

## China's SPC breaks new ground with draft rules on the PRC Company Law.

On 12 April 2016, the Supreme People's Court of the People's Republic of China (the "SPC") published draft rules ("Draft") on certain aspects of the Company Law of the People's Republic of China, last amended in 2013 ("PRC Company Law"), for a one-month consultation period. The Draft provides guidance on certain provisions of the PRC Company Law and housekeeping affairs of PRC companies that have been the subject of legal disputes in recent years, drawing upon various cases and practices of local courts and elevating them into guiding principles for courts nationwide. Key areas covered by the Draft include the validity of shareholders' and directors' resolutions, transfers of shares in limited liability companies (not including listed and unlisted joint stock companies), and shareholders' information and dividend rights.

### New grounds to invalidate and ratify resolutions

One third of the Draft's provisions cover the grounds on which shareholders' and directors' resolutions can be challenged or ratified, and extend the right to challenge resolutions to other stakeholders of a company (such as employees and creditors).

- The Draft proposes that a resolution may be challenged for non-compliance with law or administrative regulation at any time by, in addition to shareholders, directors and supervisors (as is the case currently under the PRC Company Law), any other person (such as senior management, employees and creditors) directly interested in the relevant resolution.
- The PRC Company Law also permits a resolution passed by a meeting whose convening or voting procedures were defective, or which violates the company's articles of association, to be challenged on application by a shareholder within 60 days of the resolution being passed. The Draft significantly expands this principle by allowing **all** interested parties to challenge resolutions at any time after they are passed, without being subject to the 60-day rule, in the following circumstances:
  - abuse of shareholder rights jeopardising the interests of the company or other shareholders: this clarifies current judicial practice, which includes, amongst others: (i) failure of a shareholder to abstain from voting when it has a clear conflict of interest (such as an upstream guarantee to be provided by the company to the shareholder); and (ii) a shareholder seeking to obtain trade secrets through its right to

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- inspect the company's books and records, as being abuses of shareholders' rights leading to an ability to invalidate the resolution;
- creditors' interests being jeopardised through excessive profit distribution or material improper related party transactions: this could give creditors additional protection through the claw-back of the gains from such distributions or transactions, especially in the insolvency of the debtor company. However, the principle would need to vary according to the debtor's particular situation, and what particular test will be applied (such as balance sheet or cash flow insolvency) remains to be seen;
  - further clarifying the general right to invalidate resolutions for illegality by requiring the court to invalidate a resolution which violates the mandatory provisions of laws or administrative regulations;
  - the following procedural grounds:
    - the minimum requirements of the articles of association for a quorum or a minimum number of votes to be cast are not complied with;
    - the requisite voting majority under the PRC Company Law or the articles of association is not met; or
    - signatures on the resolution are forged (although the Draft introduces an alternative test here, which states that this ground will only be applicable if, after the forged signatures are disregarded, the relevant requisite voting majority still would not have been met).
- In parallel, the Draft introduces a useful clarification for preventing a resolution from being challenged by the company's shareholders on procedural grounds if there is a proven consensus on the matters decided. The Draft proposes that a shareholder's application to invalidate a resolution ought to be struck out if the company can prove that:
- the applicant expressly agreed to the resolution;
  - the applicant accepted the resolution by conduct; or
  - a new resolution to ratify the disputed items has been passed.
- Another feature of the Draft which will be of interest to lenders and other third parties is the right to seek an injunction to halt the implementation of a resolution, if: (i) the resolution cannot be reversed after being implemented; or (ii) the resolution would otherwise irreversibly damage the legitimate rights of the applicant or an interested party. This may lead to lenders requesting copies of resolutions proposed to be passed by the company in advance, in order to decide whether or not to try to preserve the company's assets by exercising this right. It also provides scope for other affected parties (such as minority shareholders and employees) to question the business decisions made by a company.
- The claimant may, at the court's discretion, be required to provide surety before an injunction is granted, and the court may dismiss a claim that is found to have been filed to maliciously interfere with a resolution or delay its implementation. Whilst the Draft attempts to mirror the general right of injunction for the protection of a legitimate interest available under the *Civil Procedure Law of the People's Republic of China*, the safeguards for respondents under the general regime, such as mandatory surety and a

deadline within which a claimant has to file a lawsuit or apply for arbitration, are notably absent from the Draft, and may lead to potential abuse by claimants.

## Transfer of shares

- The Draft also provides that if any provisions in the articles of association of a limited liability company impose excessive restrictions rendering any transfer of shares impossible, a shareholder can apply to court to invalidate the relevant provisions. The Draft does not elaborate on what constitutes “excessive restrictions”.
- While the proposals are a further step in protecting the ownership rights of shareholders in PRC companies, the SPC ought also to tread carefully in ensuring that negotiated restrictions and common buy-out provisions in agreements among shareholders are not rewritten by the courts.

