China Master Business Law Guide

Cases

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Foreword

Foreign investors in China frequently complain that the vast system of business laws is loaded with vagueness and contradictions. "How can we proceed confidently?" they ask.

China Master Business Law Guide: Cases gives you the most complete — and best — answer to that question. In summary/analysis format, it presents of authoritative interpretations in all crucial legal areas pertaining to disputes arising in the context of a foreign investment, from planning and start-up issues to the many kinds of disputes that inevitably arise in the course of business. With its help you'll:

- learn how government agencies and courts have typically dealt with a wide variety of foreign investment-related disputes;
- benefit from detailed analyses of best practices that lead to successful dispute resolutions;
- navigate confidently through all the obstacles likely to confront you; and
- discern major trends and developments in laws affecting business investment in China.

The disputes studied include issues arising in such areas as employment, labour relations, contracts, arbitration, intellectual property, competition, banking, securities and much more.

There is a comprehensive, well-structured index and a section finding list to facilitate easy location of information.

About the Authors

Most of the cases in this book are provided and written by Mr Tao Jingzhou who is the partner in Johns Day Beijing Office.

Mr Tao has more than 20 years of experience in advising Fortune's 500 companies on China-related matters. His areas of practice include international mergers and acquisitions, arbitration, and corporate work. Mr Tao has represented major European, Japanese, and American companies in hundreds of transactions in China on such matters as the establishment of equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises, tax planning, strategic alliances, and intellectual property protection. He has acted as counsel, chief arbitrator, or party-nominated arbitrator in international arbitration proceedings involving letters of credit, construction projects, management contracts, joint ventures, technology transfers, trademark licensing agreements, agency agreements, and international sales of goods.

Mr Tao is a member of the ICC International Court of Arbitration and the Expert Committee of China International Economic and Trade Arbitration Commission. He is the Chair of the Commission on International Commercial Arbitration of ICC China, an adjunct professor at Peking University Law School, and a Fellow of the Chartered Institute of Arbitrators. In addition, he is a listed arbitrator for the Court of Arbitration for Sport (CAS), the Hong Kong International Arbitration Centre, the China International Economic and Trade Arbitration Committee, and the Beijing Arbitration Commission.

He is the author of several books in English and French on Chinese law. He also has written articles on matters related to Chinese arbitration, foreign investment, and foreign trade.

Honors and Distinctions

Appointed by the Court of Arbitration for Sports to serve as one of the 12 arbitrators in the Court's 2008 Beijing Olympic Games Ad Hoc Division (May 2008); highly recommended lawyer for China dispute resolution — cross border advice by PLC "Which Lawyer? 2008"; recommended by "Who's Who Legal 2009" for commercial arbitration and corporate governance; recognised as a "prominent and respected professional" as well as "one of the best arbitration practitioners in the region" by Chambers Asia 2009.

The rest of cases in this book are provided and written by Judges Wang Yanfang, Zhou Xiaobing, Lin Ziying, Su Hailong, Yao Jianjun and Guo Jingcheng from People's Courts in China.

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COMPANY LAW DISPUTES

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[¶10-001] Shareholders v Hainan Heping Industrial Holding Co Ltd, Li Zhoushu & Zhou Yuanquan

Theme: Shareholders protection under the PRC Company Law

Author: Jingzhou Tao[1]

Based on this case (I), the present article will analyse the relationship between shareholders and management as well as the civil enforcement framework under the *PRC Company Law* (II), before commenting on the decision itself (III) and eventually giving some recommendations as how to deal with non-competition issues in China (IV).

I. Summary of the case

On 19 September 1995, Li Zhoushu (Li) and Zhou Yuanquan (Zhou), Chairman and Vice-Chairman of Hainan Heping Industrial Holding Co Ltd (Heping Industrial) respectively, approved the transfer of the vice-president of Heping Industrial, Ji Guirong (Ji), back to his previous job.

On 3 November 1995, Heping Industrial's President Liu Jingfan (Liu) sent a letter to Zhou saying that in view of the perceived weakness in the management at Heping Industrial, he believed that the vacant post should be filled, and recommended Shao Huitian as a candidate. He also said in the letter that he needed preliminary approval so that the post could be filled immediately. Formal approval could then be obtained at the next Board meeting.

