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## CHINA SUPREME COURT ISSUES THE FORTH INTERPRETATION OF THE COMPANY LAW TO CLARIFY CERTAIN APPLICATIONS TO THE LAW

On August 25, 2017, China's Supreme People's Court (the "SPC") issued the *Provisions on Certain Issues Concerning the Application of the Company Law of the People's Republic of China (IV)* ("Interpretation IV"), which came into effect on September 1, 2017. The release of Interpretation IV is aiming to unify the application of laws and provide guidance on litigated disputes in relation to the validity of corporate resolutions, shareholder's information rights, dividend rights, right of first refusal and shareholders' derivative lawsuits. This article intends to give a brief summary about the guidance adopted in the above areas and the corresponding implications to related parties.

### VALIDITY OF CORPORATE RESOLUTIONS

Prior to the promulgation of Interpretation IV, the *Company Law of the People's Republic of China* ("Company Law") offers two remedial means to challenge the validity of corporate resolutions under certain circumstances, i.e. rescinding the resolution within sixty days' time limit and nullifying the resolution. The Interpretation IV grants the third remedy by enabling shareholders, directors or supervisors (and other applicable persons) of a company to challenge the duly establishment of the shareholders' resolution or board resolution under below circumstances:

- i. Where the resolution is adopted without convening a meeting, unless the resolution is passed pursuant to Section 2 of Article 37<sup>1</sup> of Company Law or according to the articles of association of the company the decision could be directly made without convening a shareholders' meeting or shareholders' general meeting and the shareholders' resolution is signed and sealed by all shareholders;
- ii. Where the resolved matter has not been voted by the meeting;
- iii. Where the minimum quorum of attendees or the shareholder voting rights represented at the meeting required by the Company Law or the articles of association of the company has not been met;
- iv. Where the requisite voting proportion of the resolution stipulated by the Company Law or the articles of association of the company has not been met; or
- v. Other circumstances resulting in the non-establishment of the resolution.

Interpretation IV further clarifies the participants in proceedings in relation to the application for nullification, non-establishment or rescission of the resolutions:-

Claim	Plaintiff				Defendant	Third Party
Nullification of the Resolution	Shareholder	Director	Supervisor	Others	Company	Interested Parties
Non-Establishment of the Resolution	Shareholder	Director	Supervisor	Others		
Rescission of the Resolution	Shareholder, who shall be eligible as the company’s shareholder at the time of initiating the proceedings					

<sup>1</sup> Company Law Article 37 "... The shareholders may pass a resolution in writing unanimously for a direct decision on the aforesaid matters without convening a shareholders' meeting and all the shareholders shall sign and affix their seal on the decision document."

Interpretation IV is of the view that a minor defect in the procedures for convening the meeting or the voting method without substantial impact on the resolution shall not cause the rescission of the resolution, but the definition of “minor defect” and “substantive impact” are not illustrated by the SPC, which may be further interpreted by the court on a case by case basis.

Interpretation IV also establishes a principle that the civil legal relationship between the company and a bona fide counterparty based on the resolution shall not be affected even though such resolution is ruled as null and void or revoked by the court.

## INFORMATION RIGHTS OF SHAREHOLDERS

On the basis of Company Law, Interpretation IV reinforces the information rights of shareholders in the following aspects:-

- Shareholders’ information right shall not be deprived by the articles of association, agreements between shareholders etc..
- The eligible plaintiff claiming for shareholders’ information rights shall be (i) shareholders at the time of initiating or (ii) the person has prima facie evidence that his legal rights and interests are damaged during the shareholding period.
- The people’s court shall specify in its judgment the time, place and the documents list of particular documentation for the inspection or copy if it upholds the plaintiff’s claim. Interpretation IV admits the shareholders’ right to engage third party professionals to assist the review of information.
- Directors, senior executives, etc. fail to perform their duties to produce or keep relevant documents and materials in accordance with Articles 33 and 97 of the Company Law, which causes losses to shareholders shall bear civil liabilities.
- Where a limited liability company has evidence to prove any of the following circumstances, it may reject the shareholders’ request to access to the company’s account books under the reason of “improper purpose”:
  - i. The shareholder has self-owned business or operates the business in substantial competition with the main business of the company, unless otherwise specified in the company’s articles of association or agreed by all shareholders;
  - ii. The inspection of the company’s account books is for the purpose of informing others of relevant information, which may damage the legitimate interests of the company;
  - iii. The shareholder damaged the legitimate interest of the company by informing others of relevant information they obtained through inspection of the company’s account books in the last three years; and
  - iv. The shareholder has other improper purpose.

The corresponding parties shall further review the shareholders agreement, articles of association and other corporate governance rules and documents to regulate whether a shareholder having self-owned business or operating the business in substantial competition with the main business of the company is allowed to inspect the account book of the company and to establish a proper management system to clarify the responsibilities for corporate document production and maintenance.

## DIVIDEND RIGHTS

Interpretation IV sets up the principle that the people’s court will rule in favor of the shareholders when (i) the shareholders’ request of profits distribution is supported by an effective resolution made by a shareholders’ meeting or a shareholders’ general meeting that carries the specific distribution plan; and (ii) the defense of the failure to enforce the profit distribution resolution is not established.

