

# Study on the Legal Risks of Financed Trade and Their Prevention

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## Abstract

Trade can be said to be a market product based on the demand for financing, and has been developed rapidly. Financing trade will not only alleviate the problem of enterprise financing difficulties, but also some loose funds for large and medium-sized enterprises to provide a new channel of investment and profitability, but it is undeniable that the status quo of financing trade is not optimistic, and there have been a lot of vicious cases. Financing trade is not a new thing, but the theoretical research on financing trade at home and abroad relatively lacks plaque, at the same time, the relevant definition is still controversial, the law has not yet formed a clear provision, and it is difficult to form a consistent judicial referee ideas. For this reason, the legal risk of financing trade and its prevention research. This paper believes that most of the legal risks in the financing trade are not inherent in its own risk, can be through the corresponding prevention and control measures to reduce the risk, and hopes that through the research can be comprehensive and scientific clarification of the legal risks of the financing trade and preventive measures.

## Keywords

Financing Trade, Legal Risk, Risk Avoidance

## 1. Introduction

Finance is the lifeblood of the real economy, and General Secretary Xi Jinping attaches great importance to the reform and development of the financial industry, and has repeatedly called for the prevention of financial risks and the improvement of financial services. In order to implement the spirit of General Secretary Xi Jinping, it is indispensable to carefully define the scope of financial trade, study and identify its legal risks, and strictly observe the preventive measures. Financing trade is aimed at realizing short-term financing or expanding

credit, relying on cargo rights, accounts receivable and other property rights in the course of trade, and comprehensively applying trade means, financial instruments and guarantee tools to increase the cash flow of the trade subject. Trade enterprises lacking credit conditions, due to difficulties in obtaining financing from financial institutions, sign trade sales contracts together by introducing a third party, and return the capital and pay interest after the trade enterprise sells the goods. Financing trade has the function of financing in many trade modes, and this advantage is a breakthrough in upgrading the trade chain. Financing trade has the following three characteristics. 1) Expand the transaction scale, improve the capital turnover, and exchange property rights such as property rights and accounts receivable in the original trade chain for short-term financing or credit increase of financial institutions through financing tools and financial means. Its essence is that financing trade takes financing activities as a means to rapidly expand the production, development and operation scale of trading enterprises through real trade. 2) Common in commodity trade, commodities have both commodity attributes and circulation attributes, and the trade demand is large and the total amount is high, which is easy to classify and standardize. Therefore, they are often used as financing trade commodities. Moreover, the price of commodities fluctuates greatly, and once the price falls seriously, the capital pressure is relatively high. Therefore, in order to alleviate the financial pressure, private small and medium-sized enterprises are more likely to adopt the financing trade model. 3) Breakthrough the traditional credit business. Financing trade relaxes the requirements for the overall credit approval of financing enterprises, thus lowering the financing threshold for SMEs. Financial institutions no longer examine the static financial statements of financing enterprises, but comprehensively examine the whole trade activities. Among them, it focuses on the authenticity and continuity of trade background, the scale and commercial reputation of upstream and downstream partners, and emphasizes decentralized financing quota, preset upper limit of quota, and forms a closed loop of funds (Anderson, 2016). The financing party regulates the flow of funds by carrying out trade activities with upstream and downstream enterprises, eases the financial pressure of the financing party and provides sustainable power for its development. Therefore, as an emerging financing mode, financing trade can help all parties in the trade chain to improve internal capital efficiency and adapt to the requirements of economic development in the new era. On the one hand, financing trade has a significant impact on the high-quality development of China's economy and the transformation and upgrading of the relevant industries. Therefore, it is obvious how to understand the connotation of financing trade, how to ensure that the trade activities are carried out with commercial substance, how to effectively manage them comprehensively, and how to guard against the ensuing risks. On the other hand, the SASAC's characterization and management provisions on financing trade are different from the relevant legal insights of the Supreme People's Court, which

leads to an easy misunderstanding of the overall theory of understanding financing trade. Since the definition of financing trade in different fields is both related and different, in order to avoid “one-size-fits-all”, it is of great significance to comprehensively and scientifically recognize and clarify financing trade for exploring the theory of financial innovation in the new era.

