SPC Guiding Case No. 96: Song Wenjun v. Xi’an Dahua Catering Co., Ltd. (Shareholder Qualification Confirmation Dispute)

Dan Young Business Consultancy — www.danyoungcpa.com

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

SPC Guiding Case No. 96

Discussed and adopted by the Judicial Committee of the Supreme People's Court; issued on June 20, 2018

Keywords

Civil; confirmation of shareholder qualification; initial articles of association; restriction on equity transfer; buyback

Holding

Where a state-owned enterprise is restructured into a limited liability company, and its initial articles of association restrict equity transfer and expressly stipulate a company buyback clause, such clauses may be found valid so long as they do not violate the mandatory provisions of the Company Law and other laws. Where a limited liability company, in accordance with its initial articles of association, pays reasonable consideration to buy back a shareholder's equity and reasonably disposes of it by such means as transferring it to other shareholders, the people's court shall support this.

Basic Facts

Xi'an Dahua Catering Co., Ltd. (hereinafter "Dahua Company") was established on April 5, 1990. In May 2004, Dahua Company was restructured from a state-owned enterprise into a limited liability company. Song Wenjun was an employee of Dahua Company and contributed RMB 20,000 to become a natural-person shareholder of Dahua Company. Article 14 of Chapter III, "Registered Capital and Shares," of Dahua Company's articles of association provided: "The company's equity shall not be sold or transferred to any group or individual outside the company. One year after the company's restructuring, it may be gifted, transferred, and inherited within the company with the approval of the board of directors. Upon the death or retirement of a shareholder, his or her shares may be inherited, transferred, or acquired by the enterprise with the approval of the board of directors. Where a shareholder resigns, is transferred, or is dismissed, or the labor contract is terminated, the shares shall be retained by the company upon the person's departure and acquired by the enterprise..." Article 66, under Chapter XIII, "Other Matters That Shareholders Consider Necessary to Specify," provided: "These articles of association are jointly recognized by all shareholders and take effect from the date of the company's establishment." These articles of association were signed and adopted by all shareholders of Dahua Company. On June 3, 2006, Song Wenjun proposed to the company the termination of his labor contract and applied to withdraw his RMB 20,000 in shares held in the company. On August 28, 2006, with the consent of Zhao Laisuo, the legal representative of Dahua Company, Song Wenjun received the full withdrawal payment of RMB 20,000. On January 8, 2007, Dahua Company convened the 2006 annual general meeting of shareholders, which should have had 107 shareholders and actually had 104 shareholders in attendance, representing 93 percent of the company's total shares. The meeting reviewed and approved the share-withdrawal applications of the three shareholders Song Wenjun, Wang Peiqing, and Hang Chunguo, and resolved that "their share capital shall be temporarily acquired and held by the company and shall not participate in dividend distribution." Subsequently, Song Wenjun, on the grounds that Dahua Company's buyback violated the law, failed to follow statutory procedures, and that the Company Law prohibits shareholders from withdrawing their capital contributions, requested confirmation in accordance with the law that he had shareholder qualification in Dahua Company.

Judgment

Source: https://www.danyoungcpa.com/spc-guiding-case-96-china/

On June 10, 2014, the People's Court of Beilin District, Xi'an, rendered Civil Judgment No. (2014) Bei Min Chu Zi No. 01339, ordering: rejection of the plaintiff Song Wenjun's claim for confirmation that he had shareholder qualification in the defendant Xi'an Dahua Catering Co., Ltd. After the first-instance judgment was pronounced, Song Wenjun appealed. On October 10, 2014, the Xi'an Intermediate People's Court rendered Civil Judgment No. (2014) Xi Zhong Min Si Zhong Zi No. 00277, rejecting the appeal and affirming the original judgment. After the final judgment was pronounced, Song Wenjun, still dissatisfied, applied to the Shaanxi Higher People's Court for retrial. On March 25, 2015, the Shaanxi Higher People's Court rendered Civil Ruling No. (2014) Shaan Min Er Shen Zi No. 00215, rejecting Song Wenjun's retrial application.

Reasoning

The court in its effective judgment held that, after hearing the retrial applicant Song Wenjun's grounds for retrial and the respondent Dahua Company's defense, the focal issues of this case were as follows: 1. whether the provision of "shares retained upon departure" in Dahua Company's articles of association violated the prohibitive provisions of the Company Law of the People's Republic of China (hereinafter the "Company Law"), and whether the articles of association were valid; and 2. whether Dahua Company's buyback of Song Wenjun's equity violated the relevant provisions of the Company Law, and whether Dahua Company constituted withdrawal of capital contributions.

