SPC Guiding Case No. 67: Tang Changlong v. Zhou Shihai (Equity Transfer Dispute)

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SPC Guiding Case No. 67

Discussed and adopted by the Judicial Committee of the Supreme People's Court; issued on September 19, 2016

Keywords

Civil; equity transfer; payment by installments; rescission of contract

Holding

Where, in the payment of the transfer price for the equity of a limited liability company by installments, a default such as delay or refusal of payment by the equity transferee occurs, and the equity transferor requests rescission of the equity transfer contract signed by both parties, the provision of Article 167 of the Contract Law of the People's Republic of China, which allows the seller in an installment sale to rescind the contract when the buyer's unpaid due price amounts to one-fifth of the total price, shall not apply.

Basic Facts

The plaintiff Tang Changlong and the defendant Zhou Shihai signed an "Equity Transfer Agreement" and an "Equity Transfer Fund Installment Payment Agreement" on April 3, 2013. The parties agreed that Zhou Shihai would transfer his 6.35 percent equity in Qingdao Transformer Group Chengdu Shuangxing Electric Appliance Co., Ltd. to Tang Changlong. The equity totaled RMB 7.1 million, payable in four installments, namely RMB 1.5 million on April 3, 2013; RMB 1.5 million on August 2, 2013; RMB 2 million on December 2, 2013; and RMB 2.1 million on April 2, 2014. The agreement was to take effect upon signature by both parties and was never to be repudiated. After the agreement was signed, Tang Changlong paid Zhou Shihai the first installment of the equity transfer price of RMB 1.5 million on April 3, 2013, as agreed. Because Tang Changlong failed to pay the agreed second installment of the equity transfer price on time, Zhou Shihai, on October 11 of the same year, served on Tang Changlong a "Notice of Rescission of the Agreement" by notarized means, proposing to rescind the "Equity Transfer Fund Installment Payment Agreement" signed by both parties on the ground of Tang Changlong's fundamental breach. On the following day, Tang Changlong transferred the second installment of the equity transfer price of RMB 1.5 million to Zhou Shihai, and fulfilled the payment obligations for the subsequent third and fourth installments according to the agreed time and amount. Zhou Shihai, on the ground that he had already rescinded the contract, returned the four equity transfer payments made by Tang Changlong in full. Tang Changlong then sued in the people's court, requesting confirmation that the notice of rescission of the agreement issued by Zhou Shihai was invalid, and ordering Zhou Shihai to continue performing the contract.

It was additionally found that on November 7, 2013, in the change (filing) registration of Qingdao Transformer Group Chengdu Shuangxing Electric Appliance Co., Ltd., the 6.35 percent equity held by Zhou Shihai had been registered as changed to Tang Changlong's name.

Judgment

On April 15, 2014, the Chengdu Intermediate People's Court of Sichuan Province rendered Civil Judgment No. (2013) Cheng Min Chu Zi No. 1815, rejecting the plaintiff Tang Changlong's claims. Tang Changlong, dissatisfied, appealed. On December 19, 2014, the Sichuan Higher People's Court rendered Civil Judgment No. (2014) Chuan Min Zhong Zi No. 432, ordering: 1. revocation of the original judgment; 2. confirmation that

Zhou Shihai's act of requesting rescission of the "Equity Transfer Fund Installment Payment Agreement" signed by both parties was invalid; and 3. Tang Changlong shall pay Zhou Shihai the equity transfer price of RMB 7.1 million within ten days after the judgment took effect. Zhou Shihai, dissatisfied with the judgment of the Sichuan Higher People's Court, applied to the Supreme People's Court for retrial on the ground that the second-instance court had applied the law erroneously. On October 26, 2015, the Supreme People's Court rendered Civil Ruling No. (2015) Min Shen Zi No. 2532, rejecting Zhou Shihai's retrial application.

Reasoning

The court in its effective judgment held that the focal issue of this case was whether Zhou Shihai enjoyed the contract rescission right provided in Article 167 of the Contract Law of the People's Republic of China (hereinafter the "Contract Law").

