China’s SPC finalises fourth judicial interpretation on the PRC Company Law.  

New judicial interpretation departs from April 2016 draft in several significant respects

Just over seven years since the Supreme People's Court of the People's Republic of China (the “SPC”) published its last significant judicial interpretation on transfers of shares and rights of first refusal in PRC companies¹, on 1 September 2017, the SPC’s fourth judicial interpretation of certain provisions (“Fourth Interpretation”) of the PRC Company Law came into effect. The Fourth Interpretation has been timed to follow the major reforms of the foreign investment approval system between September 2016 (see our earlier alert) and July 2017, and is intended to (amongst other things) use legal reform to make it more attractive for foreign investors to invest in PRC companies. Drawing on the experience of previously litigated disputes on corporate governance and shareholders’ rights, the Fourth Interpretation has enhanced the role of courts in several areas that are not addressed by the existing law or where the role of regulators has been reduced by the foreign investment reform. In this alert, we consider the potential impact of the Fourth Interpretation on Chinese company law and practice, focusing on the significant changes from the April 2016 consultation draft (the April draft was covered in our earlier alert).

Validity of corporate resolutions

The Fourth Interpretation contains the novel concept of a list of elements of a validly passed shareholders’ or directors’ resolution. It permits a company’s shareholders, directors or supervisors (and may also include other interested parties) to apply to the court to strike down a shareholders’ or directors’ resolution of the company as not having been passed, on one of the following grounds:

> the resolution had not been passed at a meeting of shareholders or directors (as the case may be). This ground does not apply to shareholders electing non-employee representative directors or supervisors or deciding on their remuneration, or where the articles of association provide that a decision may be made without convening a

¹ Provisions on Several Issues Concerning Trial of Disputes Relating to Foreign Invested Enterprises (Part I) 关于审理外商投资企业纠纷案件若干问题的规定（一），16 August 2010.
meeting of shareholders, where (in each case) the resolution was signed and sealed by all shareholders;

> the matter stated in the resolution had not been voted by the meeting;

> the minimum quorum of attendees or shareholder voting rights represented at the meeting required by law or the articles of association had not been met;

> the requisite voting majority under the PRC Company Law or the articles of association had not been met; or

> any other circumstance under which the resolution could be deemed not to have been passed.

Checking compliance with the second to fourth points (scope, quorum and majority) is normal process when ascertaining whether a company’s shareholders’ and board resolutions have been validly passed. In contrast, the requirement in the first ground for either the convening of a meeting or a resolution signed by all shareholders appears to be intended to prevent the company taking decisions without the knowledge of certain shareholders or directors through resolutions which appear on their face to comply with the majority voting requirements in the articles of association. The draft of the Fourth Interpretation provided for a similar right when applying Article 22 of the PRC Company Law (under Article 22 a shareholder may, within 60 days after a shareholders’ or directors’ resolution is passed, apply to the court to nullify or invalidate the resolution, if it was passed in breach of law or the company’s articles of association). The Fourth Interpretation, as finalised, clarifies that:

> in the absence of a meeting, it is possible to strike down a resolution even if there is no breach of law or the articles of association; and

> this right is independent of Article 22, and not subject to the 60-day time limit.

This new provision questions the standard clauses of a company’s articles of association that allow majority decisions to be made in writing without a meeting. It suggests that a decision taken by unanimous written resolution of the directors in lieu of a meeting must be supported by unanimous written consent of the shareholders. The need for unanimous written consent of the shareholders may significantly limit the powers of the board of directors as a decision-making body (especially for a Sino-foreign joint venture where the board of directors is the highest decision-making authority). To guard against claims for transactions being struck down due to shareholder or board resolutions being defective, creditors and other counterparties would be well advised to ensure that all written resolutions are approved by unanimous shareholder consent.

To balance the above, the Fourth Interpretation also provides grounds for companies to contest an application for a resolution to be invalidated, revoked or struck down, and mitigates the consequences of a resolution being deemed void or invalidated.
A minor defect in the procedures by which the meeting was convened, or method by which the vote was taken (in each case, which does not have substantive impact on the resolution) is by itself insufficient to invalidate a resolution. However, what constitutes a “minor defect” or “method of voting” depends on the facts of the case. It appears that the provision is intended to provide exemption for (amongst others) inadvertent failure to take procedural steps such as giving notice of a meeting or preparing a meeting notice in accordance with the articles of association.

The Fourth Interpretation contains an “indoor management” rule, to the effect that the annulment or invalidation of a resolution by the court has no effect on a contract between the company and a bona fide third party. It is unclear how far a third party contracting with the company would be deemed to have constructive knowledge of any procedural irregularity in the passing of the resolution, though any duty of inquiry into the company’s internal procedures is unlikely to be extensive.