In normal circumstance, the people's court will dismiss shareholders' claim of profit distribution if the shareholders fail to submit the resolution made by the shareholders' meeting or the shareholders' general meeting that specifies the specific distribution plan. But Interpretation IV expressly points out that the failure to distribute the profits attributable to any abuse of shareholders' rights and results in losses to other shareholders shall be an exemption to the above normal circumstance.

Interpretation IV neither enumerates the scenarios of which the defense of the failure to enforce the profit distribution resolution is regarded as being established nor defines the meaning of "abuse of shareholders' right", but on SPC's press conference it indicates that if the distribution of dividend is rejected and (i) abnormal high remuneration is paid to shareholder or personnel nominated by shareholder; (ii) goods or services is purchased not for the operation of the company but for the shareholder's personal consumption or use; or (iii) the profit is concealed or appropriated, it shall be regarded as "abuse of shareholders' right".

Generally, dividend distribution is an autonomous matter left to the decision of the shareholders at their own discretion. Interpretation IV intends to optimize the judicial remedy to the shareholders' dividend rights when the shareholders abuse their rights not to distribute the dividend and cause damages to other shareholders.

## RIGHT OF FIRST REFUSAL

According to the Company Law, when a shareholders of a limited liability company seeks to transfer its equity interest to a third party, under the equivalent conditions, the other shareholders of the company shall have right of first refusal on said equity interest, but the Company Law does not stipulate the detailed notification procedure, methods, time limit and remedies for the exercise of right of first refusal. Interpretation IV supplements this general rule by providing more detailed operative provisions:-

- The factors of equivalent conditions shall include quantity, price, payment method, payment period, etc. of the transferred equity interest. When the transfer of equity interest is through auction or the transfer of the equity interest of a state-owned limited liability company is made in a property rights exchange, the factors of equivalent condition could be interpreted by corresponding laws and judicial interpretations or the trading rules set by the property rights exchange.
- The transfer notice could be in written form or other reasonable methods that are able to acknowledge the receipt is not limited to be in written form. When the transfer of equity interest is through auction or the transfer of the equity interest of a state-owned limited liability company is made in a property rights exchange, the notification formality could be interpreted by corresponding laws and judicial interpretations or the trading rules set by the property rights exchange.
- The exercise period of the right of first refusal shall be determined by the articles of association or the transfer notice if articles of association have not prescribed the exercise period or the provisions are unclear, in any case the minimum time limit for the exercise of the right of first refusal is 30 days.
- Unless otherwise stipulated in the articles of association or agreed by all the shareholders, the shareholders intends to transfer the equity interest can discontinue the sale after the other shareholders exercise the right of first refusal but said shareholder will be liable for compensating losses reasonably caused to the other shareholders who exercise the right of first refusal.
- The people's court shall uphold the claim of the shareholders who claim to purchase the equity in question under the same conditions due to the fact their right of first refusal has been infringed by the other shareholder(s), unless such shareholders fail to make such claim within 30 days of knowing or within 30 days since they should have known such equivalent conditions for the right of first refusal or, one year has passed since the change of registration of the equity in question. Interpretation IV grants the third party transferee right to claim for civil liability against the transferor if the goal of the contract is unable to achieve due to the exercise of right of first refusal is upheld by the people's court.
- Interpretation IV supplements Article 71 and Article 75 by providing unless otherwise provided by the articles of association of the company or agreed by all shareholders, the right of first refusal shall not be applicable to the scenario where a natural-person shareholder of a limited liability company is changed due to inheritance relationship.

## DERIVATIVE SUITS

The Company Law generally provides that under certain circumstances, shareholders of a company is entitled to petition the supervisors or directors of a company, on behalf of the company, to bring a suit against directors, supervisors, senior management personnel who violate laws, regulations or articles of association and cause losses to the company. If the directors or supervisors reject or fail to take action within thirty days where the failure will result irreparable damage to the company, the requesting shareholder may bring the corresponding suit on its own name.

Interpretation IV clarifies several procedural issues in relation with such kind of lawsuit. It confirms that:-

- i. if the directors or supervisors are the subjects who bring the derivative suits, the company shall be the plaintiff; and
- ii. if the shareholder directly files lawsuit against the directors, supervisors or senior management personnel on its own name, the company shall be listed as the third party. In such case, the financial interests resulting from the derivative suit shall belong to the company itself and the company shall compensate the reasonable costs of the shareholders.

## CONCLUSION

It is obvious that the issuance and implementation of Interpretation IV will provide more certainty for legal implementation as well as judicial enforcement in practice. Also, it will have long-lasting positive impact on protecting shareholders' legitimate rights, improving the management mechanism of the company and creating good business environment. The relevant parties shall review the articles of association and shareholders agreements to evaluate whether said legal documents shall be further modified to optimize the terms in relations to written resolutions, right of inspecting the account book when the shareholder being competitor of the company, the liability of producing and maintaining the corporate documents, the right of first refusal for share inheritance, the revocation right of the transferor when the other shareholders exercise the right of first refusal. Though some concepts set forth in Interpretation IV are still relatively general, it may be further clarified by the leading cases released by SPC from time to time. Besides, the implementation regarding the validation of board resolution of sino-foreign equity joint ventures and sino-foreign cooperative joint ventures remain uncertain, which is subject to SPC's further interpretation or leading cases announced by the SPC.

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