北京大成(上海)律师事务所
上海浦东新区银城中路 501 号
上海中心大厦 15 楼，16 楼
邮编：200120

15/F, 16/F,
Shanghai Tower 501, Middle Yincheng Road,
Shanghai 200120, P. R. China

大成 Salans FMC SNR Denton McKenna Long
dentons.cn

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China Law Update

Share Repurchase under China Company Law

--- Commentary on China Supreme Court Ruling

Contents

Sparked by court cases in private equity investment world recent years, share repurchase by the company (whose shares are being repurchased) has been a hot topic in the legal arena. Foreign investors in China may well be involved in such a share repurchase arrangements, and it is of interest to foreign investors that may have made or will be making investments in China.

I. Concept of Share Repurchase in China Laws

The idea of share repurchase may be a bit different from that in the western legal and business world. According to Investopedia website, "*A share repurchase is a program by which a company buys back its own shares from the marketplace, usually because management thinks the shares are undervalued, reducing the number of outstanding shares*". In its common sense, a share repurchase refers to the purchase by a company of its own shares. However, in China, a share repurchase can often refer to the purchase by the controlling shareholder of the shares held by another shareholder who often is VC or PE investor.

In the case of China limited liability companies that don't really issue shares, then the share in "share repurchase" shall be substituted for equity interests measured in term of percentages of corporate ownership.

The share repurchase issues surge with the rampant expansion of China private investment industry recent years. A PE investor generally resorts to value adjustment mechanism to demand the invested company and/or its controlling shareholder to buy back its shares or compensate for its investment in the company or demand the company to issue additional shares or the controlling shareholder to transfer additional equity interest to it when the defined events of failure to meet certain corporate performance criteria arise.

Back in 2013, China Supreme Court made a landmark ruling in a case in which a PE investor requested both the invested company and the controlling shareholder to buy back its shares in the company at the pre-determined prices after the invested company failed to attain the annual profit goal stipulated in investment contract. The case made its way up to China Supreme Court from a municipal intermediary court (the trial court).

II. Share Repurchase by Company

First of all, is a company allowed to buy back its own equity interests or shares under China laws?

As a civil law system country, China has been sticking to the corporate capital principle of "capital maintenance" rule, meaning a China company shall not reduce its own registered capital except as otherwise mandated by the law. If we examine China Company Law, there are indeed provisions authorizing a company to buy back its own equities or shares.

In the case of a China limited liability company, without a general prohibition, Article 74 of the Law provides:

> *Shareholders who have voted against a resolution at a shareholders' meeting may request the company to buy out its equity interest at a reasonable price under the following circumstances:*

(1) where the company has not distributed profits to shareholders for five consecutive years although the company has made profit in those five years and satisfied the conditions for distributing profits in accordance with this Law;

(2) where the company undergoes a merger or division or transfers its main assets;

(3) where the term of operation of the company has expired in accordance with the company's articles of association, or where other events of dissolution as provided in the articles of association has occurred, but the shareholders' meeting has resolved to amend the articles of association to enable the company to continue its existence.

If the shareholders and the company cannot reach an agreement on the buy-out of the equity interest within 60 days of the adoption of the resolution by the shareholders' meeting, the shareholders may issue a legal proceeding to the people's court within 90 days of the adoption of the resolution by the shareholders' meeting.

So it is clear that under those circumstances set out above, a limited liability company may be ordered to buy back its own equity interests from disgruntling shareholders at reasonable price (no guidance on how to determine what a reasonable price is).

Apparently, the demand of the PE fund requiring its invested company to buy back its shares as a result of the triggering of the value adjustment mechanism does not fall within the ambit of the quoted law provision. So the question is whether it is legal or enforceable for the investor shareholder to have his shares repurchased by the company?

Before the landmark decision by China Supreme Court as mentioned above, many private investment funds design their value adjustment mechanism by asking the company to pay some money back or ask the company to buy the shares back, but not after the supreme court decision.

According to the landmark decision, value adjustment mechanism cannot demand the company to pay compensation to the investor (often PE funds) which is illegal for the reason that such payout by the company damages the interests of the company and its creditors, as provided in Article 20 of China Company Law.