On 10 November 1995, Zhou approved this preliminary appointment in the following words: "In view of the fact that Ji Guirong has left the position of Vice-President and as the work of the company so requires, upon recommendation by Liu Jingfan, Li Zhoushu and I now decide after discussion to appoint Shao Huitian as vice-president of Heping Industrial".

On 15 December 1995, Sanya People's Insurance Company and 17 other shareholders of Heping Industrial made a joint appeal to Heping Industrial for an emergency shareholders' meeting. The appeal requested Heping Industrial to hold such a meeting in Hainan before 25 February 1996 in order to discuss the safeguarding of the shareholders' legitimate rights and interests, the standardisation of the decision-making process among the Board of Directors, and the check on the company's operations generally.

On 10 February 1996, Heping Industrial held an emergency Board meeting in Beijing to discuss how to answer the request presented by some shareholders on 15 December 1995 for an emergency shareholders' meeting. The Board decided that the requested emergency meeting could and should be held at the same time as the annual shareholders' meeting scheduled in April 1996.

On 19 March 1996, Heping Industrial published an announcement in the Hainan Daily on the upcoming fourth shareholders' congress, according to which participants of the congress were limited to shareholders with more than 100,000 shares. Shareholders with less than 100,000 shares could join forces by their own will with other shareholders and choose a representative to participate in the congress once the number of their combined shares reached 100,000, or they could authorise legitimate participants of the congress to exercise their rights by proxy. This announcement was criticised by some shareholders. In view of this, Heping Industrial published another announcement in the

Hainan Daily on 23 March, which content was revised and a note was added saying, "the problems were caused by organizers of the congress and today's announcement should be used as the final information reference for shareholders."

On 19 May 1996, Heping Industrial held a Board meeting in Shenzhen where Ji's dismissal and Shao's appointment as Executive Vice-President were formally approved.

Several shareholders of Heping Industrial initiated a lawsuit against Heping Industrial as well as Zhou (Chairman of the Board) and Li (Vice-Chairman of the Board) on 17 September 1996 with the Xinhua District People's Court of Haikou City, Hainan Province (Xinhua Court), during which they complained that:

(1) although the shareholders had requested an emergency meeting, such meeting was not held within two months after the request, as required by the *Company Law*, and the legitimate rights and interests of the plaintiffs were thus infringed;

(2) the decision to remove the former vice-president and to appoint a new one was made in violation of relevant stipulations of the *Company Law* and of the articles of association and was thus null and void; and

(3) the public announcement made by Heping Industrial on 19 March 1996 was made in violation of the relevant provisions of the *Company Law* and seriously infringed upon the shareholders' decision-making rights and their right to participate in the shareholders' congress. Although Heping Industrial did publish another announcement with revised content, it did not make any public apology to the shareholders, thus causing damage to the reputation of the shareholders.

In view of the above, the plaintiffs requested the court to decide the following that:

(1) the defendants Zhou and Li make a public apology to all shareholders;

(2) the appointment and removal of vice-president of the company should be made invalid; and

(3) Heping Industrial should hold an emergency shareholders' meeting right away in accordance with relevant provisions of the *Company Law*.

The defendants Zhou and Li claimed that the plaintiffs did not possess *locus standii* to bring proceedings against the two board member defendants. According to provisions of the *Company Law*, the Chairman of the Board of Directors and the Board itself are only liable to the company. The *General Principles of the Civil Law* stipulate that the legal representative of the company only bears the company's administrative and criminal responsibilities. Therefore, the plaintiffs cannot sue individual board members. The decision to let vice-president Ji return to his previous job and appoint Shao as the new vice-president was later approved by the Board of Directors and is thus legitimate and valid.

The defendant Heping Industrial claimed that at the time when the case was submitted to the court, the shareholders' congress had already been held and the main items on the agenda raised by the shareholders in their original suggestion were already included in the agenda of the congress. Thus, the substantive rights of the plaintiffs as stated in the suggestion were not violated. After the announcement in the *Hainan Daily* on 19 March 1996 to hold the fourth shareholders' congress which was criticised by some shareholders, the company published another announcement and made an apology. As a matter of fact, all shareholders participated in the congress. Therefore, the shareholders' rights and interests were not violated, nor was their reputation damaged. In view of the above, the defendant believed that the plaintiffs' claims were unreasonable and should be rejected by the court.