## 2. Legal Risks of Financing Trade

### 2.1. Unclear Characterization of the Contract

The nature of the contract not only involves the validity of the contract and the rights and obligations of the parties, but also relates to whether the purpose of the contract can be realized, and may even have a direct impact on the collection of evidence after a contractual dispute has arisen and how the dispute is resolved. The different nature of the contract will lead to completely different legal consequences and legal risks, so the determination of the nature of the contract is a key step. Financing trade not only has the form of sales contract, but also reflects the financing purpose of the transaction subject. For many years, there have been such situations as vague concepts, unclear scope and unclear nature, which have caused many problems such as difficult judicial judgment, many disputes between the parties, and unfulfilled creditor’s rights (Bordo & Rousseau, 2012). How to identify the legal relationship of financing trade, the accurate application of the relevant laws, so as to make a fair judicial decision, is the legal risk of financing trade contract is the primary issue of practical concern.

In financing trade disputes, the plaintiff sues in the form of a sale contract, which is the external manifestation of trade, and the defendant often refutes the plaintiff’s claim by arguing that the relationship between the two parties is not one of sale and purchase, but rather one of borrowing and lending, and provides the appropriate evidence to prove it. In the course of the trial, the court in order to ascertain the facts of the case, often other enterprises in the trade chain as a third party to participate in the litigation, in order to accurately grasp the fundamental difference between the relationship of sale and loan. Ultimately, if the legal relationship identified by the court (lending relationship) is inconsistent with the legal relationship claimed (buying and selling relationship), the plaintiff’s claim may be rejected, and even if the plaintiff changes the claim to a lending relationship and then sues in a separate case, the claim will still face the risk of not being realized or the time of realization being uncontrollable.

The contractual nature of trade in finance has always been a focal point in judicial practice, and only by accurately characterizing the nature of trade in finance contracts can the relevant legal provisions be accurately applied. The autonomy of private law is an important principle of the contract chapter of the Civil Code, and only when the content of the contract terms meets the statutory characteristics of a typical contract, it is necessary to combine the specific terms of a typical contract with the legal provisions of a typical contract to arrive at a specific and concrete legal effect, which will improve the predictability and effi-

ciency of judicial decisions. Therefore, the external manifestation of the parties' agreement is the basic basis for determining the legal relationship between the parties (Brummer, 2010). In the absence of convincing evidence to show that the parties' subjective will and the objective performance of the agreement between the existence of obvious and significant differences, this paper has reason to believe that the external manifestation of the agreement is valid, that is, the agreement signed between the parties is the true expression of their subjective will. However, in judicial practice, the parties enter into a sale agreement and hide the lending relationship, mainly to achieve the purpose of circumventing the law, which is the cause of financing trade disputes. First of all, the lending relationship is transformed into a sale and purchase relationship, the repayment ability of the borrower in the original lending relationship is not fully assessed, the business personnel will focus their attention on whether the sale and purchase is an exchange of equal value as well as the form of the sale and purchase contract to review, so that the recovery of the funds continued to be invested in the recovery of the funds is not effectively monitored. When the overdue accounts receivable generate capital risk, the wood is often already greased. When the accounts receivable are overdue, there is no way to save money. Secondly, since the name of the trade, the rights and obligations of the participating subjects are regulated by the relevant provisions of the "contract of sale". Therefore, borrowing for the actual rights and obligations will be difficult to get "loan contract" relevant provisions of the constraints and protection, civil behavior and legal relationship dislocation. After the occurrence of a risk, the capitalist is often unable to effectively protect its own rights and interests because of the difficulty of proving its case.

With regard to the legality of the financing trade contract, there is no law or administrative regulation with a higher level of effectiveness in our country to make clear provisions on this, and different courts in judicial practice have different standards and conclusions, and before the implementation of the provisions on private lending and borrowing, the reason for invalidating the inter-enterprise financing trade contract in judicial practice is that it is "called a trade contract which is in fact an inter-enterprise loan". The reason for invalidating business-to-business financing trade contracts in judicial practice before the implementation of the provisions on private lending was that "trade in name of trade is actually business-to-business lending", which was in line with the situation of "invalidating a contract that conceals an illegal purpose in a lawful form" as provided in Article 52 (3) of the Contract Law. However, after September 1, 2015, the Supreme People's Court issued "on the trial of private lending cases on the application of the law on a number of issues", changed this determination, the provisions of the private lending contract concluded between legal entities for the needs of production and business is valid; but if it is in order to obtain the financial institution's funds followed by high-interest transfer of loans to the borrower, and the borrower knew or should have known in advance, it is

considered invalid.

