Legal Commentary

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漢坤律師事務所
HAN KUN LAW OFFICES

BEIJING | SHANGHAI | SHENZHEN | HONG KONG

Company Law Interpretation V: Explanations and Analysis

Authors: Andy LIAO | Shirley LIAO | Wenmin YU

The Supreme People's Court on April 28, 2019 promulgated the *Rules (V) on Issues Involving Application of the Company Law of the People's Republic of China* ("**Interpretation V**"), which officially came into effect on April 29, 2019. The primary objectives of Interpretation V are to protect company shareholders, particularly minority shareholders, and to optimize the business environment, according to the relevant person responsible from Civil Adjudication Tribunal No. 2 of the Supreme People's Court at a news briefing[1] ("**Briefing**") describing the promulgation background. Based on these objectives, Interpretation V separately provides for (i) judicial review and remedies for related-party transactions, (ii) director removal without cause and compensation, (iii) a time limit for profit distributions, and (iv) mechanisms for resolving material differences between shareholders of a Limited Liability Company.

In general, Interpretation V provides relatively specific judicial rules for certain types of corporate disputes, and plays a guiding role for common disputes and issues unaddressed in judicial practice. However, due to the level of generality of Interpretation V, there remains room to discuss the reasonableness and feasibility of some provisions, which will also be subject to examination and improvement in judicial practice. The authors have combined their practical experience to interpret the key clauses of Interpretation V to provide a preliminary discussion of potential issues for the reference of clients and colleagues.

I. Due process is insufficient to defend against damage claims for related-party transactions

> ***Article 1*** *Where a related-party transaction damages a company's interests, if a plaintiff claims for compensation against the controlling shareholder, actual controller, directors, the supervisor or senior management for losses caused under Article 21 of the Company Law, and the defendants' only defense is that performance of the transaction had been disclosed and approved through procedures such as a shareholders' assembly or general assembly of shareholders under provisions of laws,*

[1] *Protecting shareholders' rights according to law, serving the business environment – New briefing by the relevant person responsible from Civil Adjudication Tribunal No. 2 of the Supreme People's Court on Rules (V) on Issues Involving Application of the Company Law of the People's Republic of China*, Apr. 28, 2019, http://www.court.gov.cn/zixun-xiangqing-155282.html (Chinese).

administrative regulations or the company's articles of association, the People's Court shall not sustain [such defense].

Where the company has not filed a lawsuit, shareholders who conform to conditions stipulated in paragraph 1 of Article 151 of the Company Law may initiate legal proceedings in the People's Court in accordance with the provisions of paragraphs 2 and 3 of Article 151 of the Company Law.

The legal remedy for damages caused by related-party transactions to the interests of a company is found under Company Law at Art. 21, which provides for a legal basis for "company related-party transaction liability disputes." Based on our observations, such cases account for a small proportion of corporate disputes, and the plaintiff success rate in such cases is relatively low, which is partially attributable to the impracticability of the law and the excessive burden of proof on plaintiffs.

The issues contended in company related-party transaction liability disputes typically include: (i) whether there exist related parties and related-party transactions, and (ii) whether the related-party transactions, if existing, have caused any losses to the companies. It is relatively easy for a plaintiff to prove the existence of related parties and related-party transactions. However, it is not easy to prove that the related-party transactions have harmed the interests of the company and to quantify damages, which are the biggest risks that plaintiffs face and common reasons for dismissal. The core criteria for the legality of related-party transactions is to judge whether the price was fair and the procedures were legitimate. There are no statutory provisions or criteria for judging fairness of price, and it depends on the opinion of the judge in the litigation. The Company Law only has provisions on recusal for certain related-party transactions. For example, a shareholder or actual controller must recuse itself from voting when it seeks to provide guarantees to the company (Company Law, Art. 16), and directors of listed companies must recuse themselves on matters involving related entities (Company Law, Art. 124). However, well-established mechanisms for recusal and related-party transactions have not been established, which has led to decision-makers of actual controlling companies to control voting procedures for related-party transactions (typically controlling shareholders, actual controllers and senior managers). After entering litigation, defendants often prevail by showing that there was sufficient information disclosure and that the voting procedures were legitimate. It is not uncommon for judges to rule against plaintiffs in such cases, unless the plaintiff provides convincing evidence proving the unfairness of the related-party transactions.