The Xinhua Court held as follows:

(1) The right to hold a shareholders' meeting rests with the Board of Directors, not the Chairman or Vice-Chairman. The Chairman and Vice-Chairman were elected by the Board and are thus responsible only to the Board, not the shareholders. There are not sufficient legal grounds for the claim by the plaintiffs that Zhou and Li shied away from their responsibilities, which led to the emergency shareholders' meeting not being held within the legitimate period of time and the rights and interests of shareholders being violated. Nor are there any legal grounds for the plaintiffs to ask Zhou and Li to make a public apology. Therefore, the court cannot support the claims by the plaintiffs.

(2) The acts of defendants Zhou and Li to approve Ji's transfer and Shao's appointment without discussion by the Board is improper, but the decision was later formally approved by the Board and should thus be legal and valid. There is obviously no legal ground for the plaintiffs to ask the court to invalidate the decision. Therefore, the court cannot accept such request by the plaintiffs.

(3) Though the announcement by Heping Industrial in the *Hainan Daily* on 19 January 1996 violated relevant provisions of the *Company Law*, Heping Industrial later made a new revised announcement with a note saying that the problem was caused by the inefficient organisation of the congress. In addition, the shareholders did participate in the congress. Therefore, the right of shareholders to participate in the congress was not violated and their name and reputation were not damaged.

(4) The *Company Law* does provide that shareholders with over 10% of the company's shares are entitled to request the company to hold an emergency shareholders' meeting, but there is no stipulation on how to realise such right of the shareholders when the Board rejects the request or deliberately delays execution of the request. Therefore, it is still difficult at this stage for the court to support the plaintiffs.

The Court therefore rejected all claims by the plaintiffs.

II. The legal issues at stake

The main issue at stake is the protection of shareholders' rights and their enforcement against a management that does not comply with the law and/or the articles of association. This question is particularly interesting in the light of the recent revision of the *PRC Company Law* in 2005, and which entered into effect from 1 January 2006 (2006 Company Law).

Under the former *Company Law* which was revised in 2004 for the second time after its promulgation (2004 Company Law), although shareholders were conferred certain rights, those rights were provided mainly without corresponding civil remedies leaving the door wide open to abuses by members of the management. The *2006 Company Law* introduced new rules governing the relationship between shareholders, ie investors, and the management, accompanied by direct and indirect civil remedies. In the light of the case at stake, which was decided upon under the *2004 Company Law*, the present analysis will show where the deficiencies lay and in how far these have been cured by the *2006 Company Law.*

A. Shareholders' rights and management liabilities under the 2004 Company Law

Under the *2004 Company Law*, the shareholders meeting was the authoritative organisation of the company and the law contained several provisions on the holding of shareholders' meetings, their organisation and the participation thereto (Art 37–44). Besides the annual meeting, the law also provided for the possibility of a so-called "interim" shareholders meeting upon request by shareholders holding 10% or more of the company's total share capital. Upon such request, the Board of Directors shall organise a shareholders' meeting within two months (Art 104).

Further, shareholders had the right to review the minutes of meetings of the shareholders meeting and the financial and accounting statements of the company (Art 32).

Finally, the *2004 Company Law* also set forth a series of obligations and liabilities of the management, such as:

(1) Directors, supervisors and manager of a company shall abide by the articles of association, perform their duties faithfully, and safeguard the interests of the company. They are not allowed to exploit their positions and powers in the company for personal gains. Directors, supervisors or manager of a company shall not exploit their position to accept bribes or other illegal income or wrongfully take over the company property (Art 59).

(2) Directors or manager of a company are not allowed to misappropriate the funds of the company or loan such funds to others. Directors or manager of a company are not allowed to deposit the assets of the company in their own or other personal bank accounts. Directors or manager of a company shall not provide assets of the company as guarantee for the debts owed by shareholders of the company or by others (Art 60 and 214).

(3) Directors or manager of a company shall not engage on their own behalf or on behalf of others in any businesses that are the same of that of the company or activities that are harmful to their own company. The proceeds from any such businesses or activities shall belong to the company. A director or a manager shall not enter into any contracts or transactions with the company except otherwise provided for in the articles of association or with the consent of the meeting of association or with the consent of meeting of shareholders (Art 61).

(4) A director, a supervisor, or a manager of a company shall not divulge secrets of the company except according to law or with the consent of the meeting of shareholders (Art 62).

(5) Where a director, a supervisor, or a manager of a company violates the law, administrative decrees, or the company's articles of association in performing his/ her official corporate duties resulting in harm of the company, such director, supervisor, or manager is liable for compensation for the damage (Art 63).