## **2.2. Tax Legal Risks**

When enterprises carry out financing trade, in order to comply with the regulatory requirements of “four flows in one”, they frequently issue VAT invoices to match the flow of contracts, funds and goods to ensure that the form complies with the regulations. Through the flow of trade documents, the financier realizes the ultimate purpose of financing from the funders (Garg, 2022). If the financier lacks the real trade substance and trade purpose when carrying out this kind of business, it will have the legal risk of inflating income and issuing VAT invoices falsely.

### **2.2.1. Legal Risk of Inflated Operating Income**

Analyzing from the perspective of tax law, the characteristics of financing trade are as follows: first, the trade scope is mainly bulk commodity trade, and the trade mode is mainly circular trade; second, there are many affiliated companies, and they are manipulated by the same actual controller; third, the amount of a single transaction is huge, tens of millions or even hundreds of millions; fourth, a large number of “million-version” VAT special invoices are issued, and the VAT burden is extremely low. Fourth, the issuance of a large number of “million versions” of special VAT invoices, the VAT tax burden is extremely low. Circular issuance of VAT special invoices, operating income inflated, account processing will lead to an increase in the current income of the enterprise, but the VAT special invoices have not been added to the layers, in essence, only to obtain the capital occupancy fee, the cost and income will also be a significant difference. Trading enterprises usually issue VAT special invoices to achieve the purpose of inflated income, and at the same time, they can also enhance the credit conditions for multiple companies in the closed loop. This is very attractive to enterprises (funders) that are eager to make a large scale but do not have enough business channels. Too much reliance on financing trade will lead to a large amount of funds being occupied, which is not conducive to improving their own business, and also hides the risk of capital loss and penalties from tax and other administrative departments.

### **2.2.2. Legal Risks of Fraudulent VAT Invoices**

The core criteria for judging whether financing trade is false VAT invoicing are whether there is a purchase and sale of goods, whether there is purchase and sale of goods, but whether the quantity or amount issued is real. Analysis from the business operation: first, the trade chain transactions using online transactions or fax transactions, can be completed in a short period of time upstream and downstream multiple contract signing, with a small profit or even loss; second, the flow of goods in the flow of goods by the buyer to pick up the goods, warehousing costs are extremely low, no transportation business; finally, the flow of funds, invoice flow and logistics basically out of touch with each other, often between the trading companies against each other, no funds, to the same ware-

house receipt as a proof of multiple contracts. Proof of multiple contracts (Ioannou & Demirel, 2022). Since financing trade generally has no physical delivery, the purchase and sale behavior without physical delivery may not have real purchase and sale, if the contract signed in financing trade is found to be invalid, the enterprise is afraid that the invoice flow can not correspond to the actual logistics and is suspected of constituting false VAT invoices. During the trade period, the fulfillment of the contract and the payment of tax will have an impact on the upstream and downstream enterprises in the trade chain. Once the upstream enterprises have falsely issued VAT invoices, it will inevitably lead to the breakage of the deduction chain and the outbreak of the tax risk of the whole trade chain.

### **2.3. Process Characterization**

After contracting, the parties to a financing trade should perform their corresponding obligations in accordance with the contract to ensure that the purpose of the contract can be realized. In practice, the funders engaged in the financing trade business are mostly core enterprises with sufficient sources of funds and high credit limits granted by banks. On the contrary, the financing parties are mostly private small and medium-sized enterprises with poor risk resistance, high credit risk and high moral risk. Once the financial chain of SMEs breaks, they are unable to continue to perform due to their insufficient ability to pay, thus giving rise to many financing trade disputes. With the continuous improvement of the rule of law environment and the increasing awareness of the rights of enterprises, enterprises in order to minimize the loss of funds or property rights, the face of disputes usually choose litigation rights, through legal means to resolve disputes, to safeguard their legitimate rights and interests, which will inevitably have to face the risk of litigation. Enterprises in the operation, production process involved in litigation also belong to the legal risk of a manifestation of the litigation stage is extremely important stage of enterprise self-help, the referee results will directly affect the enterprise's economic interests, business reputation and responsibility (Niepmann & Schmidt-Eisenlohr, 2017).