In this context, Article 1 clarifies that a defendant will not prevail merely by proving that the information disclosure and voting procedures were legitimate. This is highly relevant to problems existing with the plaintiff's burden of proof in judicial practice, it could even be considered to imply a reversal of the burden of proof in such cases. Although Article 1 does not clearly specify the defendant's burden of proof, it is implied that defendants in these cases will inevitably have to prove fairness or lack of causality between the related-party transactions and claimed damages, etc.

Considering the defendant's control and influence over the company, it is difficult for the company to decide to file a lawsuit on its own behalf. Article 1, para. 2 explains that a shareholder derivative suit may be filed by shareholders of a Limited Liability Company or by one or more shareholders of a Joint Stock

Limited Company who have collectively one percent or more of the company's shares for 180 consecutive days or more. This paragraph is not part of a newly created procedure in this judicial interpretation. In past judicial practice, there have been many cases where shareholders have brought derivative lawsuits against related-party transactions that have damaged the interests of the company in accordance with the Company Law at Art. 151.

In general, it has yet to be tested in judicial practice whether the provisions of Article 1 have certain deterrent power to the controlling shareholders, actual controllers and senior managers of the company and protect the rights and interests of minority shareholders. That said, a defendant's risk of losing in a related-party transaction case will significantly increase if the courts require the defendant to bear the burden of proof in respect of the fairness of the related-party transactions and the absence of causality between the related-party transaction and the claimed damages.

II. Shareholders entitled to file derivative lawsuits to invalidate or revoke related-party transaction contracts

Where invalid or revocable conditions exist in a related-party transaction contract and the company does not sue the counterparty to the contract, shareholders who conform to conditions stipulated in paragraph 1 of Article 151 of the Company Law may initiate legal proceedings with the People's Court in accordance with paragraphs 2 and 3 of Article 151 of the Company Law.

Use of related-party transactions to damage the interests of a company constitutes a tort, for which the Company Law at Art. 21 provides compensatory damage liability as a remedy. In practice, however, damages may not fully protect a company's interests, especially where damages are difficult to prove and quantify. Related-party transactions generally need to be realized through contract. Thus, in practice, where damages cannot fully protect the company's interests, it is necessary to allow relief through a mechanism such as invalidation or rescission. Taking into account the special context of related-party transactions, Article 2 gives shareholders the right to file a derivative lawsuit in cases where the company does not file a lawsuit against the contract counterparty.

This provision is undoubtedly positive from the perspective of affirming shareholders' right to sue. That said, Article 2 is extremely principled and simple, and there are still many issues to be further clarified. For example, suppose there is a lawsuit in which a company sues the controlling shareholder for compensatory damage liability from a related-party transaction and, concurrently, the shareholders seek to rescind the contract in accordance with the requirements of Article 2. The company may confirm the amount of damages based on the completion of the contract, which would be contrary to the claim for rescission of the contract under the shareholders' derivative lawsuit. Article 2 does not answer whether courts should give priority to respecting the company's exercise of its right to claim for damages or whether they should first wait for the shareholders' derivative suit to determine the validity of the contract before hearing the claim for damages and determining the scope of damages. Considering the complexity, we believe that it would be difficult to formulate a unified provision. It would be reasonable, for example, to give priority to a derivative suit where the controlling shareholder has directed the company to drop the transaction counterparty from the suit. However, priority should be given to the company's lawsuit where

it is shown that it is suing on its own volition and to maximize shareholder returns and is able to operate and exercise its rights.

In addition, the issue of shared losses needs to be addressed in cases where the minority shareholders prevail in invalidating or rescinding a contract and the parties cannot be returned to the status quo ante. According to the Contract Law at Art. 58, both parties to the contract will bear liability in proportion to their degree of fault. In cases of related-party transactions damaging a company's interests, the company is often found to be at fault for the conduct of the controlling shareholder, since the company is a nominal party to the contract while the controlling shareholder manipulates the company's decision-making. Article 2 does not provide clarity as to whether minority shareholders can name the controlling shareholder as a defendant and seek recovery in a derivative action. However, we believe the answer is affirmative because the law does not prohibit minority shareholders from concurrently suing the controlling shareholder and contract counterparties, and the minority shareholders' right to request that the controlling shareholder bear liability for damages is a right implied in the invalidation or rescission of the contract, which should be dealt with at the same time.