(6) Directors and manager of a company shall abide by the provisions of the articles of association, faithfully perform their duties, protect the interests of the company and may not exploit their positions and powers to seek personal gains (Art 123).

Thus, although the *2004 Company Law* clearly put limits to the powers of the management and provided for a liability in case of violation of the managers' duty, it did not specifically provide for a civil enforcement mechanism at the disposal of the shareholders. Thus, although a director who violated the articles of association or a provision of the Company Law was to be held liable for damage deriving therefrom, it was unclear who was entitled to sue him/her and under what procedural rules.

Article 111 of the *2004 Company Law* further provided that if resolutions of a shareholders' meeting or of the board of directors have violated the law, administrative decrees or encroached upon the legitimate rights of shareholders, the shareholders concerned have the rights to sue at the people's courts, to demand that such acts of violation or infringement be stopped. Although this article seemed to give a direct right to the shareholders to sue before the court, the defendant to such lawsuit would be the company itself and not the faulty managers. Moreover, courts, including the Supreme People's Court, were very reluctant to accept such cases[2].

This is exactly what happened in the present case, where the court acknowledged that the management had not acted appropriately and in accordance with the law and articles of association, but nevertheless was not willing to take any specific actions and grant the plaintiff's requests.

In summary, the *2004 Company Law* contained few provisions protecting shareholders' interests and almost completely lacked civil enforcement remedies against misbehaving management members.

B. Shareholders' rights and management liabilities under the 2006 Company Law

The *2006 Company Law* clearly reinforces the concept of corporate governance and grants shareholders extensive rights to bring civil lawsuits to force compliance with corporate governance matters.

Articles 20, 21 and 149 of the *2006 Company Law* provide for minority shareholder protection by imposing stricter liabilities on majority shareholders and management:

(1) The shareholders of a company shall abide by laws, administrative regulations and the articles of association of the company, exercise their rights according to law, and shall not abuse their rights to damage the interests of the company or other shareholders nor abuse the independent status of corporate legal person and shareholders' limited liability to damage the interests of the company's creditors. The shareholders, who abuse their rights so as to cause losses to the company or other shareholders, shall undertake the liability for compensation. If the shareholders of a company abuse the independent status of corporate legal person and shareholders' limited liability to avoid debts and damage the interests of the company's creditors, they shall undertake the joint and several liability for the company's debts (Art 20, so-called doctrine of "piercing the corporate veil").

(2) The holding shareholders, actual controllers, directors, supervisors, senior executives of a company shall not, by taking advantage of their affiliate relationship, damage the interests of the company. They shall, in violation of the provisions of the preceding Paragraph, undertake the liability for compensation if any loss is caused to the company thereby (Art 21).

(3) The directors, supervisors and senior executives of a company shall not commit any of the following acts:

- Misappropriate the company's funds,
- Deposit the company's assets in their own personal accounts or in personal accounts of other individuals,
- In violation of the company's articles of association and without the consent of the shareholders meeting or the shareholders general meeting or the board of directors, lend the company's funds to others or use the company's property to provide guarantee to others,
- In violation of the company's articles of association or without the consent of the shareholders meeting or the shareholders general meeting or the board of directors, enter into contracts or conduct transactions with the company,
- Without the consent of the shareholders' meeting or the shareholders' general meeting, by taking advantage of their positions, seek for themselves or others the commercial opportunity that should belong to the company, or operate for themselves or others the same category of business as that of the company,
- Accept and possess the commission in the transaction between others and the company,
- Disclose the company's secrets without authorisation, and
- Commit other acts in violation of the duty of loyalty to the company.

The *2006 Company Law* then provides the shareholders with explicit civil remedies:

(1) Shareholders of the company may, within 60 days upon the date of making the resolution, request the people's court to cancel resolutions of the shareholders' meeting or the Board of Directors if the convening procedures and voting method were taken in violation of the laws or articles of association, or the contents of such resolutions are in violation of the articles of association (Art 22).

(2) Where directors, supervisors and senior executive of a company violate the laws, administrative regulations or the articles of association of the company in performance of their functions and thus cause loss to the company. In such cases, the responsible member of management is liable for compensation and the *2006 Company Law* introduces a derivative action, according to which shareholders may directly initiate legal proceedings in the people's court in their own name for the benefit of the company (Art 152).