#### **2.3.1. Risk of Improper Litigation Claims**

Once the financier is unable to perform the payment, the financier litigating to defend its rights often chooses to assert apparent rights against the seller (financier) or the bridge party. Financed trade generally takes the form of trade with a contract of sale and purchase, and when disputes arise they are often sued as disputes over the contract of sale and purchase. However, in the course of the trial, the defendant usually asserts that the substance of the financed trade is a borrowing and lending relationship and provides corresponding evidence to prove it, at which point the court may add other enterprises in the trade chain as third parties to the litigation (Schwartz, 2017). If the court ascertains that the legal relationship of the dispute is a loan, the following three situations may occur:

First, the claim sued in the dispute over the sale contract is rejected, and the plaintiff has to sue separately for the dispute over the loan contract. Secondly, after the court explained, ruled that the contract of sale is invalid, the plaintiff needs to change the claim to a loan contract dispute within the time limit of proof, after which the court will not hear the case. Thirdly, the court ruled that the false act was invalid by the false conspiracy, and the hidden act was valid, and the trial was conducted on the basis of the hidden act. Therefore, the plaintiff's improper claim will face the risk of losing the case or prolonging the litigation cycle, increasing the litigation fees and costs, or even leading to the waiver of the right to litigation. In (2018) Supreme Court Civil Court No. 888, the Supreme Court specified that the court has the right to determine the nature of the case in accordance with the facts of the case as determined by law and decide whether to support the party's litigation claim. Even if the party's claim is not consistent with the court's determination based on the facts of the case, it does not necessarily lead to the court's dismissal of his or her litigation claim, but the party shall bear the litigation risk that may be unfavorable to him or her.

### **2.3.2. Risk of Insufficient Property for Execution**

Because financing trade does not have commercial substance, the business is mainly through prepayment in the trade business, credit sales and other forms of disguised capital occupancy fee profits, seemingly without the need to bear the operational and financial risks, but in fact does not grasp the sovereignty of the transaction. The hidden risk is that once the operating efficiency of the financier declines, the capital chain breaks down, unable to fulfill the payment obligation, it is very easy to cause the asset loss of the financier and has greater difficulty in recovery (Mateut & Chevapatrakul, 2018). The root cause of litigation based on this type of trade is that the financier is out of funds, and at this time, the financier is generally heavily indebted and on the verge of bankruptcy, and its assets may be seized by different courts. In addition, financing trade is mostly bulk commodity trade, involving high amounts of money, and the financier has no property or the property is insufficient to cover all the debts. It is difficult to apply for execution of the litigation preservation filed with the court by the financier based on the property clues or property information obtained earlier. The lack of sufficient property on the part of the financier will also lead to the risk that the preservation fee and the actual expenses incurred in the execution will not be refunded, and that even if the applicant succeeds in the lawsuit, the result of the judgment will not be realized.

## **3. Legal Risk Prevention Strategies**

### **3.1. Principles of Legal Risk Prevention**

Risks are everywhere. When enterprises face legal risks, they will suffer irreparable losses in economic aspects and business reputation, and may even have to bear civil, administrative and criminal responsibilities. Different from other