Strengthening and defining the limits of information rights

Under the PRC Company Law, shareholders may inspect or copy the articles of association, meeting minutes of shareholders, resolutions of directors and supervisors, financial reports and accounts of a limited liability company. The Fourth Interpretation has strengthened shareholders’ information rights by the remedy of specific performance to compel the company to provide the requested information at a specific time and location. Another useful reform is the ability of a shareholder to grant its accountants, lawyers and other advisors who are under professional confidentiality obligations access to the information.

At the same time, the Fourth Interpretation has also clarified the company’s right under the PRC Company Law to refuse to grant a shareholder access to its books of account requested for an “improper purpose”. The relevant provisions deem a shareholder conducting business that substantively competes with the company’s main business (subject to contrary provision in the articles of association), or seeking to provide the information contained in the company's books of account to a third party which may damage the legitimate interests of the company to have an “improper purpose”.

The new provision strengthens investors’ legitimate access to information whilst providing additional checks to prevent the right being abused. Creditors of shareholders of PRC limited liability companies may find these provisions useful in ensuring they are able to receive the necessary information to effectively monitor the performance of the underlying businesses in which their loans are invested. At the same time, the Fourth Interpretation does not change the scope of the information rights under the PRC Company Law, being limited to minutes, resolutions and financial information and excluding, for example, important communications and technical information. The Fourth Interpretation does not remove the need for clearly drafted provisions
defining the scope of a shareholder’s information rights, although it does provide a general principle that such rights cannot be abrogated by provisions of the articles of association or shareholders’ agreements.

Dividend rights

> The Fourth Interpretation fortifies the pre-existing PRC Company Law, which gives an exit right to a shareholder of a profitable limited liability company that has not distributed dividends through the company buying back its equity interest. Exercise of this right is subject to high burdens of proof and the need to establish a reasonable price at which the buyback is to be exercised.

> The Fourth Interpretation provides that a shareholder can compel the company (including a limited liability company as well as a joint stock company) to distribute a dividend on the following grounds:

- the distribution had been approved by shareholder resolution of the company, but was withheld by the company without good cause; or

- any of the shareholders had abused their rights by preventing the company from distributing profits when it was profitable. In its press conference, the SPC indicated that common examples of such abuses include: (i) remuneration paid to shareholders, or directors or senior management personnel nominated by them, being disproportionate to the levels prevailing in the industry having regard to the company's scale and performance; (ii) the company, at the direction of shareholders with a position in the company, purchasing goods or services for their benefit which are unrelated to the operation of the company; or (iii) shareholders diverting revenues in order to conceal or appropriate the company’s profits.

> It thus appears that the concern of the Fourth Interpretation is with cases where revenues of the company appear to have been diverted to other parties at the expense of the shareholders as a whole. No mandatory requirement to distribute available profits appears to apply if the majority have genuine commercial reasons why profits should not be distributed (e.g. future business expansion). That said, no definition of “abuse” is provided and it is hoped that the courts will adopt a consistent approach.

> Creditors of shareholders of PRC companies may find these provisions to be of use in ensuring profits generated by the business are duly up-streamed to service the loan.

Statutory right of first refusal

The Fourth Interpretation supplements the basic mechanism for the exercise of the right of first refusal available to shareholders of limited liability companies under the PRC Company Law. Under the basic mechanism, a shareholder of a limited liability company (“transferor”) seeking to transfer its shares to a
transferee who is not an existing shareholder ("third party transferee") must seek the consent of a majority of the other shareholders (or all of the other shareholders, in the case of a Sino-foreign joint venture). If the non-transferring shareholders neither give consent nor purchase the shares of the transferring shareholder, they are deemed to have consented. If the non-transferring shareholders consent or are deemed to have consented, the non-transferring shareholders (subject to any contrary provision in the articles of association) have a right of first refusal to purchase the shares on equivalent terms to the sale to the third party transferee. The Fourth Interpretation clarifies that factors determining equivalence include the percentage of equity to be transferred, price, manner and timing of payment and other typical buyer’s obligations. As the Fourth Interpretation also indicates, compliance with the above obligations in relation to a transfer of state-owned equity taking place on an assets and equity exchange may, consistent with the practice, be established in accordance with the exchange rules.

The main principles of the Fourth Interpretation are analysed below. They provide additional protection to non-transferring shareholders in several important respects, especially in foreign invested enterprises outside the “negative list” of the Catalogue of Industries for Guiding Foreign Investment (2017) where the substantive examination and approval of equity transfers by the Ministry of Commerce and its local counterparts (which would be expected to cover review of non-transferring shareholder consent and compliance with rights of first refusal) has ceased to apply.

