

Interpretation of “Equal Conditions” in the Preemptive Shareholders' Right in a Limited Company

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Abstract: As stipulated in the Company Law in China, shareholders' preemptive right means that the shareholders of a limited company shall have priority in the purchase of equity under the same conditions, which protects the interests of other shareholders and third parties and the attribute of the cooperation among shareholders in a limited company. The importance of this right has also been fully reflected in judicial practice of which the interpretative approach suitable for “equal conditions” judgment is worth exploring. Based on the above background, this paper first raises problems when determining “equal conditions” in the shareholders' preemptive right of a limited company in China. Second, it discusses “equal conditions”, “number”, “share price”, “method of transaction”, and “time limit” from perspectives of textual and teleological interpretations. Third, it explores the most reasonable interpretative approach of “equal conditions” and its elements suitable for judgment. It is hoped that better applying confirmation rules of “equal conditions” in shareholders' preemptive right of a limited company in practice to solve practical problems in the process of equity transfer in a limited liability company and protect the vested interests of remaining shareholders except for transferring shareholders, thereby maximizing the value gained through equity transfer by transferring shareholders.

Keywords: Limited Company; Shareholders' Preemptive Right; Equal Conditions; Textual Interpretation; Teleological Interpretation; Interpretative Approach

1. Introduction

As the global economy develops, commercial disputes in daily economic transactions are increasing. Remarkably, in a socialist market economy, the equity transfer based on a limited liability company, the main form of company in China, is getting frequent, which not only means the rapid flow of capital but also impacts the attribute of the cooperation among shareholders in a limited company. *The Company Law* in China stipulates the shareholder's preemptive right, an important right given by the law to the shareholders of a limited company, which protects the interests of other shareholders and third parties. Besides, this right protects the cooperation among shareholders in a limited company, meaning that the shareholders of a limited company shall have priority in the purchase of equity under the same conditions. Establishing the right system is based on the maintenance of the company's internal relationships to ensure the stable development of the company's economy.

Moreover, the importance of the shareholders' preemptive right has been fully reflected in the judicial practice of which the interpretative approach suitable for “equal conditions” judgment is worth exploring, particularly the central element of “equal conditions” in the rights system. At present, for the definition of “equal conditions”, *the Company Law* has no details, and its latest draft amendment adds relevant content that illustrates the price, quantity, mode of payment, and time limit for the identification of “equal conditions” in Article 18 of the *Provisions of the Supreme People's Court on Certain Issues Concerning the Application of the Company Law of the People's Republic of China (IV)* (hereinafter referred to as the *Judicial Interpretation of the Company Law (IV)*). Due to the general provisions in the law and legal gaps, especially the unclear specific provisions on equivalent conditions and relevant interpretation, there have difficulties in practice.

Above all, although *the Company Law* and *the Judicial Interpretation of the Company Law (IV)* have made further provisions on the shareholders' preemptive right, there is no unified standard for the interpretative approach suitable for “equal conditions” judgment in the shareholders' preemptive right based on the rapid developing market economy. Therefore, this article examines and compares the domestic and foreign literature and analyzes the relevant cases to find a reasonable interpretative

approach to remedy the shortcomings in legislation and judicial practice.

2. Presentation of the problem

2.1 Overview of “equal conditions” in shareholders’ preemptive right of a limited company in China

A limited company, also referred to as a limited liability company, is a crucial type of business entity in China and an essential component of the market economy. Among the various systems related to a limited company, the system of the shareholders' preemptive right is a statutory restriction on the freedom of disposal of the transferring shareholders, which is confirmed in Article 71 of *the Company Law of the People's Republic of China* (hereinafter referred to as *the Company Law*).^[1] Considering the stable shareholders for limited company compatibility from the perspective of jurisprudence, creating the shareholders' preemptive right can ensure the operation of a limited company to a certain extent.

