SPC Guiding Case No. 8: Lin Fangqing v. Changshu Kailai Industry Co., Ltd. and Dai Xiaoming (company dissolution dispute)

Dan Young Business Consultancy — www.danyoungcpa.com

Unofficial English translation prepared for reference only. The official Chinese text prevails.

Discussed and adopted by the Judicial Committee of the Supreme People's Court; issued on April 9, 2012.

Keywords

Civil / company dissolution / serious difficulty in operation and management / corporate deadlock

Holding

Article 183 of the Company Law treats "serious difficulty in the operation and management of the company" as one of the conditions for a shareholder to bring an action for dissolution of the company. In determining "whether serious difficulty in the operation and management of the company has arisen," a comprehensive analysis should be conducted from the operating state of the company's organizational organs. Even if the company is in a state of profitability, if its shareholders' meeting mechanism has been dysfunctional for a long period and there are serious internal management obstacles such that the company has fallen into deadlock, this may be determined as serious difficulty in the operation and management of the company. Where the other conditions prescribed by the Company Law and relevant judicial interpretations are met, the people's court may, in accordance with the law, rule to dissolve the company.

Basic Facts

The plaintiff, Lin Fangqing, alleged that serious difficulty had arisen in the operation and management of Changshu Kailai Industry Co., Ltd. ("Kailai Company"), that the company had fallen into corporate deadlock that could not be resolved by other means, and that his rights and interests had suffered major damage, and he requested dissolution of Kailai Company.

The defendants, Kailai Company and Dai Xiaoming, argued that Kailai Company and its subordinate branches were operating well and did not meet the conditions for company dissolution; that the conflict between Dai Xiaoming and Lin Fangqing could be resolved by other means; and that the company should not be forcibly dissolved through judicial procedure.

Upon trial, the court found as follows. Kailai Company was established in January 2002. Lin Fangqing and Dai Xiaoming were shareholders of the company, each holding 50% of the shares. Dai Xiaoming served as the company's legal representative and executive director, and Lin Fangqing served as the company's general manager and supervisor. The articles of association of Kailai Company expressly provided that resolutions of the shareholders' meeting must be adopted by shareholders representing more than one-half of the voting rights, but that resolutions on increasing or reducing the company's registered capital, merger, dissolution, change of company form, or amendment of the articles of association must be adopted by shareholders representing more than two-thirds of the voting rights; and that shareholders exercised voting rights at shareholders' meetings in proportion to their capital contributions. Beginning in 2006, conflicts between Lin Fangqing and Dai Xiaoming gradually emerged. On May 9 of the same year, Lin Fangqing proposed and gave notice of a shareholders' meeting, but because Dai Xiaoming considered that Lin Fangqing had no right to convene the meeting, the meeting failed to convene. On June 6, August 8, September 16, October 10, and October 17 of the same year, Lin Fangqing, through his lawyer, sent letters to Kailai Company and Dai Xiaoming stating that, because his shareholder rights and interests had been seriously infringed, Lin Fangqing, as a shareholder holding one-half of the voting rights of the company's

shareholders' meeting, had voted and adopted a resolution to dissolve Kailai Company in accordance with the procedures prescribed in the articles of association, and demanding that Dai Xiaoming provide the financial books and other materials of Kailai Company and liquidate the company. On June 17, September 7, and October 13 of the same year, Dai Xiaoming replied by letter that the shareholders' meeting resolution made by Lin Fangqing had no lawful basis, that Dai Xiaoming did not agree to dissolve the company, and demanded that Lin Fangqing hand over the company's financial materials. On November 15 and 25 of the same year, Lin Fangqing again sent letters to Kailai Company and Dai Xiaoming demanding that they provide the company's financial books and other materials for inspection, distribute company income, and dissolve the company.

The Jiangsu Changshu Garment City Management Committee ("the Garment City Management Committee") certified that Kailai Company was still operating normally and expressed willingness to organize mediation between Lin Fangqing and Dai Xiaoming.

It was further found that the articles of association of Kailai Company stated that the supervisor exercised the following rights: (1) inspecting company finances; (2) supervising the conduct of the executive director and manager in performing company duties in violation of laws, regulations, or the articles of association; (3) requiring the directors and manager to make corrections when their conduct harmed the interests of the company; and (4) proposing to convene an extraordinary shareholders' meeting. From June 1, 2006 to the present, Kailai Company had not convened a shareholders' meeting. The mediation committee of the Garment City Management Committee organized mediation between the two parties on December 15 and 16, 2009, but neither was successful.

