

## A Comparative Study on Voting Rights of Preferred Shareholders in China

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**ABSTRACT.** Shares can be divided into common and preferred shares based on different shareholder's rights. Generally, holders of common shareholders have the following rights such as unlimited voting rights, unlimited dividend possibilities and unlimited rights on liquidation. As for preferred shares, the shareholders' rights are usually provided by the articles of association. Unlike the US or English law which allows multiple classes of preferred shares and entitle the company itself to having strong flexibility of establishment of different shares in its bylaws, the Chinese Company Law has not recognized different classes of shares. However, Article 131 of the Chinese Company Law authorized the State Council of China to enact provisions for different kinds of shares other than common shares, which is regarded as the fundamental clause of developing preferred shares. As expected, the Guiding Opinion Concerning the Pilot Implementation of Preferred Shares (hereinafter referred to as the 2013 Guiding Opinion) was released by the State Council on 30 November 2013. Following the 2013 Guiding Opinion, Measures for the Administration of the Pilot Program of Preferred shares (the 2014 Measures for short) was promulgated by the China Securities Regulatory Commission on 21 March 2014. As the only effective document involved in the field of preferred shares in China, the 2014 Measures has played a significant role not only in helping dealing with disputes related to preferred shareholders' rights, but also in helping utilizing the preferred system as an alternative tool to raise finance or funds in the absence of relevant stipulations in the Chinese Company Law. Voting rights of preferred shareholders are a major concern both for legal practitioners and academics, among others, as the voting right functions as deciding who can be the real owner of the company. Hence, this essay will focus on voting rights of the preferred shareholders within the scope of the 2014 Measures and illustrate the legal practice of several advanced countries and regions in this respect by comparative approaches, aiming at putting forward operable suggestions to solve present dilemma having existed in the Chinese preferred share market.

**KEYWORDS:** Preferred shareholders; Common shareholders, Voting rights.

## **1. Brief examination on voting rights for preferred shareholders**

### ***1.1 Definition of preferred shareholders***

According to Article 2 of the 2014 Measures, the preferred share means a class of shares, the holders of which have priority over common shareholders in the distribution of profits and residual assets but have restricted rights to participate in the decision-making and management of the company, among others. The preferred share is defined as a kind of share that does not generally entitle the holder to voting rights at a general meeting and that gives the shareholder specific entitlement to the distribution of dividends or redemption on the winding up of the company in the Singapore Companies Act. Preferred shares refer to a separate class of shares possessing unique or specific rights and privileges and these rights usually are beyond the rights enjoyed by ordinary shareholder such as preferred right of distribution of profits and surplus property, but at the same time, corporate decision-making voting rights are being relinquished. Generally, voting rights have played the part of core corporate power, including making important resolutions and choosing company managers.

### ***1.2 Distinction between preferred shareholders and common shareholders***

In reality, a company has its discretion to issue common shares and preferred shares in accordance with the fluctuating market, aiming at luring more investors and funds. Common shares represent all of the assets of the company. Common shareholders are vested with complete legal rights to the assets and undistributed profits of the company after the special rights of the preferred shareholders. Common shareholders constitute the majority shares in the company, and they are able to decide the development direction of their businesses. Traditional company theory holds that shareholders are the owner of a company. Among all shareholders, common shareholders act as the absolute possessor of company assets. However, common shareholders also have to run up against market commercial risks and may end up with nothing. On the contrary, preferred shareholders cannot be called the true owners of a company, for they are unable to obtain some pivotal shareholder rights, especially the voting rights to decide the corporate growth, which always belong to common shareholders. In fact, Common shareholders are the majorities who possess fundamental voting right and their profit is not limited to a set amount, who care more about the future direction of the company such as investment preferences, the inclination to merge and acquire which could ultimately lead to conflicts of interests between these two parties. Preferred shareholders are mainly medium and small size shareholders as they only have limited voting power and would only get the fixed percentage of preferred profit like the company's creditors, who care less about the development prospect of the company.