> **Principle 1:** the non-transferring shareholders can require the transferor to notify them of what constitutes the equivalent terms to the sale to the third party transferee. The notice must be in writing or by other reasonable means by which receipt of notice can be confirmed. This principle underlines the importance of clearly drafted notice provisions in a company’s articles of association setting out the prescribed equivalent conditions (and adherence to them) to the avoidance of disputes arising under a first refusal right provision.

> **Principle 2:** if a non-transferring shareholder exercises its right of first refusal, the transferor can discontinue the sale at any time, unless otherwise provided in the terms of the articles of association or the agreement among all shareholders. If the transferor discontinues the sale, it will be liable to compensate losses reasonably incurred by the shareholder(s) who exercised the right. To pre-empt the risk of the transferor relying on the Fourth Interpretation to refuse to sell shares to a non-transferring shareholder in this manner, the articles of association should, once the first refusal right is validly exercised, clearly establish the binding nature of the contract between the transferor and the non-transferring shareholder and limit the right to retract.

> **Principle 3:** anti-circumvention provisions have been added to enable non-selling shareholders to purchase the shares from the transferor on equivalent terms in the following situations where the transferor’s conduct falls into one of the following categories, which would be
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...deemed to have effectively deprived them of the opportunity to exercise the right of first refusal:

- not having sought the view of the non-selling shareholders on the proposed transfer; or
- prejudicing the rights of first refusal of the non-selling shareholders by fraud or collusion.

> Principle 3 shows the importance for transferors of strict compliance with the notification obligations associated with the right of first refusal.
> The non-selling shareholders have a time limit of 30 days from knowledge or deemed knowledge of the equivalent terms, or one year from the registration of the transfer of shares by the transferee (whichever expires first) to exercise the new rights under Principle 3.

> **Principle 4:** the transferor remains liable to the third party transferee for any inability to fulfil the purpose of the agreement for the transfer of shares due to a non-selling shareholder exercising its first refusal right. This points to the need for transferors to include the necessary conditions precedent in their share transfer agreements, as well as for strict compliance with the terms of the first refusal rights before agreeing with a third party transferee to sell their shares. Given the extent of the remedies available to the non-transferring shareholders, it appears that the transferor’s liability to the third party transferee in this situation would be primarily in damages (as opposed to a specific performance remedy to deliver the shares).

**Shareholders’ representative lawsuits**

> The PRC Company Law, which pre-dates the Fourth Interpretation, had already provided that a shareholder of a limited liability company or joint stock company is entitled to petition the company’s directors or supervisors to initiate legal proceedings against supervisors or directors (as the case may be) causing loss to the company by their breach of laws, regulations or legal obligations, or against any other third parties damaging the legitimate interests of the company. If the directors or supervisors fail to take action where failure would cause irremediable damage to the company, the shareholder may bring proceedings in its own name.

> The Fourth Interpretation aims to make the above provision more practically workable through guidance to courts on how the proper claimants should be identified and when the company, co-shareholders and other third parties should be joined as participants in the litigation.

> On the financial consequences of such litigation, the Fourth Interpretation provides that in the event the petitioners successfully contest the litigation:
- the benefits accrue to the company, and in no event shall the court order the defendant to directly assume liability to shareholders; and
- the company must reimburse the shareholders’ reasonable expenses (however, the Fourth Interpretation is silent on the company’s responsibility for the costs of a failed lawsuit).

**Overall assessment**

The overall objective of the Fourth Interpretation is to clarify and enhance the rights of shareholders in PRC companies. It covers a broad range of issues, including corporate governance, information, dividends, rights of first refusal and shareholder representative lawsuits. Whether the Fourth Interpretation will make it more attractive for investors to invest in PRC companies remains to be seen, though (as shown above) it shows the need for companies’ articles of association to have clear and comprehensive provisions in certain areas. The enhanced rights made available to minority shareholders by the Fourth Interpretation should be taken into account when structuring the provisions of shareholders’ agreements, joint venture contracts and articles of association. The enhanced information and dividend rights may also be considered by structurally subordinated creditors seeking to monitor the underlying business and/or control capital flows.
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Reference

The Supreme People’s Court of the People’s Republic of China: Provisions on Several Issues Concerning the Application of the Company Law of the People’s Republic of China ("PRC Company Law") (IV) 最高人民法院关于适用《中华人民共和国公司法》若干问题的规定（四）

Issuing authority: The Supreme People’s Court of the People’s Republic of China