Case Study: Shareholder's Pre-emptive Right to Purchase Equity Interests under China Company Law

Description

It is a landmark court decision in China corporate law practice in the judicial system, having far-reaching impact for anyone that holds equity interests in China limited liability companies.

The decision was made not long ago by a Shanghai People's First Intermediary Court in the high profile dispute between Fosun and Soho in regard of the equity interest transfer in the project company that had acquired a piece of land in Shanghai Bund area, the most expensive part of Shanghai. Because both parties, Fosun and Soho are well-known developers in China, and their bosses are also big names in China, the fight engaged between them has attracted wide attention in both real estate industry and law practice.

Let me summarize the facts of the case and the gist of the court ruling.

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1. Facts of Fosun-Soho Dispute

Facts: the project company, a limited liability company incorporated under China Company Law, was originally held by four shareholders at the following ratios: Fosun 50%, A 35%, B 10% and C 5%. Fosun is the majority shareholder, being able to make many daily management decisions for the project company, subject to the articles of association of the project company. Then mouth-watering at the piece of golden land, Soho indirectly purchased the equity interests held by A, B and C by acquiring full ownerships of A, B and C from their parent companies through two of its wholly owned subsidiaries D and E. Note specifically here that Soho did not purchase the equity interests in the project company directly from A, B and C, which would put itself at par with Fosun. However, Fosun was not happy with the deal. Fosun alleged that Soho's acquisition of the equity interests in the project company violated Fosun's pre-emptive right to purchase the same equities which right is provided under China Company Law. Soho apparently proceeded to complete the deal against Fosun's allegation.

Naturally, Fosun took Soho to court to stop and annul the deal based on the ground that the said deal violated its pre-emptive right to purchase. So the whole legal saga in the end boiled down to the very question: whether Soho violated Fosun's pre-emptive right, without much disputes over facts.

2. Point of Law in Question

So basically, the court was asked to interpret the rules regarding pre-emptive right under China Company Law.

Article 72 is the main provision of China Company Law regarding transfer of equity interests in a limited liability company, which says:

> Article 72 Shareholders of a limited liability company may transfer all or part of its equity interest amongst one another.
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> If a shareholder transfers its equity interest to a party other than a shareholder, it shall be consented to by more than half of the other shareholders. The shareholder shall notify the other shareholders of the equity transfer in writing and seek consent from the other shareholders. If the other shareholders fail to reply within 30 days after receipt of the written notice, they shall be deemed to have consented to the transfer. If half or more of the other shareholders disagree with the transfer, the shareholders who disagree with the transfer shall purchase the equity interest to be transferred, otherwise, they shall be deemed to have consented to the transfer.
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> In respect of equity interest the transfer of which has been consented to by the shareholders, other shareholders shall have a pre-emptive right of purchase under the same terms and conditions. If two or more shareholders claim to exercise the pre-emptive right to purchase the equity interest, they shall determine their respective ratio of purchase through negotiation. If no agreement can be reached through negotiation, the pre-emptive right of purchase shall be exercised on the basis of their respective ratio of capital contribution at the time of transfer.
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> If the company's articles of association contain other provisions in respect of equity transfer, those provisions shall govern.

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The literal meaning of the clause or the general understanding of it, is that pre-emptive right is intended to regulate and govern the relationship of shareholders of the same one limited liability company, to ensure the stability or equilibrium between shareholders of a certain company without causing turbulence within the company.

With that understanding in mind, it is actually quite simple to conclude that Soho has not violated Fosun's pre-emptive right because the shareholders of the project company have not changed at all after Soho's moves.

3. Court's Interpretation of the Law

The Shanghai First Intermediary Court started with finding that the project company was controlled by three different stake-holders establishing its reasonable corporate governance whereby Fosun enjoyed the controlling stake as a majority shareholder. But after the deal, because the other 50% percent of equity interests was ultimately held by Soho, the deal had substantially infringed upon Fosun's position as a controlling shareholder, in the project company, breaking the original internal equilibrium and trust between shareholders that were there from outset of setup of the project company.

Then the court interpreted that a limited liability company under China Company Law is a personal and closed company stressing on inter-shareholder personal relationship as opposed to a public company, and this is reflected in Article 72 of the company law. The pre-emptive right provided therein is a statutory and personal right that should be complied by related parties. Soho and those sellers of the equity interests in the project company while aware of such laws had circumvented the law by

conducting indirect sale of the equities with a direct effect of avoiding compliance with the rules set out in the Article 72, and depriving Fosun of its pre-emptive right. Therefore, the deal by Soho was against the laws and the contracts were just the legal disguise in covering up their illegal objectives. In the end, the deal by Soho was declared void and invalid, and the transfers thereunder shall be restituted to its pre-deal state.

4. Question and Impact of the Court Decision

While the decision may be subject to controversy and dispute, I personally support it, as otherwise the pre-emptive right will be easily circumvented leading to injustice against shareholders. But once the protection of the pre-emptive right is extended beyond the company whose equity interests is being transferred, one cannot help asking how far the court can go in protecting the pre-emptive right?

Assuming that Soho just buys out A from A's shareholder(s) only but uses another entity to buy out B and C which entity is controlled by Soho by way of contract arrangement or other methods other than shareholding, will the court be able to come to the same decision?

To stretch the issue further, as most foreign-invested enterprises in China take the form of limited liability companies with the foreign investors very often setting up an offshore intermediary companies in HK or other places which immediately hold the equity interests in such foreign-invested enterprises, will the foreign investors transferring their equity interests in the foreign invested enterprises indirectly by transferring their shares in the offshore intermediary entities, infringe upon the pre-emptive right enjoyed by their Chinese partners in the foreign invested enterprises? It is question that has to be answered carefully.

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So the court decision will greatly affect the corporate practice in respect of limited liability company in China including foreign invested companies.

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