In legislation, it is necessary to restrict this right to ensure the realization of fairness and justice. Therefore, Article 71 of *the Company Law* defines “equal conditions”, meaning that shareholders in a limited company can exercise the preemptive right on the premise that the conditions given by the original shareholders and third parties except for the shareholders are equal. As stipulated in *the Judicial Interpretation of the Company Law (IV)* issued in 2017, the price, quantity, mode of payment, and time of performance of the equity transfer and other relevant elements shall be taken into account, with a more detailed enumeration. However, in practice, there are different interpretations of “equal conditions” and their elements, and there is no clear provision in the law on how to identify “Equal”, thus causing difficulties for company practices and judicial trials.

2.2 Problems when determining “equal conditions” in the shareholders’ preemptive right of a limited company in China

From the legislative perspective, *the Company Law* and relevant judicial interpretations have only made a general overview of “equal conditions” in the shareholders’ preemptive right of a limited company. Additionally, judges do not have a clear and specific legal basis when applying the decision and have a large discretionary power due to lacking guidance from normative documents in judicial trials, thus causing different interpretations from different judges for “equal conditions”, with problems such as “different judgments in the same case” and “lawfulness but unreasonableness”. Therefore, how determining and interpreting “equal conditions” is the key for judges in dealing with disputes in such cases as equity transfer.

Article 18 of *the Judicial Interpretation of the Company Law (IV)* issued in 2017 clearly stipulated the court needs to consider the price, quantity, mode of payment, and time limit of equity transfer with a more detailed provision by an illustrative method when determining whether “equal conditions” referred to in Article 71(3) of *the Company Law* and this provision are met.^[2] Undeniably, it is still vague and cannot be a clear standard for judges to determine in disputes over equity transfer of limited companies in practice. Besides, no relevant normative documents can provide a more detailed explanation of these elements stipulated in Article 18 of *the Judicial Interpretation of the Company Law (IV)*. In the face of unclear interpretation of “equal conditions” and their elements in the shareholders’ preemptive right of a limited company in current legislation, how to interpret “equal conditions”, “number”, “share price”, “method of transaction”, and “time limit” is a difficult issue to be discussed in this paper.

3. Interpretative approach suitable for “equal conditions” judgment in the shareholders’ preemptive right of a limited company in China

3.1 From the perspective of textual interpretation

In law and doctrine, the relevant laws and regulations do not give a special meaning to “equal conditions” on reference, so “equal conditions” can be interpreted in everyday expression. The word “equal” refers to the same degree or the same content, meaning the consistency of things without a difference.^[3] From this viewpoint, the definition of this word has the meaning of reference, requiring two or more subjects to compare. It would be impossible to compare objects and identify the meaning of “equal” without reference. From the perspective of textual interpretation, the interpretation of “equal conditions” is consistent with the “Theory of Absolute Equivalence”, meaning a shareholder can exercise the preemptive right on the premise that all consistent conditions are met. Therefore, when interpreting

“equal conditions” from the perspective of textual interpretation based on fairness and justice, two or more subjects are required to be identical in rank and status, which is not reasonable combined with the above analysis. As a result, the textual interpretation cannot support the interpretation of “equal conditions”.

3.2 From the perspective of teleological interpretation

Creating “equal conditions” is to balance the relationship among the transferring shareholders, third parties, and other shareholders and maintain the stability of the economic order and the cooperation among shareholders in a limited company. Therefore, the meaning of autonomy and freedom of contract under civil law is moderated in the system of the shareholders' preemptive right.^[4] This system under civil law pays more attention to the balance of interests and interest maximization. Therefore, implementing it in China should consider the interests of all parties and restrict “equal conditions” in the shareholders' preemptive right after integrating the situation of multiple parties, thereby better protecting the rights of the selling shareholders and third parties and restricting the dominant position of other shareholders who enjoy the preemptive right reasonably. It shows that interpreting “equal conditions” from the perspective of the teleological interpretation is more reasonable by combining the above analysis and comparing the meaning of “equal conditions” based on the textual interpretation.