III. Clarifying the nature of no-cause removal of directors

> *Where a director, before expiration of his term, has been removed from office by an effective resolution of the shareholders assembly or general shareholders assembly, and the director asserts that such removal is not legally effective, the People's Court shall not sustain [such assertion].*
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> *Where a director, upon removal from office, initiates legal proceedings due to a dispute with the company over compensation, the People's Court shall determine whether and how much compensation to award in accordance with provisions of law, administrative regulations, the company's articles of association or contractual undertakings, and by fully considering other factors, such as the cause for removal, remaining term and the director's remuneration.*

Article 3 further confirms the principle that a director may be removed without cause. Debate exists in respect of for-cause and no-cause removal of directors. The Company Law initially stipulated that removal of directors was to be for cause. The Company Law as adopted in 1993 provided at Art. 47 that "the shareholders assembly of a company may not, without cause, dismiss a director of the board prior to the expiration of his term in office." This provision was deleted in the 2005 revision to the Company Law, which indicated an inclination towards the principle of removal without cause.

Removal without cause is generally accepted both in theory and practice, based upon the idea that the relationship between company and the director constitutes an entrustment—either the company or the director thus has the right to arbitrarily terminate the mutual relationship. However, the concept that "a director may not be replaced during his term of office" still has some influence in practice. Many directors and officers who are removed from office sue to revoke the resolutions for their removal on the ground that the reason for removal was unfounded, and some courts will accept such reasoning. For example, in the Supreme People's Court's 2012 Guiding Case No. 10, the plaintiff filed suit to revoke the resolution for his removal because he believed a factual error existed in the cause for removal, i.e., "without consent of the

board of directors, privately used company funds to trade stocks in the secondary market, resulting in substantial losses." The first instance held that "the resolution to remove the general manager is unjustified for lack of factual and legal bases, and the result of the resolution is improper. For the purposes of safeguarding the legitimate interests of the plaintiff and to improve the fairness and legitimacy of the resolutions of the board of directors, the resolution is hereby ordered revoked." However, the second instance court corrected the first instance court, finding that the statement of cause for removal in the resolution did not violate the company's articles of association and the resolution should before considered valid in the absence of other grounds for revocation. This case demonstrates the Supreme People's Court's position on the no-cause removal of officers.

Removal without cause is again confirmed in Article 3, para. 1 by characterizing the company-director relationship as an entrustment. However, parties to an entrustment may legally agree to dissolve the entrustment only for cause. Therefore, a further concern of ours about Article 3 is whether a resolution for removal can be resisted if the director and company have expressly agreed that removal may only be for cause. Article 3 does not answer this question, and it is foreseeable that differences will appear in judicial practice.

To balance the protection of directors' rights, Article 3, para. 2 provides directors reasonable compensation and grants the right to file a lawsuit against removal from office. However, Article 3 does not explicitly resolve the conflicts that arise in the case of removal between the Company Law and the Labor Law. Debate also remains in judicial practice as to whether a director's removal is equivalent to the termination of labor relations with the company. Shanghai courts have taken the position that a board resolution dismissing an officer who has signed a labor contract with the company should be regarded as an adjustment in position, which does not necessarily result in the dissolution of labor relations between the officer and the company (e.g., (2015) Hu Er Zhong Min San (Min) Zhong Zi No. 747). In terms of legal procedures, disputes over remuneration and employment compensation for a director should be handled separately by following different legal procedures; disputes over employment compensation are to first be submitted to labor arbitration. However, failure to clearly distinguish between remuneration and compensation in a director's engagement letter or contract is indeed prone to disputes over jurisdiction, which will depend on the judgment in the case.