risks, legal risks have certain certainty, so they can be prevented and controlled. How to prevent and control enterprises through certain measures should be based on the principle of “prevention first and remedy afterward”, and do a good job of supervision and control in the process, so as to effectively deal with and resolve legal risks. There are three preventive measures: first, before signing the contract, review the credit status of the other party to the contract and screen high-quality customers for trading. Before signing the contract, fully understand the credit standing of the contract to the other party, whether it is involved in litigation, being executed, etc. through the channels of enterprise investigation, Qixinbao and judgment document network. Second, when signing the contract, fully disclose the transaction facts to the guarantor, pay attention to the effectiveness of the guarantee, and prevent the guarantor from leaving the guarantee. Third, in the performance of the contract, we should pay attention to collecting and fixing the evidence about the ownership and circulation of the goods. In the real financing trade, the flow of goods should be followed up in the process of contract fulfillment, the corresponding transportation and storage documents should be collected, and the formalities required for delivery should be fulfilled in accordance with the contract, so as to prove the delivery of the goods in case of disputes, and to avoid the results of both money and goods being empty. There are two remedies one is the civil route. Financing trade disputes, you can defend their rights and interests through civil litigation. Through the evidence to the court to prove that the name of the sale, but actually borrowing, and require the relevant defendant to bear the return of property and related economic losses. It should be noted here that although some participants in financing trade are channel parties, they may also bear certain responsibilities. Therefore, when using financiers, all participants can be listed as defendants and required to bear joint and several liabilities. The court will judge according to law according to the facts of the case and the degree of fault of all parties. The second is the criminal way. After filing a case, the public security organ may take criminal seizure measures against the relevant property. The intensity of criminal pursuit is often greater than that of civil execution, which is more conducive to safeguarding the legitimate rights and interests of state-owned enterprises. As for the way to safeguard their legitimate rights and interests, we need to analyze the specific case. Generally speaking, the criminal way to investigate the investigative organs can be investigated and evidence collection through the public power of the way to track down property clues, the strength of the civil lawsuit than the strength of the civil case follows the principle of who claims who proves, so the facts of the case need to be parties to their own evidence-based, the parties to the burden of proof is heavier. If indeed suspected of committing a crime, timely reporting, through the intervention of the investigating authorities, can be faster to seize the property, to identify the facts of the case, in favor of safeguarding their legitimate rights and interests.

To effectively prevent the legal risks that enterprises may encounter, it is ne-



cessary to take comprehensive preventive measures and require the participation of all employees. Legal risks occur in the business activities of enterprises, and their prevention and control can not be separated from the business management process. Therefore, preventing legal risks of enterprises should be integrated into the whole process of business management, running through the links of decision-making, implementation, supervision and feedback, and employees in all links should participate and bear corresponding responsibilities (Schmidt-Eisenlohr, 2013). At the same time, legal risk belongs to the important risk category of enterprises, and enterprises should focus on it when making decisions, and bring it into the decision-making process, so as to control legal risk within a certain range.

The market economy is changing rapidly, and enterprise legal risk prevention should be able to adapt to changes in the internal and external environments of enterprises, maintain sensitivity to various changes and respond in a timely manner. Legal risk is special, its development is a dynamic process, so the legal risk management should respect the law, do not violate the obligatory norms and prohibitive norms of the law, with the continuous improvement of the rule of law environment and scientific and reasonable adjustment. In order to ensure that the enterprise's legal risk prevention achieves good results, enterprises should also give full consideration to the internal environment changes, the formulation of strategies and measures to the strategic objectives of the enterprise as a guide and the overall management level of the enterprise to adapt.

### **3.2. Contractual Legal Risk Prevention**

When enterprises carry out financing trade business, there are corresponding legal risks in the process of contract formation, management and execution, and they need to implement the management before, during and after the event, assess the business model, business background and creditworthiness of the counterparty in-depth, treat the content and terms of the contract with caution, ensure that the contractual rights and obligations of the contract are centered on the goods, set up specific terms according to the business logic, control the ownership of goods and Pay attention to the flow of goods, avoid the common expressions of loan contracts such as fixed income and interest, beware of the main contents and key terms of trade contracts in the framework agreement of financing trade, and refrain from unilateral commitments, so as to effectively regulate and control the occurrence of legal risks.

After the conclusion of a contract, the contracting parties can only achieve the purpose of the contract and ultimately realize economic benefits if they fully perform in accordance with the contract. In practice, the fulfillment of the financing trade contract is a dynamic and long-term process, and the due diligence before the conclusion of the contract is only a basic review of the contracting party. Dynamic supervision of enterprises in the process of contract fulfillment is the key, pay attention to the upstream and downstream cooperative

enterprises and the risk changes of trade from multiple perspectives, familiarize yourself with the trade operation norms and contract management norms, and understand all kinds of trade documents, to avoid incomplete fulfillment of the contract or non-performance of the situation.

