract Law. If the creditor is out of good faith, the contract is valid. Otherwise, the contract is invalid.

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- [17] Item 2, article 134 of General provisions of civil law: "If a legal person or an unincorporated organization makes a resolution in accordance with the discussion-making method and voting procedures prescribed by the laws or the articles of association, the resolution shall be valid"
- [18] Item 3, article 61 of General Provisions of Civil Law: "The corporate articles of association or corporate power organization's restriction on the right of legal representative shall not be against the third party of good faith".
- [19] Article 50 of Company Law: "The contract reached by the legal representative or responsible staff of the corporate or other organizations beyond their authorization shall be valid, excluding that the opposite

party already know or shall know the ultra vires.”

[20] Item 5, article 52 of Contract Law: “The contract is invalid if one of following situations appears: (5) Violate the compulsory provisions of related laws and administration regulations. ”

[21] Article 14 of Judicial interpretation of contract law II: “The compulsory regulation mentioned in item 5, article 52 of contract law means effect mandatory provisions”

[22] Article 50 of Company Law: “The contract reached by the legal representative or responsible staff of the corporate or other organizations beyond their authorization shall be valid, excluding that the opposite party already know or shall know the ultra vires.”

[23] Item 1, article 16 of Company Law of People’s Republic of China: “When company invests other companies or guarantees for others, the resolutions of board of directors, shareholders meeting or shareholders general meeting shall be passed based on articles of association.. If the articles of association regulates the total guarantee amount limit or single investment amount limit, the guarantee or investment amount shall not exceed the limit”

[24] Article 11 of Interpretation of several issues concerning the application of the Guarantee Law of the People’s Republic of China: “The guarantee contract reached by the legal representative or responsible staff of the corporate or other organizations beyond their authorization shall be valid, excluding that the opposite party already know or shall know the ultra vires”

[25] Article 17 of Minutes of civil and commercial trial meeting: “In order to prevent legal representatives randomly providing guarantee for others which will cause company loss and damage the interest of minority shareholders, article 16 of Company Law limits the representation right of the legal representative. Based on this article, the guarantee act shall not be completely determined by legal representative, and the authorization shall be given based on the resolution of shareholder (general) meeting. If the legal representative guarantees for others without authorization, it constitutes ultra vires representation. Based on the provisions of the extra vires representation act conducted by legal representative regulated in article 50 of Contract Law, People’s Court shall distinguish whether the creditor is out of good will and then determine the effect of the contract. If the creditor is out of good faith, it is valid. Otherwise, it is not valid.”

[26] Article 18 of Minutes of civil and commercial trial meeting: “As long as the creditor can prove that they have investigated the resolution of board of directors or resolution of shareholders (general meeting) when concluding the contract and know that number of persons who agree to the resolution and sign the resolution meet the provisions of the articles of association of the company, it is regarded that the creditor is out of good faith. The situation that company can prove the creditor already knows the articles of association of the company have clear provisions on the resolution authority shall be excluded. The creditor’s inspection on the resolution made by company organizations is only formality inspection and the creditor only needs to fulfill necessary obligations. The standard shall not be too strict. If the company declares the creditor is out of bad faith for the reasons that legal representative fakes or alters information, that resolution procedure is illegal or signature and seal are not true or that the guarantee amount exceeds legal limit amount, the People’s Court shall not support the declaration, excluding the situation that the company can provide evidence to prove that the creditor already knows the resolution is faked or altered.”