IV. Distributions of profits shall be made no later than one year following the making of a resolution

After the shareholders assembly or general shareholders assembly has made a resolution to distribute profits, the company shall complete the distribution of profits within the time specified in the resolution. Where the resolution does not specify the time, it shall be subject to provisions of the company's articles of association. Where the resolution and the articles of association both do not stipulate the time or the time exceeds one year, the company shall complete the profit distribution within one year from the date of the resolution.

Where the time to complete the distribution of profits specified in the resolution exceeds the time stipulated in the company's articles of association, the shareholders may apply to the People's Court to

revoke the provisions of the resolution regarding the time in accordance with paragraph 2 of Article 22 of the Company Law.

Article 4 provides a time limit for the completion of profit distributions. The earlier Interpretation IV of the Company Law shared three provisions on the issue of lawsuits regarding shareholders' rights to distributions: the subject to the action (the company as defendant), a pre-existing resolution requirement (the action is preconditioned on an effective resolution for the distribution of profits having been adopted the shareholders assembly or shareholders general assembly) and provisions for exceptional circumstances. Interpretation IV, notably, does not provide for how to deal with the distribution of profits if the resolution fails to specify a concrete time for distribution, which had led to inconsistent rulings. However, based on our observations, it is uncommon for courts to dismiss shareholders' claims for the distribution of profits merely on the ground that the resolution failed to specify an exact time for distribution. Some courts have found that shareholders' right to claim for profit distributions becomes a creditor's right after the adoption of a resolution, and shareholders have the right to make a claim at any time ((2018) Chuan 01 Min Zhong 13591 Judgment).

Article 4 further resolves this remaining issue regarding the right to distributions in Interpretation IV. The timing of profit distributions is in principle based on the time specified in the resolution, and under different circumstances is based on the provisions of the resolution and the company's articles of association. However, upon a careful reading of the article, we believe that some of the language of may be subject to misinterpretation, and the reasonableness of the process is still open to debate. Specifically, the situation in which the company should complete the distribution within one year from the date of the resolution is "[w]here the resolution and the articles of association both do not stipulate the time or the time exceeds one year," but it is questionable whether "both" modifies "the time exceeds one year." Based on a strict contextual interpretation, "both" should modify "do not stipulate the time" or "the time exceeds one year"—and the resulting issue may frustrate the purpose and original intent of Article 4. For example, suppose the resolution does not specify a time for the distribution, but the company's articles of association stipulates a time in excess of one year; this sentence cannot be applied to conclude the profit distribution is completed within one year, but the profit distribution will essentially exceed one year by applying "[w]here the resolution does not specify the time, it shall be subject to provisions of the company's articles of association." A major shareholder could, in theory, act not to pay or to postpone payment of dividends so long as a long dividend payment term is specified in the articles of association and the dividend resolution does not specify a payment term. Therefore, in terms of contextual logic and legislative purpose, the completion of distributions within one year should be applied in all cases where either the time stipulated in the resolution or the articles of association is greater than one year.

Article 4, para. 2 stipulates that when the time specified in the resolution exceeds that stipulated in the company's articles of association, the shareholders may file a lawsuit to revoke the provisions on timing of distributions in accordance with Company Law Art. 22, para. 2. It is worth noting in this case that under the Company Law, shareholders will need to file a revocation suit rather than a suit demanding the right to distribute profits in accordance with the company's articles of association. In practice, disputes over company resolutions and distributions of surplus are independent company lawsuits. It is rare to resolve a profit distribution issue while at the same time revoking the resolution. This means that shareholders

will still need to file a separate lawsuit on dividends after revoking the provisions on timing. In addition, the right to revoke a resolution must be exercised within 60 days after the resolution is made, claims filed outside the time limit shall be rejected, according to the Company Law at Art. 22. Although Article 4 does not clearly stipulate the consequences of exercising the right to revoke beyond the 60-day time limit, it should mean, after the plaintiff's failure in the case, that the resolution continues to be effective and that the profit distribution is subject to the resolution.