### ***1.3 Scope of voting rights for preferred shareholders in China***

Article 10 of the 2014 Measures has stipulated that preferred shareholders are entitled to attend a shareholders' meeting to vote by class on crucial matters with common shareholders. "Crucial matters" here consist of five special circumstances related to preferred shareholders' voting rights, which will be discussed in detail in subsequent chapters. The rationale behind conferring voting rights to preferred shareholders in China may be that preferred shareholders occupy part of ownership in the company, too. Strictly speaking, shareholders are totally independent from the company once they invest their property into the company, but shareholders as investors are actually the eventual owner of the assets of the company. Preferred shareholders mostly are minority shareholders whose interests might be damaged by common shareholders or board of directors' decisions which has happened quite often, so the voting right is served to protect their own interests and also to prevent abuse of power to assure good corporate governance. In the 2014 Measures in China, preferred shareholders have voting rights under situations which are closely associated with their interests. China's legal system belongs to civil law jurisdiction, which has presented different modes of thinking from those of common law jurisdiction nations such as UK and the U.S.A. By comparison, when cases to define the scope of preferred shareholders' voting rights arise, UK courts often utilize a narrow literal approach to interpret the plain meaning of the wordings of relevant clauses to restrict their voting rights and also take into consideration the contents of AOA of the company as it would be viewed as 'exhaustive' to prevent obstruction and excessive interference to company's autonomy.

In a word, there do exist divergences and contradictions over the scope of voting rights for preferred shareholders between China and other countries (including civil law systems and common law systems), though it can be concluded that preferred shareholders are granted with some restricted voting rights due to similar contractual arrangements. Hence, the author will further examine in detail whether the scope of preferred shareholders' voting power is appropriate for Chinese legal system or not at present by comparing the provisions of Article 10 in the 2014 Measures with those of other developed countries and regions.

## **2. Detailed analysis of voting rights within the scope of Article 10**

The freedom and autonomy of a company have direct effects on the efficiency of the decision-making and also determines the adaptability and flexibility of the company to the current market. The company's freedom and autonomy will be infringed if the scope of voting rights which the law confers to preferred shareholders is too wide as they could also exploit those voting rights to influence decisions to their advantages. Thus, a detailed analysis of voting rights within the scope of Article 10 of the 2014 Measures will be of great significance for a company's overall development strategy.

### ***2.1 Amendment of the bylaws of the company involved in preferred shares***

With respect to Article 10 subsection 1, a fraction of amendments concerning the

bylaws of the company can fall into the scope of voting rights for preferred shareholders. They can exercise their voting rights only over matters related to their preferred shares alteration, which belongs to a mandatory voting right. In this sense, common shareholders own much stronger voting right than that of preferred shareholders because voting rights of common shareholders are conferred by the law. Preferred shareholders acquired their voting right by way of bargaining negotiations in the past, particularly depending on the express stipulation in articles of association, or else the USA or English Courts might not recognize their voting rights by applying strict restrictive literary interpretation, which was defined as an approach “a contract is a contract”, and the courts refused to put forward broader interpretations over preferred share contracts. Hence, preferred shareholders’ interests cannot be guaranteed, if it is allowed that common shareholders are able to modify the bylaws of the company without limits, which of course will discourage them and jeopardize corporate financing. Thus, the relevant voting right granted to preferred shareholders will, to a large extent, contribute to the protection of minority preferred shareholders and the avoidance of corporate deadlock.

Comparatively, Article 10.04 of Model Business Corporation Act 2010 (MBCA 2010 for short) in the USA and Article 322.1.1 of Companies Act in Japan both enumerate voting rights over the amendments of bylaws related to preferred shareholders (referred to as class shareholders here). In these two Acts, it is definitely stipulated that preferred shareholders are entitled to vote as a separate voting group. Furthermore, besides expressly specifying separate class meetings, these two Acts provide for specific provisions under which circumstances voting rights can be summoned.