Judgment

On December 8, 2009, the Suzhou Intermediate People's Court of Jiangsu Province rendered Civil Judgment (2006) Su Zhong Min Er Chu Zi No. 0277, dismissing Lin Fangqing's claims. After the judgment was pronounced, Lin Fangqing appealed. On October 19, 2010, the Jiangsu Provincial High People's Court rendered Civil Judgment (2010) Su Shang Zhong Zi No. 0043, revoking the first-instance judgment and, in accordance with the law, modifying the judgment to dissolve Kailai Company.

Reasoning

The effective judgment of the court held as follows.

First, serious difficulty had arisen in the operation and management of Kailai Company. Under Article 183 of the Company Law and Article 1 of the Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (II) ("the Company Law Interpretation (II)"), the determination of whether serious difficulty has arisen in the operation and management of a company should be based on a comprehensive analysis of the operating state of the company's shareholders' meeting, board of directors or executive director, and board of supervisors or supervisor. The emphasis of "serious difficulty in the operation and management of the company" lies in the existence of serious internal obstacles in company management, such as dysfunction of the shareholders' meeting mechanism and inability to make decisions on the operation and management of the company, and it should not be one-sidedly understood as operational difficulties such as lack of company funds or serious losses. In this case, Kailai Company had only two shareholders, Dai Xiaoming and Lin Fangqing, each holding 50% of the shares. The articles of association of Kailai Company provided that "resolutions of the shareholders' meeting must be adopted by shareholders representing more than one-half of the voting rights," and all parties acknowledged that "more than one-half" did not include the number itself. Therefore, so long as the opinions of the two shareholders diverged and they did not cooperate with each other, no effective vote could be formed, which clearly affected the operation of the company. Kailai Company had not convened a shareholders' meeting for four consecutive years and could not form an effective shareholders' meeting resolution, and therefore could not manage the company through shareholders' meeting resolutions;

Source: https://www.danyoungcpa.com/spc-guiding-case-8-china/

the shareholders' meeting mechanism had become dysfunctional. Dai Xiaoming, the executive director, was one of the two shareholders in conflict, and his conduct in managing the company could no longer carry out the resolutions of the shareholders' meeting. Lin Fangqing, as the company's supervisor, could not normally exercise his supervisory powers and could not play a supervisory role. Because Kailai Company's internal mechanism could no longer operate normally and could not make decisions on the company's operation, even if it had not yet fallen into a state of loss, this could not change the fact that serious difficulty had arisen in the operation and management of the company.

Second, because Kailai Company's internal operating mechanism had long been dysfunctional, Lin Fangqing's shareholder rights and supervisory rights had long been in a state where they could not be exercised, the purpose of his investment in Kailai Company could not be realized, and his interests had suffered major losses, while Kailai Company's deadlock could not be resolved by other means over a long period. Article 5 of the Company Law Interpretation (II) expressly provides that "where the parties cannot reach a consensus to maintain the company's existence, the people's court shall render a judgment in a timely manner." In this case, before bringing the action for company dissolution, Lin Fangqing had already attempted through other means to resolve the conflict with Dai Xiaoming, and the Garment City Management Committee had also organized mediation between the parties, but the parties still could not reach a consensus. The two courts of first and second instance, based on the consideration of cautiously using judicial means to forcibly dissolve the company, actively conducted mediation, but neither was successful.

In addition, Lin Fangqing held 50% of the shares of Kailai Company, which also met the condition under the Company Law that a shareholder bringing an action for company dissolution must hold 10% or more of the shares of the company.

In summary, Kailai Company had met the conditions prescribed by the Company Law and the Company Law Interpretation (II) for a shareholder to bring an action for dissolution of the company. From the perspective of fully protecting the lawful rights and interests of shareholders, reasonably regulating the corporate governance structure, and promoting the sound and orderly development of the market economy, the second-instance court rendered the above judgment in accordance with the law.

Relevant Legal Provisions

Article 183 of the Company Law of the People's Republic of China.

Disclaimer: This translation is provided for reference and informational purposes only. In the event of any discrepancy, the official Chinese text issued by the Supreme People's Court shall prevail. This translation does not constitute legal advice.