There is no denying that the meaning of “equal conditions” based on the textual interpretation has its value. However, provided that interpreting “equal conditions” with everyday expression by combining the purpose of creating “equal conditions” in the shareholders' preemptive right, it is right to restrict the scope of “equal” by the teleological interpretation, thus allowing judges to make a reasonable judgment as far as possible when deciding a case to fully explain and exert the true meaning of “equal conditions”, thus balancing the interests of all parties.

4. Interpretative approach of the consideration of “equal conditions” in the shareholders' preemptive right of a limited company in China

4.1 Equity transfer price

Equal equity transfer price refers to a scenario where other shareholders may choose to exercise their preemptive right to purchase equity. In such cases, the price of the equity sold to them should be equivalent to that offered to a third party. The concept of equal pricing should consider not only the actual monetary amount but also any other non-monetary equivalents.

Firstly, one of the most important features of a case that can be converted to money is it can be quantifiable. In an economic transaction, when judging a condition except for price can be converted into a price factor, it is necessary to determine whether the condition can be quantifiable. Generally, factors related to daily economic transactions can be quantifiable. For example, when the third non-shareholder in the equity transfer contract has borrowed interest-free money from a transferring shareholder, the interest on the borrowings can be included in the equity transfer price. In such case, if the other shareholder who has the preemptive right exercises such right, the transferring shareholder may decide whether to calculate the interest on the loan in the share transfer contract.^[5]

Secondly, non-convertible special factors may cover emotional factors such as emotions arising from personal relationships and gifts of specific goods. Taking the emotional factors arising from personal relationships as an example, in daily economic transactions, a transferring shareholder may have such close personal relationships as relatives and friends with the third party; the transferring shareholder is likely to give account to the equity transfer in the equity transfer contract with a more favorable price based on emotional factors. If such a situation arises, it raises the question of how “equal conditions” should be determined. This special emotion cannot be measured by money as such special factors cannot be convertible. Therefore, it is improper to such factors included into price factors. If a shareholder with the preemptive right is allowed to purchase equity at a preferential price for this emotional factor, it will jeopardize the interests of a transferring shareholder.^[8]

In conclusion, the most appropriate interpretative approach for the equity transfer price as the core factor in determining “equal conditions” is that such emotional factors arising from personal relationships should be excluded from the determination of “equal conditions” while other conditions that can be quantified as price should depend on situations agreed by the parties to the contract of transfer of equity, respecting the autonomy of the parties.

4.2 Number of equity transfers

The number of equity transfers is essentially a question of whether the other shareholders partially use the preemptive right to purchase equity, involving whether shareholders buy partial equity transferred by a transferring shareholder.^[6] The partial use of the preemptive right to purchase equity mainly occurs when the other shareholders cannot afford the cost of purchasing the entire equity at once or for other reasons and require to buy partial equity under the same conditions. The significance of exploring the equal number of equity transfers is to avoid the incomplete exercise of the preemptive right by shareholders in the determination of “equal conditions” to secure access to the economic value of transferring shareholders from the transfer of the entire equity.

For whether the partial exercise of the preemptive right is reasonable, there are two views in the theoretical cycle: some think that the preemptive right shall be allowed to be partially exercised because shareholders are given this right and not prohibited from the partial exercise of this right by the law and the division of equity is also allowed by the law so the free disposition of partial rights by the shareholders with the preemptive right should be allowed; ^[7] others are not in favor of the partial exercise of the preemptive right because the determination of “equal conditions” shall comprehensively consider various factors rather than be restricted to equity transfer price and the division of equity number that is indispensable for determining “equal conditions” would result in the change in “equal conditions” to fail to ensure transferring shareholders’ interests in the system of the shareholders’ preemptive right.^[8]

In conclusion, it is believed that the partial exercise of the preemptive right by a shareholder in actual equity transfer transactions is not in line with the legislative value of the system and a transferring shareholder cannot get complete interest when transferring the remaining equity in the hands, if reaching the equal price but not reaching the equal number in the determination of “equal conditions”. Therefore, from the perspective of the parties to transactions, I am in favor of prohibiting the partial exercise of the preemptive right by the shareholders to protect the interests of a transferring shareholder, thus reducing disputes over equity transactions in practice and protecting the normal operation of a company.