## ***2.2 Reduction of the company’s registered capital***

In regard to reduction of the company’s registered capital, the requirement of more than 10% at a time or cumulatively is compulsory in Article 10 subsection 2. From the point of view of market economy, the company entity should have such freedom as the reduction or decrease of a company’s registered capital to adapt to any change of the target market. However, unlimited arbitrary reduction of the company’s registered capital could possibly harm some minority shareholders’ benefits, especially preferred shareholders among them. Hence, how to strike a balance between the company autonomy and the protection of preferred shareholders has been the focus of corporate research all the time.

Comparatively, Article 242 (b) (2) of Delaware Corporations Law in the USA provides that preferred shareholders shall be entitled to vote as a class if some kind of amendments would involve in the alteration of preferred shares no matter whether the voting right could be incorporated into the bylaw. Likewise, Article 630 of English Companies Act 2006 specifies that a consent in writing from at least three-quarters of preferred shareholders has to be obtained with variation of preferred shares.

### ***2.3 Combination, division of the company and the like***

As regards combination, division, or dissolution of the company or modification of the business form of the company, preferred shareholders are entitled to vote by class in Article 10 subsection 2. It is undisputed that the aforesaid transformations constitute fundamental changes to the company, and may be disadvantageous to preferred shareholders. Although preferred shareholders have the same fixed dividends as the holders of debentures and can get profits prior to common shareholders even at the stage of liquidation, they might be able to get nothing back from the struggling company having underwent massive changes. Hence, it is advisable to allow them to determine their own destiny when their company strives for a reform.

Comparatively, preferred shareholders have no voting right over matters related to combination, division, dissolution etc. in MBCA 2010 and Japanese Companies Act, in which common shareholders are entitled to determine all the transformations without the cooperation of preferred shareholders. In Taiwan Mergers and Acquisition Act, combination of the company will not go through the consent procedure from the preferred shareholders[1].

### ***2.4 Issuance of new preferred shares***

New preferred shareholders may have priority over original preferred shareholders. Owing to limited corporate property, such issuance will have much adverse impact on the distribution of dividends and surplus values. New preferred shares can also dilute the current cash flow and the residual assets of the company to cut down the proportion of original shareholders' fixed earnings even with equal status of both shares. In this sense, issuance of new preferred shares shall be adopted only with the voting approval by original shareholders.

Comparatively, similar provisions are formulated in Article 141.2 of German Stock Law and Article 10.04 of American MBCA 2010 to convey the legislative intent that the issuance of new preferred shares must be voted by the current preferred shareholders. In addition, defensive terms against issuance of preferred shares are incorporated into bilateral agreements or articles of association to require two-thirds or three-quarters consent from preferred shareholders.

### ***2.5 Other circumstances as set forth in the bylaws***

Article 10 subsection 5 is a miscellaneous clause to supplement the previous mandatory provisions. However, the preferred share system is still unfamiliar to Chinese investors. In other words, 'one share, one vote' is regarded as the ground rule of equity investment, or, the basic principle that equal shares enjoy equal rights and profits is still deeply embedded in Chinese investors' mind. Frankly speaking, as a company practitioner, the author has never seen our investors set forth other circumstances in the bylaws. They have got accustomed to following the fixed legal

regulation, not to creating new things[2].

### **3. Suggestions for improvements based on the preceding analysis**

Preferred shareholders are the minorities as they only have limited voting power and would only get the fixed percentage of preferred profit. They always do not care about whether the company's plan for growth is right or wrong. Therefore, it is normal to limit their voting rights to some special circumstances, or else the operational autonomy and the majority interests of a company will be infringed upon.

The construction of Article 10 of the 2014 Measures inherits a problem in rendering the voting right to preferred shareholders compared with those of other jurisdictions. In Japan, Article 322(1) of the Companies Act states that[3]:

In cases where a Company with Class Shares carries out an act listed in the following items, if it is likely to cause detriment to the Class Shareholders of any class of shares, such act shall not become effective unless a resolution is made at a Class Meeting constituted by the Class Shareholders ....