I. Article 167(1) of the Contract Law provides: "Where the amount of the due price unpaid by the buyer under an installment sale amounts to one-fifth of the total price, the seller may require the buyer to pay the full price or rescind the contract." Paragraph (2) provides: "Where the seller rescinds the contract, it may require the buyer to pay a fee for the use of the subject matter." Article 38 of the Interpretation of the Supreme People's Court on Issues Concerning the Application of Law in the Trial of Sales Contract Dispute Cases provides: "The 'installment payment' under Article 167(1) of the Contract Law refers to the buyer paying the total price payable to the seller at least three times within a certain period. Where an installment sales contract, by agreement, violates Article 167(1) of the Contract Law and harms the buyer's interests, and the buyer claims that the agreement is invalid, the people's court shall support this." Based on the above provisions of the law and the judicial interpretation, the main characteristics of an installment sale are: first, the buyer pays the total price to the seller in three or more installments, and the seller delivers the subject matter before the buyer pays the price in two or more installments; second, it occurs frequently and commonly between operators and consumers, generally being a transaction in which the buyer, as a consumer, conducts to satisfy living consumption; and third, the seller has granted a certain amount of credit to the buyer, and the seller, as the credit grantor, bears a certain risk in recovering the price. To safeguard the seller's recovery of the remaining price, the seller may exercise the right to rescind the contract under certain conditions.

This case involved a shareholder of a limited liability company transferring equity to a person other than the company's shareholders. Although the transfer of the equity in question was also in the form of installment payment, because the subject matter of the sale in this case was equity, it had characteristics different from a general sale for the purpose of consumption: first, Tang Changlong acquired the equity in order to participate in the company's operation and management and obtain economic benefits, not to satisfy living consumption; second, Zhou Shihai, as the transferor of the equity of a limited liability company, based on the characteristic that the equity he held had always existed in the target company, bore a risk in recovering the equity transfer price by installments that was not equivalent to the risk of the seller recovering the price in a general installment sale for the purpose of consumption; and third, there was no circumstance of requiring the transferee to pay a fee for the use of the subject matter in the rescission of the equity transfer contract by both parties. Based on the above characteristics, an equity transfer installment payment contract differs considerably from a general installment sales contract for the purpose of consumption. The contract rescission right under Article 167 of the Contract Law should not be applied simply to the "Equity Transfer Fund Installment Payment Agreement" in question.

II. In this case, the purpose of the contract in signing the "Equity Transfer Fund Installment Payment Agreement" could be realized. The purpose of Tang Changlong and Zhou Shihai in signing the "Equity Transfer Fund Installment Payment Agreement" was to transfer Zhou Shihai's 6.35 percent equity in Qingdao Transformer Group Chengdu Shuangxing Electric Appliance Co., Ltd. to Tang Changlong. Based on Tang Changlong's performance of the equity transfer price, except for the second equity transfer payment of RMB 1.5 million, which was paid two months late, the remaining three equity transfer payments were all paid as agreed. Zhou Shihai's view that Tang Changlong's late payment constituted a breach and his

request to rescind the contract and return of the RMB 7.1 million paid by Tang Changlong did not affect the establishment of the fact that Tang Changlong paid the remaining three equity transfer payments as agreed. Moreover, during the first- and second-instance proceedings, Tang Changlong expressly stated his willingness to perform the payment obligation. Therefore, the purpose of the contract in Zhou Shihai's signing of the "Equity Transfer Fund Installment Payment Agreement" in question could be realized. It was additionally found that on November 7, 2013, in the change (filing) registration of Qingdao Transformer Group Chengdu Shuangxing Electric Appliance Co., Ltd., the 6.35 percent equity held by Zhou Shihai had already been registered as changed to Tang Changlong's name.

III. From the perspective of good faith, Article 60 of the Contract Law provides: "The parties shall fully perform their respective obligations as agreed. The parties shall follow the principle of good faith and perform such obligations as notification, assistance, and confidentiality according to the nature, purpose, and transaction practice of the contract." Given that the two parties expressly agreed in the equity transfer contract that "this agreement is made in duplicate, takes effect upon signature by both parties, and shall never be repudiated," Zhou Shihai, even under Article 167 of the Contract Law, should first choose to require Tang Changlong to pay the full price, rather than rescind the contract.

IV. From the perspective of safeguarding transaction security, an equity transaction of a limited liability company involves many aspects, such as the acceptance and trust of the transferee Tang Changlong by other shareholders (approval of the equity transfer by more than half), recording in the register of shareholders and registration of the equity with the industrial and commercial authorities, and social costs and impacts have already been invested in it. In this case, after acquiring the equity, Tang Changlong had already actually participated in the company's operation and management, and the equity had already been transferred and registered in his name. If there had been no fundamental breach by Tang Changlong, casually revoking the contract could adversely affect the stability of the company's operation and management.

In summary, in this case, Tang Changlong's ground that Zhou Shihai's request to rescind the contract based on Article 167 of the Contract Law lacked sufficient basis was well founded in law and should be supported.

(Judges of the effective judgment: Liang Hongya, Wang Yue, Li Li)

Relevant Legal Provisions

Articles 94 and 167 of the Contract Law of the People's Republic of China

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