### **3.3. Tax Legal Risk Prevention**

#### **3.3.1. Prevention of Inflated Operating Income**

Firstly, the management of enterprise accounts receivable is strengthened by the division of labor among the business department, the financial department and the legal department, and the clearing of current accounts is strictly implemented in accordance with their respective responsibilities. Secondly, it strictly implements the approval of fund collection and payment, and approves it according to the hierarchy of amount to prevent early recognition of income. Lastly, it verifies major related transactions of enterprises, verifies the original accounting documents item by item to confirm whether the accounting accounts are correct, determines whether the business is real, and assesses whether the transaction price is reasonable.

#### **3.3.2. Avoiding Fraudulent VAT Invoices**

First, before the purchase and sale of the business, it is necessary to check the other party's business scope, scale of operation, enterprise qualifications and other relevant circumstances to assess and prompt the corresponding tax risks. Second, when signing a contract, improve the terms of preventing relevant tax risks and increase the agreement on the default liability of false VAT invoices in the contract. Third, when making financial transactions, transfer the payment for goods to the corresponding account of the invoicing party through the bank account. Fourth, when collecting invoices, pay attention to comparing whether the information is correct or not. Verify whether the tax registration information of the invoicing party, the warehouse receipt, the invoice, and the enterprise name on the bank account are the same, verify whether it is a general taxpayer or not, verify whether the invoices are purchased by the invoicing party or not, and verify whether the flow of the contract, the flow of funds, the flow of the invoice, and the flow of goods are the same. Fifth, when the business is completed, properly keep all kinds of original documents, such as purchase and sales contracts, invoices, remittance slips, warehousing slips, outgoing slips, etc., and implement the provisions of tax clearance.

### **3.4. Litigation Legal Risk Prevention**

In judicial practice, it is not unlawful for enterprises to take advantage of the existing law to pursue optimal efficiency unless it is substantially contrary to public order and morals. Therefore, the current trial environment is more lenient to bona fide traders than before and the legal awareness of enterprises has been enhanced, so when a financing trade dispute occurs, enterprises will mostly file lawsuits to deal with it effectively, so as to safeguard their own rights and inter-

ests. In order to ensure that the case can be enforced after the judgment, the enterprise as the plaintiff can adopt the two property preservation methods of pre-suit preservation and litigation preservation (Li, 2012). If the case, the plaintiff finds that the litigation object has maliciously transferred, hidden property tendency, then in case of emergency can immediately apply to the court for pre-suit property preservation, the court shall make a decision within 48 hours; In addition, in the process of the litigation, the plaintiff or the court found that there is an impact on the implementation of the results of the judgment or other damage caused by the parties to the case, you can apply for or ex officio to take the property preservation measures. The scope of property preservation for the property involved in the case, common property including houses, vehicles, bank deposits, goods, equipment and so on. When applying for preservation, the applicant shall provide the court with clear information on the property to be preserved and submit corresponding guarantees, so as to facilitate the court to take preservation measures. If, for objective reasons, the applicant is unable to provide clear information about the property, but is able to provide specific clues about the property, he can apply in writing for a network search and control. As the network search and control system information is relatively late, the feedback may be inaccurate, and if no property for preservation is found, the failure of property preservation will also result in the loss of the preservation fee, so it is recommended as an alternative.

#### 4. Concluding Remarks

Legal risks belong to the most common risks in the business activities of enterprises, for the legal risks in the field of financial trade, if not controlled and prevented, enterprises will face significant economic losses. The essence of financial trade is to realize the purpose of capital financing through the apparent form of trade in goods, and this kind of transaction mode which does not correspond to the name and reality makes it easy to make the risk prevention mechanism in normal trade in goods unable to be fully implemented, thus bringing great risks to all parties to the transaction. This paper takes the legal risk of financing trade as the research object, after a lot of theoretical research, focuses on the contract risk, tax risk and litigation risk of financing trade. The research in this paper is helpful for enterprises to improve their management system and do a good job of legal risk prevention. In addition, on the basis of quoting the relevant laws and regulations, this paper explains the specific provisions, which have certain practicality. However, the precautionary measures given in this paper stay on the existing research, and the precautionary measures are relatively single, the lack of practical operation of the argument, I hope that the future can be further practical research.

#### Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this pa-

per.

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