Corporate deadlock – a reason to dissolve your China company

Description

It is not rare to see a Sino-foreign joint venture company (indeed any type of company) to run into a stalemate where the operation comes to halt or the minority shareholder(s) is marginalized with no rescue. For the victims in such deadlock, there should be a way out of it. After all, justice should be upheld.

I. The Law and Judicial Interpretation

As a remedy to the shareholder(s) caught in such a stalemate, China Company Law (revised in 2013) provides for the following rule in its Article 182:

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> Where a company has serious difficulty in its operation and management and its continuance would cause material losses to the interests of the shareholders, and such difficulties cannot be resolved through other means, shareholders who hold 10% or more of all the voting rights of the company may request the people's court to dissolve the company.

This simple clause is too general and of principle only. As a customary practice, it is the China Supreme Court's job to elaborate on the interpretation and application of this general rule. So here comes the CSC's second judicial interpretation on China Company Law issued in May of 2008 (as further amended in 2014) which much centered on this Article 182 and its application in judicial practice. Article 1 of the judicial interpretation goes:

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> Article 1 Where shareholder(s) that hold(s) 10% or more voting rights alone or in aggregate initiates legal proceeding to dissolve a company in compliance with Article 182 of China Company Law, the people's courts shall accept the filing of such cases:

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> the company is unable to convene its shareholders' meeting for consecutive two years, resulting in serious difficulties in corporate operation and management;

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> upon voting, shareholders are unable to reach the percentage as provided by law or company's articles of association, and fail to deliver any valid resolution for consecutive two

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years, resulting in serious difficulties in corporate operation and management;

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Corporate directors are in disputes for long which are unable to be solved through shareholders' meeting, resulting in serious difficulties in corporate operation and management;

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other serious difficulties in corporate operation and management whereby the continuous subsistence of the company will lead to material damage to the interests of the shareholders.

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The people's courts shall not accept filing of cases for dissolving companies which are initiated by shareholders on the grounds such as infringement on their right to know, right to dividend, or corporate loss/deficit, assets being insufficient in paying of debts, or failure to liquidate the company following cancellation of its business license.

These are the basic rules in this regard under Chinese laws.

II. Theoretical Understanding of Corporate Deadlock

There are few articles offering academic insights into the commonplace phenomena in the corporate world. Most corporate law professors/books simply explain what a corporate deadlock and how to deal with it in practice. While pragmatically, that is fine, there is a conspicuous lack of theory that can well explain corporate deadlock.

A company is a legal person with its own "will", the essence of being a person under law. As in the case of natural person whose capacity to act is closely examined in light of the soundness of the mental state of that person, in other words, in light of the power and soundness of his or her will. A company as a legal person has its own capacity to act (as compared with capacity for rights) issue which shall be examined and determined in light of the running of the mechanism to form and express corporate will.

There are two layers of Will issues in the case of a company. As the agent of and for shareholders (please refer to the other article on this blog, Corporate Personality and Limited Liability), the company has its own will on the one hand and it is also subject to and in deference to the will of shareholders (who are principal in the agency relationship with the legal-person company). Now, any failure or dysfunction of the will at both layers would lead to the incapacity to act on the part of the company, namely, the corporate deadlock.

The listed circumstances in the China Supreme Court interpretation are related to the will issue at either shareholders (principal) level or at the company level (the agent, the company's will is based on and abstracted from the collective will of corporate directors).

So in my opinion, corporate deadlock is the temporary cease or loss of the company's capacity to act

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in which case the purpose of shareholders incorporating the company is frustrated, thus the law should allow the shareholders to dissolve the company.

The goal or rationale behind this provision is to protect the suffering shareholder (often the minority shareholder) in a company that is stuck in stalemate situation and finally break the deadlock.

III. Application in Judicial Practice

Facts triggering the application of this clause seem not hard to determine except the proving of the fact that the company is in serious difficulties in corporate operation and management.

Confusion arises in particular when the company in question is being managed in good condition and is actually making good profits (often due to the reason that the controlling shareholder or management is taking care of the company competently) at the time of being sued for dissolution.

Over time, the confusion is no longer existing after China Supreme Court made it clear in one of the published guiding precedent cases in which the Supreme Court stated that courts should look into the functioning of the corporate organs in determining whether there is a deadlock, and a deadlock shall be found if the share-holders meeting or board of directors cannot operate despite that the company is making money.

So investors in foreign invested companies esp Sino-foreign joint ventures in China shall take advantage of this clause in China Company Law to end the impasse in the dead valley.

Lastly, it shall be noted that the China Company Law requires that other remedies shall be exhausted before the court can order the dissolution of a deadlocked company. Because of this, in practice, Chinese courts are not that ready to easily dissolve a company. Instead, the courts will organize the parties to the dispute to reach a settlement and this mediation efforts by courts may happen repeatedly in a lawsuit, which will generally drag the legal proceeding over a very long period, say one or two years. So parties embarking on this road to end their misery in a deadlocked company shall be prepared for a long battle.

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