We understand the purpose of Article 4 is to urge companies to constrain the timing of the payment of dividends, protect the interests of minority shareholders effectively, and the overall legal effect is that once a resolution is made to distribute profits, the distribution should be completed within one year, regardless of whether the resolution or the articles of association stipulate otherwise. However, we are uncertain whether a one-year time limit is necessary, or whether it will excessively interfere with shareholder autonomy. As in the previous example, if there is no clear definition of profit distribution, the court will refer to provisions of the Contract Law regarding unspecified periods of performance, which can also protect the interests of plaintiffs and be more flexible. However, after setting an upper limit of one year, if all shareholders adopt a resolution to distribute profits in more than one year, the shareholders who voted in favor may still question the validity of the resolution and apply to a court for an early distribution. Doing so would essentially contradict the estoppel principle, and not be conducive to maintaining strict enforcement and stability of corporate resolutions. In this sense, the balance between profit distribution rights and autonomy still requires further exploration and research.

V. Mediation shall be emphasized when hearing cases of major disputes among shareholders of limited liability companies

> *When the People's Court hears cases involving material differences among shareholders of a Limited Liability Company, mediation shall be emphasized. Where the parties agree to resolve their differences by means of the following methods and it does not violate mandatory provisions of law and administrative regulations, the People's Court shall support [such resolution]:*
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> *(1) The company partially repurchases the shareholders' shares*
>
> *(2) Shareholders partially purchase the other shareholders' shares*
>
> *(3) Other parties partially purchase the other shareholders' shares*
>
> *(4) Reduction in company capital*
>
> *(5) Company separation*
>
> (6) *Other methods that may resolve differences, restore normal business operations, and avoid company dissolution*

Article 5 expressly states that mediation will be emphasized when the People's Court hears cases involving major differences among shareholders of a Limited Liability Company for purposes of maintaining the company's operations. We note that although the first sentence of Article 5 refers to the application of

differences among shareholders of a Limited Liability Company, the later text references “shares” rather than “equity”, which may cause misunderstandings that this Article 5 also applies to joint-stock limited companies. The wording used at the Briefing may resolve such doubts. During the Briefing, the spokesperson mentioned that “Article 74 of the Company Law stipulates the right of shareholders of a Limited Liability Company to request to repurchase shares.” In fact, however, the Company Law at Art. 74 stipulates the right of shareholders of a Limited Liability Company to request the company to repurchase “equity” rather than “shares.” By analogy, the “shares” used in Article 5 appears more like a typographical error and should not be interpreted to expand the scope of application to joint stock limited companies. Moreover, Article 5 provides that mediation methods must not violate mandatory provisions of laws and administrative regulations. However, for joint-stock limited companies, especially those that are publicly listed, mediation of shareholders’ differences must comply with CSRC ministerial rules and exchange trading rules. Based on the above, we believe Article 5 is not intended to apply to joint-stock limited companies.

Mediation is already emphasized in Interpretation II of the Company Law at Art. 5, para. 1. By comparison, the types of cases subject to mediation in Article 5 are expanded from disputes involving the company dissolution to all major differences involving Limited Liability Company shareholders. And the mediation methods have also been expanded to include the shareholder buyouts by a third party, company separation as well as a catch-all method.

Mediation is the first dispute resolution method that the courts should consider in resolving disputes. Article 5 reflects the efforts of the Supreme People’s Court to promote diversification of dispute resolution methods and optimization of the business environment. It is worth noting that the dispute resolution methods stipulated in Article 5 involve many additional parties and procedures in addition to the parties to the dispute, but this Article 5 fails to clearly stipulate how the court will provide judicial support with respect to those additional issues and procedures. Therefore, the effect of implementing Article 5 remains to be seen in judicial practice.

Generally speaking, Interpretation V, although short in length with six articles only, provides strong guidance for the resolution of disputes and controversies arising in case trials, which reflects the position of the Supreme People’s Court to truly deal with concrete issues existing in judicial practice. However, as discussed in this article, Interpretation V leaves open many procedural and substantive issues and has the potential risk of impeding company decision-making procedures and governance due to over-protection of the interests of minority shareholders. We believe that those open issues should be resolved through continuous exploration in judicial practice, and we will monitor implementation of the rules.

Important Announcement

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If you have any questions regarding this publication, please contact:

Andy LIAO

Tel: +86-10-6080 0990
Email: andy.liao@hankunlaw.com