Now, are we saying that share repurchase by the limited liability company is all illegal except for those set forth in Article 74 quoted above?

Not really.

There have been quite a number of cases involving company buying back equity interests from outgoing employees who had received such equity interests as part of corporate incentive plan. The company usually retains the right to buy back the equity interests from the employee in the stipulated circumstances.

However in the case of a repurchase of shares by the company, consequently the corporate capital will be undermined as a result of share repurchase, which will cause adverse impact on the protection of corporate creditors. As provided in China Company Law, the company upon repurchasing its own shares shall undertake to effect the capital reduction formalities during which proceeding creditors shall have the right to request the company to pay off its debts or offer security.

The above is mainly focused on share purchase by a limited liability company, then what about the stock company limited by shares?

China Company Law imposes a stricter restriction on stock company in terms of buying back their own shares. Article 142 of China Company Law prescribes a general prohibition on share repurchase by a company limited by shares:

Article 142　A company shall not repurchase its own shares, except under one of the following circumstances:

(1)　to reduce its capital;

(2)　to merge with another company that holds its shares;

(3)　to reward its staff and workers with shares;

(4)　when a shareholder who votes against the resolution of the shareholders' general meeting on the merger or division of the company requires the company to repurchase his shares.

When a company repurchases its own shares by reason of the provisions in (1) to (3) of the preceding clause, the resolution of the shareholders' general meeting shall be required. After a company has repurchased its own shares in accordance with the preceding clause by reason of the provision in (1), the repurchased shares shall be cancelled within ten days of the repurchase, and if *by reason of the provision in (2) or (4), the repurchased shares shall be transferred or cancelled within six months.*

When a company repurchases its shares by reason of the provision in (3) of Clause 1, the amount of shares it repurchases shall not exceed 5% of total amount of shares it has already issued. Funds used to repurchase such shares shall be paid out of the after-tax profits of the company. The shares so repurchased shall be transferred to the staff and workers within one year.

A company may not be the pledgee of its own shares.

So for a company limited by shares, share repurchase can only be conducted in the circumstances as set out in the Article 142. It is noteworthy that in the case of rewarding or incentivising employees (or the employee stock option plan), the company can buy back its own shares so long as the fund for the repurchase is from the cumulated profits. The rationale behind the provision is that if the money for repurchasing the shares is from the profits and does not invade the legal capital of the company, then such repurchase won't necessarily erode the financial health and credibility of the company, in particularly, in terms of repaying debts owed to its creditors.

III. Share Repurchase by Other Shareholders

In that aforementioned landmark case, as per the investment contract (capital increase agreement), the PE investor was also entitled to demand the other shareholder (the original promoting shareholder of the company in question) to pay to the PE investor a compensation as calculated with pre-determined formula.

So is it legal to request one shareholder to buy back the equity interests or shares held by another shareholder?

Apparently this is not really an easy question to answer.

In the landmark case mentioned above, the judges at the provincial appellate court (subordinate only to China Supreme Court) based its erroneous ruling of nullifying the VAM agreement on the ground that the VAM compensation clauses in the agreement violated the general principle of risk-sharing in the investment world, meaning between shareholders, no one is obligated to ensure the investment return for another. Similarly, the trial court (the intermediary people court in Lanzhou city cited Article 8 of *Sino-Foreign Equity Joint Venture Law* which provides that JV parties shall share profits in accordance with their capital contribution ratio in the joint venture company, thus inferring to the conclusion the VAM compensation by one shareholder to another is in violation of the law, and therefore void.

Given that China Company Law has since 2006 allowed shareholders of a company to share corporate profits in such a ratio as could be different from that of their capital contributions, the idea of shareholders having to share profits in such a ratio of their capital contributions seems old-school and outdated. But one should however duly take note of the fact those rules are basically applied to domestic companies (without foreign equity interests or shares). When a Sino-foreign invested company is in question, rules are different. In Article 271 of China Company Law, it provides that foreign invested limited liability company or company limited by shares shall be governed by this China Company Law ***except as otherwise provided in foreign investment laws***. This means that if both China Company Law and foreign investment laws provide for the same subject matters, then foreign investment laws shall prevail. This plausibly gives credit to the ruling of the trial court. Foreign investors making investment in China Company shall be mindful of articles of association in regard of profit sharing issue.