(3) Further, where directors, supervisors and senior executives of a company violate the laws, administrative regulations or the articles of association of the company in performance of their functions and thus cause loss to the shareholders directly, the latter are given now the possibility to sue directly on their own behalf the responsible management staff (Art 153).

C. Procedural aspects

These provisions provide for a direct and a derivative action in favour of shareholders fulfilling certain requirements, such as having held 1% of the shares of the company for at least 180 consecutive days as concerns companies limited by shares. The standing to sue belongs to the shareholders directly and more specific guidelines in this respect have been issued by the Supreme People's Court in its *Provisions on Several Issues concerning the Application of the PRC Company Law* of 28 April 2006, the defendants to such action being the directors, senior officers or supervisors of the company.

As of today, the law does not provide that majority or otherwise controlling shareholders may be subject to derivative or direct actions. Further, it is still unclear which role the company will hold in a derivative action, whether it should be co-defendant with the concerned staff of the management, or whether it shall act as co-claimant, or simply as a third party without independent claim. It is to be seen how this issue will be handled by the various courts.

However, in any case, before initiating a derivative action, shareholders must first either:

- ask the company's board of supervisors to initiate a lawsuit against the concerned members of the management, or
- file a request with the board of directors to cause the company to sue the offending supervisors (so-called "demand requirement").

Only if the board of supervisors or the board of directors refuses or fails to take action within 30 days upon receipt of the request, can the demanding shareholders bring a derivative action on the company's behalf against the concerned members of the management.

As concerns the statute of limitation, since the *2006 Company Law* does not provide for any specific limitation period, the general rule of two years apply (Art 135, *General Principles of Civil Law*). The limitation period is usually calculated from the day the entitled person knew or should have known about the damage (Art 137, *General Principles of Civil Law*). The problem is that in a derivative action the damage is caused to the company, but the action is initiated by the shareholders. So whose knowledge of the harm is relevant? The company's or the shareholders'? The shareholders, and in particular minority shareholders, are not always immediately informed of a harm caused to the company, and it would therefore seem somewhat unfair to have the limitation period start on the day the company, ie the faulty management, knew or ought to have known about the damage, whereas the shareholders may remain in the dark for several months or years. It will be interesting to see how Chinese courts will deal with this issue and whether it will be necessary for the legislator to provide for a specific limitation period.

III. Commentary on the decision

The decision in itself may seem disappointing to the western legal scholar, but it is not surprising taken into account the legal framework in place at the time the decision was rendered. The way the *2004 Company Law* was conceived was not corporate governance friendly and was not supposed to give shareholders direct rights to interfere with the company's management. However, with the economy developing so quickly, shareholders got more educated and started to claim their rights, which put the courts in a delicate situation pushing them to make a choice between extrapolating the law and ignoring the needs of the shareholders. Not surprisingly, courts mostly chose to ignore the needs of the shareholders. The same thing happened in the present case. The decision of the Xinhua Court was all the more unspectacular as the lawsuit was filed after a shareholders' meeting had in the meantime ratified the controversial decisions taken by the management, so that besides a public apology from part of the concerned members of management for their wrongdoing, nothing else could really be done to revoke these decisions.

IV. Recommendations

As mentioned above, the *2004 Company Law* contained few provisions with regard to the protection of the shareholders' interest and lacked civil enforcement remedies against the misbehaviours of the company management members. It is good to see that the *2006 Company Law* has made some "revolutionary" revision in reinforcing the protection of the shareholders' interests and providing the shareholders with some explicit civil remedies.

However, there still remains some loopholes in the protection of the shareholders' rights and interests in the current Chinese legislation, in particular in the procedural aspects which may need to be enriched in the course of court practice and the confirmation in the judicial interpretations.

Further, it is also worthy to note that the *2004 Company Law* has remained almost unchanged for the past ten years regardless of the significant changes in social activities, resulting in Chinese company law lagging behind these developments for almost 10 years. Therefore, it would be more practical for the legislator to amend the *2006 Company Law* regularly to meet the requirements of social development.

Footnotes:

1 The author gratefully acknowledges the assistance of his colleagues, Clarisse von Wunschheim and Edward Hillier, in the preparation of this paper.

2 See the *SPC Circular on Temporary Dismissal of Securities-related Civil Remedies Cases* issued on 21 September 2001, which stated that judicial remedies to illegal securities activities such as insider trading, fraud and market manipulation were new issues that should be looked into by the people's courts, but that the latter were not yet in a position to accept and hear cases due to the existing legislative and judicial limitations.