## Statutory right of first refusal

The Draft proposes several useful clarifications on the nature of a shareholder’s right of first refusal under the PRC Company Law. The PRC Company Law gives shareholders of a limited liability company a right of first refusal to purchase shares transferred by the other shareholders. However, the detailed terms of the right of first refusal are not provided in the PRC Company Law and this has given rise to the need to include extensive provisions in shareholders’ agreements and/or articles of association detailing how the right is to be exercised.

- The current judicial practice, which does not extend a shareholder’s right of first refusal to transfers among existing shareholders, is made explicit in the Draft.
- The Draft elaborates the meaning of the term “under equivalent conditions” under which the right of first refusal must be exercised under the PRC Company Law. Factors to be taken into consideration include transfer price, payment method and payment period.
- In addition, the Draft proposes guidance on the information to be provided by the selling shareholder to other shareholders and the time for them to respond, which is designed to provide a default position if the articles of association are silent on this.
- It should be noted that the selling shareholder can discontinue the sale without being bound to sell to the non-selling shareholders who have exercised their first refusal rights, unless the articles of association provide otherwise or the selling shareholder has entered into an agreement with the relevant shareholders.
- In an attempt to prevent recurrence of common disputes over conduct alleged to be in deliberate circumvention of the right of first refusal, the Draft proposes that, in the following circumstances, transfers of shares in a limited liability company will be deemed to be void and the non-selling shareholders will have a right to purchase the shares on the terms of the purported transfer:
  - the transfer agreement was not entered into in accordance with the PRC Company Law and SPC’s judicial interpretations;
  - the price was reduced or the transfer terms were changed after the right of first refusal was waived by the non-selling shareholders,

depriving them of the opportunity to exercise the right under the “equivalent conditions”; and

- the selling shareholder colluded with the third-party transferee such that the actual terms of the transfer were more favourable to the buyer than the terms on which the non-selling shareholders agreed to waive their rights of first refusal.

However, the draft fails to clarify how to deal with the right of first refusal in the case of an indirect transfer.

### Shareholders' information right

- The Draft includes provisions clarifying the right of a company's shareholders to obtain information of the company. Though the PRC Company Law gives shareholders the right to inspect and copy the company's articles of association, minutes of shareholder, board and supervisor meetings and financial reports and accounts, it is not uncommon for shareholders to encounter practical obstacles imposed by the company or its actual controller(s) when requesting for such information from the company. Accordingly, the Draft allows PRC courts to render a judgement of specific performance under which a company must provide the relevant information at a specific time and location to the shareholders or their agents.
- The Draft prohibits constitutional provisions and shareholders' agreements from being used to stop a shareholder from gaining access to company information. In addition, it expands the scope of the “accounts” available for access by shareholders to include original vouchers and records, unless the company can prove to the court's satisfaction that the access to such information is for an improper purpose and would, if granted, jeopardise the company's legitimate interests.

### Dividend rights

- The current PRC Company Law provides limited remedies for shareholders whose rights to request distribution of profits are undermined as the prevailing view is that it is not appropriate for a PRC court to interfere with commercial questions such as whether a dividend should be distributed and if so, how much. In most cases, the shareholder of a limited liability company would currently only be entitled to an exit right through the company buying back its shares, and the conditions for triggering such exit right are relatively onerous. The Draft now offers a shareholder the possibility of demanding its dividend distribution whilst remaining a shareholder of the company. To the extent that a shareholder resolution is passed with respect to a specific dividend distribution plan but such plan is not implemented, upon presentation of such resolution to the court, the court must order the company to pay the shareholder its dividend entitlement within a certain period of time in accordance with the plan specified in the resolution. Even if no such resolution is passed, a shareholder can still require the company to pay it a dividend if it can be proven that other shareholders have abused their shareholders' rights or the directors or senior management have committed fraud, in each case resulting in the company's failure to distribute profits.
- Lenders to offshore shareholders of PRC companies may find these provisions to be of use in increasing the range of possible remedies for shareholders seeking to extract cash from such PRC companies.

The Draft is set to be the first major reform of the PRC Company Law since the changes to the registered capital and annual inspection system were introduced in 2013 (see our earlier [alert](#)). It is a wide-ranging piece aimed at gradual reform, the overall objective of which is to incentivise companies to comply with their legal obligations and articles of association in maximising the interests of their shareholders and protecting the interests of other stakeholders. Its emphasis on the right of first refusal, information and dividend rights are likely to be of particular interest to minority shareholders in PRC companies seeking to negotiate or enforce such rights.

## Reference:

[The Supreme People's Court of the People's Republic of China: Comments Sought for Draft Provisions on Several Issues Concerning the Application of the Company Law of the People's Republic of China \(IV\) \(最高法就《关于适用〈中华人民共和国公司法〉若干问题的规定\(四\)》向社会公开征求意见\)](#)

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