4.3 Modes of payment

Modes of payment are also one of the criteria for determining “equal conditions”. The equal modes of payment are to ensure that the vested interests from equity transfer. For example, ensuring a transferring shareholder can eventually get the equity transfer payment. In reality, modes of payment are generally divided into one-time payment, payment in installments, and trade acceptance. The safest one-time payment is the most advantageous and effective mode for a transferring shareholder because the transferring shareholder does not need to worry about obtaining the final price.^[9] This mode of payment meets the requirements of “equal conditions”.

The payment in installments requires a transferring shareholder to bear a higher risk as the time of the final payment is closely related to the number of installments, which is not conducive to protecting the transferring shareholder's interests. Similar to this method, trade acceptance has a higher risk. Generally, on the premise of negotiating the specific method between a transferring shareholder and a third party, the transferring shareholder will choose an advantageous method based on the credit and financial status and personal relationships of the third party. If the two parties choose a method that relies on interests, such as the payment in installments, exercising the preemptive right by a shareholder with this right on “equal conditions” will damage the interests of transferring shareholders. Meanwhile, the payment in installments cannot meet the requirements of “equal conditions”, unless the shareholder with the preemptive right can offer the same conditions, such as offering properties as security for the good faith of himself/herself and third parties, thus reducing the risk to be borne by the transferring shareholder.

In conclusion, a transferring shareholder will bear different degrees of risk due to the differences among different modes of payment. It is necessary to set up the criteria for determining “equal conditions” according to the different modes of payment to protect the interests of a transferring shareholder as much as possible. When a transferring shareholder bears a higher risk, the equal modes of payment shall not be regarded as an equal condition for the other shareholders to exercise their preemptive right to purchase equity. In this case, it is necessary to require a shareholder with the preemptive right to provide security property of the same value combined with other conditional factors.

4.4 Time limit of payment

The time limit of payment for equity transfer refers to the time that a third party shall pay the price

of the transferred equity to a transferring shareholder agreed by the two parties, which can affect the success of a transaction.

Where a contract between a transferring shareholder and a third party for equity transfer and a subsequent agreement with a shareholder with the preemptive right, it is key to determine the duration of the exercise of the two contracts. In this case, confusing the duration of the two contracts will damage the interests of the shareholder with the preemptive right. As said by a Germany Scholar, "A valid sale-sell agreement between the seller and a third party is a prerequisite for the exercise of the preemptive right to purchase equity."^[10] It means that the shareholder with the preemptive right can exercise the right on the premise the contract between the transferring shareholder and the third party is valid. From this point of view, I believe that the "Relative Equivalence Theory" should be used to judge the duration of the exercise. In other words, the time limit of payment shall be calculated from the contract signing date, or from the date on which the shareholder with the preemptive right claims the right and "equal conditions" have been met. It is good to negotiate the start and end time of payment in accordance with the contract.

5. Conclusion

This paper takes Article 71 of *the Company Law* and Article 18 of *the Judicial Interpretation of the Company Law (IV)* as the starting point. First, it explains the shareholders' preemptive right and discusses the problems for interpreting "equal conditions" in the shareholders' preemptive right. Second, it provides a qualified interpretation for elements in "equal conditions" suitable for judgment based on textual and teleological interpretations. Finally, it gives an analysis and discussion of the four factors listed in the judicial interpretation and clarifies the specific criteria for number, price, modes of payment, and time limit of equity in "equal conditions" based on domestic and foreign doctrines and opinions, and practical experiences. It is hoped that the discussions of "equal conditions" and elements of the interpretative approach suitable for judgment in the shareholders' preemptive right will provide references for improving relevant laws and regulations and promote the formation of "equal conditions", thus facilitating the establishment of the system.

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