On the first focal issue: First, Article 14 of Dahua Company's articles of association provided: "The company's equity shall not be sold or transferred to any group or individual outside the company. One year after the company's restructuring, it may be gifted, transferred, and inherited within the company with the approval of the board of directors. Upon the death or retirement of a shareholder, his or her shares may be inherited, transferred, or acquired by the enterprise with the approval of the board of directors. Where a shareholder resigns, is transferred, or is dismissed, or the labor contract is terminated, the shares shall be retained by the company upon the person's departure and acquired by the enterprise." Pursuant to Article 25(2) of the Company Law, which provides that "shareholders shall sign and affix their seals to the articles of association of the company," the articles of association of a limited liability company are a regulatory document unanimously agreed upon by all shareholders at the time of the company's establishment and binding on the company and all shareholders. Song Wenjun's act of signing the articles of association shall be regarded as his recognition of and consent to the foregoing provisions, and the articles of association were binding on both Dahua Company and Song Wenjun. Second, based on the closed and personal (intuitu personae) characteristics of a limited liability company, it is an expression of company autonomy for the articles of association to impose certain restrictive provisions on shareholders' transfer of equity. In this case, the reason Song Wenjun became a shareholder of Dahua Company during the enterprise restructuring was that he had a labor contract relationship with Dahua Company; had Song Wenjun not established a labor relationship with Dahua Company, there would have been no possibility of his becoming a shareholder of Dahua Company. Likewise, Dahua Company's articles of association, in taking whether a labor contract relationship existed with the company as the basis for acquiring shareholder status and accordingly making the "shares retained upon departure" provision, conformed to the closed and personal characteristics of a limited liability company, and was also an expression of the principle of company autonomy, not violating the prohibitive provisions of the Company Law. Third, Article 14 of Dahua Company's articles of association, concerning equity transfer, was a restrictive provision rather than a prohibitive provision on shareholders' transfer of equity. Song Wenjun's right to transfer equity in accordance with the law was not prohibited by the articles of association, and the articles of association did not infringe Song Wenjun's right to transfer equity. In summary, the courts of first and second instance were correct in finding that Dahua Company's articles of association did not violate the prohibitive provisions of the Company Law and should be valid, and this ground for retrial raised by Song Wenjun could not be established.

On the second focal issue: The dissenting shareholder's buyback request right provided in Article 74 of the Company Law has statutory conditions for its exercise, namely, only under the three circumstances of "the

company has failed to distribute profits to shareholders for five consecutive years while the company has been profitable for those five consecutive years and satisfied the conditions for profit distribution under this Law; the company has merged, divided, or transferred its major assets; or the business term prescribed in the articles of association has expired or another cause for dissolution prescribed in the articles of association has arisen, and a shareholders' meeting has passed a resolution to amend the articles of association so that the company continues to exist," is a dissenting shareholder entitled to require the company to buy back his or her equity. This corresponds to whether the company should perform the statutory obligation to buy back the dissenting shareholder's equity. This case, by contrast, concerned whether Dahua Company had the right to buy back Song Wenjun's equity based on the agreement in the articles of association and its consensus with Song Wenjun, and corresponded to whether Dahua Company had the right to buy back Song Wenjun's equity. The two are different in nature, and Article 74 of the Company Law could not be applied to this case. In this case, on June 3, 2006, Song Wenjun proposed to Dahua Company the termination of his labor contract and on the same day wrote by hand an "Application for Share Withdrawal," stating "I request full withdrawal of my shares, and I have nothing to do with year-end profits or losses." This "Application for Share Withdrawal" shall be regarded as an expression of his true intent. Dahua Company refunded his full share capital of RMB 20,000 on August 28, 2006, and on January 8, 2007, convened a shareholders' meeting that reviewed and approved the share-withdrawal applications of Song Wenjun and the other two shareholders. Dahua Company, based on Song Wenjun's share-withdrawal application and in accordance with the provisions of the articles of association, bought back Song Wenjun's equity, and the procedures were not improper. In addition, "withdrawal of capital contributions" as provided in the Company Law refers specifically to a company shareholder's withdrawal of his or her capital contribution to the company; a company cannot constitute the subject of withdrawal of capital contributions. This ground for retrial raised by Song Wenjun could not be established. In summary, the ruling rejected the retrial applicant Song Wenjun's retrial application.

(Judges of the effective judgment: Wu Qiang, Pang Dong, Zhang Jie)

Relevant Legal Provisions

Articles 11, 25(2), 35, and 74 of the Company Law of the People's Republic of China

Disclaimer: This translation is provided for general informational and reference purposes only and does not constitute legal advice. It is an unofficial English rendering of a guiding case of the Supreme People's Court of the People's Republic of China prepared by Dan Young Business Consultancy. Only the official Chinese text issued by the court is authoritative. While every effort has been made to ensure accuracy, no warranty is given as to the completeness or correctness of the translation, and no liability is accepted for any reliance placed on it. For advice on any specific matter, please consult a qualified legal professional.