Surprisingly China Supreme Court didn’t follow the reasoning and logic described in the preceding paragraph to nullify the VAM clause between shareholders, instead, without addressing why the appellate court was wrong in its reasoning and decision, it simply stated that the compensation and buyback agreement between shareholders won’t damage the interests of the company and its creditors, therefore it is held valid.

The Supreme Court decision is so concise and simple (or I should use the word “rough”) that prompted me to think that there must be something that was intentionally left out and untold. The decision was made in response to the outcries and confusion caused by the trial and appellate courts’ decisions in the private investment world which industry has relied heavily on share repurchase and other VAM mechanisms in structuring their equity investments in companies. Nullification of such VAM mechanism will deal a severe blow to private equity investment industry that is very crucial for China to upgrade its economy.

To me, the China Supreme Court is not a good judgment from legal point of view, but is good judgment as a pragmatic concession to social economic development and reality.

IV. Questions on China Supreme Court Decision

While this landmark decision from China Supreme Court has pacified the private equity investment world and avoided chaos, as said above, this decision is not a good one from legal professional point of view as it carried no convincing reasoning and logic in arriving at the ruling.

Following the issue of this landmark decision, many lawyers have taken it for granted that this is right and have written a lot heralding the decision without questioning the credibility of the ruling. Actually, there are questions to be asked about the supreme court decision.

(1) Application of Article 20 of China Company Law

In its ruling, China Supreme Court after summarizing the VAM clauses in the case went on saying that the agreement made it possible for the investor shareholder to make relatively fixed return that was not based on the performance of the company, which damaged the interests of the company and its creditors, and then continued to affirm the application of Article 2o of China Company Law by the trial court in nullifying the VAM clause between the shareholder seeking to have its share repurchased and the company.

Anchoring the decision on Article 20 of China Company Law sparked controversies on the credit of the judgment.

Article 20 provides:

> *Shareholders of a company shall abide by the laws, administrative regulations and the articles of association of the company and exercise shareholders' rights according to law. Shareholders shall not abuse their rights as shareholders to impair the interests of the company or other shareholders, or abuse the independent legal person status of the company or the limited liability of shareholders to impair the interests of creditors of the company.*
>
> *Where the shareholders of a company abuse their rights as shareholders and cause losses to the other shareholders, the shareholders shall be liable to compensate such losses according to law.*
>
> *Where the shareholders of a company abuse the independent legal person status of the company or the limited liability status of shareholders, evade debts and seriously impair the interests of the creditors of the company, the shareholders shall bear joint and several liability for the debts of the company.*

Article 20 is the "piercing corporate veil" clause of China version to which corporate creditors can resort to impose personal liability on the shareholders of the company for the debts owed by the company.

The application of this law in the said case seems far-fetched to me for, *inter alia*, the following reasons:

(i) Piercing corporate veil in China requires the existence of abusive conducts of the controlling shareholder that often include obvious under-capitalization and egregious disregard of corporate forms etc.. But in this case, the private equity investor simply exercised a right that had been duly inked in a contract with no intention to hurt any third party creditor. Indeed, the fact that the investment by the investor had actually augmented the company's capability in meeting its obligations to third parties and that the PE investor was just a minority shareholder holding 3.85% of the company entire equity interests will render it ridiculous to allege abuses on the part of the PE investor shareholder.

(ii) Piercing corporate veil will require the proof of actual damages to the third party who then gains the right to sue not only the company but also its shareholders for joint and several liability. In this case, there is no actual damage incurred by any third party creditor. Actually, there is no third party creditor involved in the case at all.

So from this simple analysis, it is not difficult to find a bad ruling out of the judgment.

(2) Role of Capital Maintenance Principle in the Landmark Case

Personally, under current China corporate laws, I did agree at large with the decision of China Supreme Court except for its reasoning in reaching its decision, I mean the application of Article 20 of China Company Law.