This provision reflects the fact that the prerequisite for class shareholders, including preferred shareholders, to invoke their rights to vote must be in the condition that their interests are being adversely affected or have caused them a financial detriment. This prerequisite is also distinct in Article 159 of the Taiwan's Company Act where it addresses that:

In case a company has issued special shares, any modification or alteration in the Articles of Incorporation prejudicial to the privileges of special shareholders shall be adopted in a resolution by a majority of the shareholders ... and shall also be adopted by a meeting of special shareholders ....

Similar prerequisites are also discerned in Article 179(3) of the German Stock Corporation Act. However, such prerequisite can not be seen in the entire provision of Article 10 of the 2014 Measures. That is, Chinese preferred shareholders can summon their rights to vote when an issue is associated with one of the five provisions in Article 10 even when their interests are not being violated. However, to bestow such wide power to them not only would contravene the essence of the preferred shares which is issued to raise finance without changing or diluting the ordinary shareholders' ownership structure, but it would also increase the cost and decrease the efficiency of the decision-making process as the voting process is conducted separately from that of ordinary shareholders. This would have negative impact on the company's autonomy as decisions cannot be made quickly in accordance with the fluctuating market which would fail to seize the great opportunities to allow companies to thrive. Hence, the prerequisite that only infringing preferred shareholders' interest can they invoke their voting rights should be inserted in Article 10.

### ***3.1 Upholding the majority interests of the company***

Common shareholders and preferred shareholders have assumed different commercial risks, especially unequal ways of distributing profits. This would lead to different perspectives on the future direction of the company. Whenever there exists a conflict between common shareholders and preferred shareholders as for major changes involving a company, the author believes the majority interests of the company should be given preferential protection, in order to increase the company's efficiency and maximize the profit[4].

For example, if the majority of the common shareholders pass a resolution to merge with another company, this decision represents the majority interests of the company. Article 18 of the Taiwan Business Merger and Acquisition Act addresses that merger does not need special shareholders to vote unless it is stipulated in the AOA of the company. However, Article 10(3) of the 2014 Measures is a compulsory provision which stipulates that when the circumstances involve merger, division or dissolution, preferred shareholders have the right to vote automatically. The author believes this is unnecessary, because the decision made by the majority common shareholders was based on their profound and comprehensive analysis of the company's capacity aiming at obtaining better business opportunities through opening up a new potential market which would contribute to economic growth. Thus, so long as the merger will not have unfavorable impact on preferred shareholders such as releasing another higher class of shares which would dilute their shares, conferring such wide voting power can be concluded as sacrificing the majority interests of the company just to protect or compromise preferred shareholders' interests. Furthermore, they could obtain judicial remedy by seeking relief in accordance with the protection rules for the minority shareholders in the Chinese Company Law. Most importantly, the company's future direction should not be made upon minorities' interests, so Article 10(3) should be modified.

### ***3.2 Avoidance of ambiguity in terms***

Lastly, Article 10(1) of the 2014 Measures addresses that "Amendment of the provisions related to preferred shares of the bylaws of the company". This provision is vague by comparing to Article 322(1)(i) of the Japan's Companies Act 2005 as it elaborates on the matters that are associated with amendment. Therefore, it would be better to be more specific, because it would not only prevent future ambiguities or unnecessary disputes or litigations, but it could also deter amendments which could potentially undermine the majority interests of the company[5].

## **4. Conclusion**

In conclusion, preferred shareholders nowadays do have limited voting rights in pursuant to Article 10 of the 2014 measures. However, it is obvious from the discussion above that the scope of the voting power is wider than that of the other nations or regions. By conferring such wide voting power, the author believes that it

detracts the nature of the preferred shares and it would also have negative influences on the company's autonomy of conducting cooperation and fail to uphold the majority interests of the company which would eventually lead to loss of efficiency and failure to maximize the profit. Hence, the author believes that further amendments of Article 10 should be conducted to restrict such wide power such as inserting a prerequisite that only damaging their interests can they summon their rights to vote and further modify Article 10(5) to be more detailed. Lastly, Article 10(3) should not be a compulsory provision but rather should leave to company's discretion to insert into AOA or not.

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