

New Judicial Interpretation on PRC Company Law and Its Implications for Financial Investors and Minority Shareholders

September 25, 2017

On August 25, 2017, China's Supreme People's Court (**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 took effect as of September 1, 2017.

Interpretation IV applies to all PRC incorporated companies, including both domestic companies and foreign-invested companies. So it impacts international investors, including offshore investment funds with portfolios, in China.

Interpretation IV is the fourth judicial interpretation of the Company Law of the People's Republic of China (the "**Company Law**"). As were all previous judicial interpretations of the Company Law issued by SPC, Interpretation IV is intended to provide clarification, elaboration and guidance on certain provisions of the Company Law that have been the subject of legal disputes and enforcement in the past years.

Set out below is a brief summary of the subject areas addressed by the Interpretation IV and their implications to financial investors of PRC companies (including onshore and offshore private equity funds) who typically do not control the operation of the companies in China.

1. Validity of Shareholders' and Directors' Resolutions

The Company Law provides very general rules on the validity of shareholders' and directors' resolutions. Interpretation IV supplements these general rules in a number of aspects. Among others, Interpretation IV provides for certain specific circumstances under which a shareholders' or a directors' resolution may be invalidated, which include: (i) adoption of a resolution without convening a meeting, unless an exception applies (i.e., a shareholders' resolution duly signed by all shareholders pursuant to law or the articles of association); (ii) adoption of a resolution at a meeting without voting on it; (iii) quorum not met or present voting rights insufficient; or (iv) vote at a meeting not reaching the proportion required by law or specified in the articles of association. To protect bona fide third parties' interests, Interpretation IV provides that the invalidity of a shareholders' or a directors' resolution should not affect the legal effect of the business transaction between the company and a bona fide third party which has been approved by such resolution.

It is anticipated that with the above detailed guidance in place, a financial investor of a PRC company who does not hold a majority interest or does not control the board would get better protection from abuse of shareholders' rights by the majority shareholder of the company. However, the financial investor would not be able to stop a transaction that already has been approved by an invalid shareholders' or board resolution, unless it can prove that the counterparty of the transaction is not a bona fide third party.

2. Shareholders' Inspection Rights

The Company Law includes certain general provisions on shareholders' access to company books and records. Interpretation IV further defines and provides detailed rules for these general provisions. On the one hand, Interpretation IV provides that it is a statutory right of a shareholder to inspect the books and records of the company and such a statutory right cannot be excluded through contractual arrangements between the shareholders; while on the other hand, Interpretation IV provides several specific circumstances under which a company may refuse a shareholder's request to inspect the books and records of the company, which include: (i) the requesting shareholder owns or operates a substantially competing business; (ii) the requesting shareholder is to provide the information to others and this would damage the interests of the company; or (iii) the requesting shareholder, at any time during a three-year period before he/she/it makes the request, provided relevant information he/she/it obtained during the process of inspecting the books and records of the company to others which caused damage to the company's interests.

A financial investor who has investments in more than one company in a single sector should be aware that its statutory inspection rights as a shareholder in these companies would be restricted under these detailed rules and, if possible, it is advised to request a waiver of such restriction from other shareholders when negotiating the shareholders' agreements for the above investments.

3. Dividend Distribution

Under the Company Law, dividend distribution is an autonomous matter left to the discretion of the shareholders, and the Company Law does not provide the statutory legal basis for a compulsory dividend distribution. Interpretation IV now improves this by offering a shareholder the right to demand dividend distribution under certain limited circumstances, which include: (i) a validly passed resolution on the dividend distribution, but such resolution remains unimplemented; or (ii) there was no valid resolution on such dividend distribution passed, but the demanding shareholder can prove that the lack of such resolution is due to the abuse of shareholders' rights by another shareholder and such abuse of shareholders' rights has caused losses to him/her/it and/or other innocent shareholder(s).

To a financial investor of a PRC company who does not hold a majority interest or does not control the board, this is another protection from abuse of shareholders' right by the majority shareholder.

4. Pre-emptive Rights

Like many other jurisdictions, the Company Law provides a general rule that shareholders of a company have pre-emptive rights to purchase the equity of another shareholder who intends to transfer all or part of its equity to a third party, under the same conditions. Interpretation IV supplements this general rule by providing more detailed operative provisions on how to implement such pre-emptive purchase rights, and such detailed provisions are generally in line with commercial practice which has been in existence. Specifically, these detailed provisions include: (i) intended equity transfer to a third party requires notification of other shareholders; (ii) the time limit for exercising the pre-emptive right must not be shorter than 30 calendar days; (iii) the term "under the same conditions" is defined to include transfer price, payment method, timeline for payment and other factors; (iv) refusal to exercise the pre-emptive purchase right shall be deemed as consent to the transfer to the intended third party; and (v) a transferring shareholder refusing to proceed with the equity transfer to the shareholder(s) who has exercised its pre-emptive purchase right may face compensation claims from such exercising shareholder(s).

The above detailed rules may not be something new to many financial investors (especially those sophisticated international investors) of PRC companies, as their customary shareholders' agreements normally have included similar or even more detailed provisions on pre-emptive rights following international practice. But no doubt this judicial interpretation clearly confirms and elaborates the relevant rules and provides more certainty for legal implementation and judicial enforcement.

5. Derivative Suits

The Company Law generally provides that under certain circumstances, shareholders, supervisors and directors of a company may, on behalf of the company, bring a lawsuit against directors, senior officers, supervisors or third parties who violate laws, regulations or articles of association or infringe the rights and interests of the company and cause damages or losses to the company. Interpretation IV clarifies a number of procedural issues relating to this type of lawsuit on the legal status of various parties, distribution of awards granted and assumption of expenses, etc. It is anticipated that with these concrete and accommodating procedural rules in place, it might be easier for a financial investor of a PRC company who does not control the operation of the company to protect its interests as a shareholder through derivative suits which, as a legal concept, has existed for a while.