I personally believe the real rationale and legal ground underpinning the Supreme Court decision lie with the capital maintenance principle that is considered the structural backbone of China Company. Emanating from capital maintenance principle, it is widely recognized and upheld that unless explicitly mandated by the law, shareholders shall not take back or be disbursed with any fund or asset from their invested company with a view to keeping legal capital within the company for purpose of meeting obligations owed to third party creditors, a balance many civil law countries' corporate laws trying to strike and achieve between corporate shareholders and creditors.

As a fundamental principle, contractual agreements in violation of capital maintenance rule ought to be negated on the ground that it will damage the interests of the corporate third party creditors. In the cited landmark case, the agreement of the company to pay additional compensation to the private equity investor shareholder had no legal basis in China Company Law, was an apparent breach of the capital maintenance principle, and thus should be declared as void.

But the problem before judges trying the case is that while capital maintenance principle is manifested in quite a few articles in China Company Law such as watered stock and profit distribution, the Law has no provisions directly prohibiting unauthorized payments by a limited liability company to its shareholders. This poses a difficulty to the judges' delivery of written judgment since judicial practice of writing judgments requires reference to specific law provisions.

Though I agree at large with the court decision of invalidating the VAM clause with the company in this case, I also have reservations on the decision.

(i) Worldwide, capital maintenance principle has seen a decline in its importance because effectuality of this principle in protecting corporate creditors has been seriously doubted and challenged. A conspicuous example is the corporation laws in United States where most of states have abandoned the legal capital rules, paving the way for a much more flexible regime concerning the repurchase by the company of its own shares. It is possible that China will revise its company law to allow more liberal practice of share repurchase.

(ii) Even under the current China Company, it could be argued for room for validating the VAM clauses in the landmark case. Assuming that after the payment of compensation out of its profits or even its capital reserve fund, by the company to the PE investor shareholder, the company still has sufficient funds to meet its overall debts to creditors, would it still be reasonable or justifiable to invalidate the VAM compensation clause in the case? After all, nobody is hurt and no interests are damaged. When the corporate creditors' interests are well protected and served, the current China Company Law even allows the reduction of registered capital of a company, why not the company be allowed to pay out a compensation it has agreed from the outset of entering into the investment deal with the private equity investor?

(3) What If the PE Investor Were Foreign Fund

In this landmark case, the private equity investor is a domestic company with no foreign shareholder, and the party that was requested to repurchase the shares is actually a foreign company incorporated in Hong Kong (for purpose of laws, Hong Kong is regarded as foreign territory). The upholding of the share repurchase agreement between shareholders in this case is in favor of the Chinese party which won't trigger the sensitive issue of money flight out of China. I personally believe if the parties reversed their identities where the foreign PE investor requested the Chinese controlling shareholder to repurchase its shares or give additional compensation or otherwise readjust their position to give away more benefits to the foreign PE fund, the court would have difficulty in delivering a positive ruling in favor of the foreign PE investor that, though I cannot be ruled it out completely. Instead, the courts may readily resort to Article 8 of Sino-foreign Equity Joint Venture Law in invalidating the VAM arrangements between the shareholders.

The rationale is that such readjustment would create a new pipeline for Chinese citizens and businesses to transfer their assets and money out of China illegally.

So foreign investors in China entering into similar arrangements shall be mindful of such pitfalls.

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田杰 律师	**Jason Tian**
北京大成（上海）律师事务所	Dentons Shanghai Office
中国上海浦东新区银城中路 501 号上海中心大厦 15/16 楼	15, 16F, Shanghai Tower, No. 501, Middle Yincheng Road, Shanghai, China
直线电话：+8621-20283433	Office Line：+8621-20283433
移动电话：+86-13816548421	Mobile Phone：+86-13816548421
传真：+8621-20283853	Fax：+8621-20283853
网站：www.dentons.com, or, www.sinoblawg.com	Website：www.dentons.com, or, www.sinoblawg.com
电子邮件：jie.tian@dentons.cn 或者 jasontian78@gmail.com	Email：jie.tian@dentons.cn, or, jasontian78@gmail.com