

# China Legal Briefing\* 263

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## **1. China 4th Judicial Interpretation of the PRC Company Law**

The PRC Supreme People's Court published the 4th interpretation of the PRC Company Law ("4<sup>th</sup> Interpretation") on 25 August 2017. This interpretation came into effect on 1 September 2017. The 4<sup>th</sup> Interpretation mainly aims at strengthening the protection for shareholders, promoting corporate governance in PRC companies, fostering a stable and transparent environment for investment, as well as improving the mechanism for resolving the increasing number of disputes relating to corporate governance and shareholder rights. The 4<sup>th</sup> Interpretation primarily covers five areas, namely: (A) the validity of resolutions; (B) shareholders' information and inspection rights; (C) profit distribution; (D) pre-emptive rights; and (E) shareholders' derivative actions.

### **A. Validity of Resolutions**

According to article 22 of the PRC Company Law, a resolution of the shareholders' meeting, the general meeting or the board of directors shall be invalid if it is in violation of laws or administrative regulations. A shareholder may file an action to request a competent court to declare the resolution invalid or cancel the resolution. The 4<sup>th</sup> Interpretation, for the first time, introduces the concept that a resolution has not been established in the case of very grave procedural shortcomings. Based on the 4<sup>th</sup> Interpretation, the company's shareholders, directors and supervisors can lodge a claim that a shareholder or board resolution is either invalid or not established.

### **B. Shareholders' Information and Inspection Rights**

The 4<sup>th</sup> Interpretation reaffirms the protection of shareholders' information and inspection rights and provides in detail for the further strengthening of such rights. Relevant provisions include the following:

- (1) A shareholder may file a lawsuit in order to demand access to or the reproduction of specific documents and materials of the company in accordance with article 33 or article 97 of the Company Law or the companies' articles of association.
- (2) A company's articles of association or the shareholders' agreement cannot substantially deprive a shareholder of its information and inspection rights;
- (3) Shareholders may engage accountants, lawyers or other intermediaries to inspect the company's documents; and
- (4) Shareholders may claim damages against the directors or senior management responsible for performing relevant obligations, where their actions cause the company to fail to prepare or preserve the documents and materials prescribed in Article 33 or Article 97 of the Company Law, and where such failure caused losses to the shareholders.

The abovementioned provisions specify shareholders' rights as prescribed in the PRC Company Law.

### **C. Profit Distribution**

The Supreme People's Court is of the opinion that the decision whether or not to distribute profits should rest with the respective company, allowing the company to exercise its own business judgment and autonomy. The 4<sup>th</sup> Interpretation provides that the court will generally reject a shareholder's request for the company to distribute profits in the absence of a valid shareholders' resolution authorising it. However, to balance the interests of minority shareholders and to prevent abuse by a controlling shareholder, the 4<sup>th</sup> Interpretation provides that a shareholder may claim for distributing profits in cases, where the failure to distribute profits is the result of an abuse of other shareholders' rights and causes losses to other shareholders.

### **D. Pre-emptive Rights**

According to Company Law, the shareholders of a limited liability company may transfer all or part of their equity among each other. The proposed transfer of equity by a shareholder to any non-shareholder party shall be subject to the consent of more than half of the other shareholders. The shareholder shall notify the other shareholders in writing of the proposed equity transfer and ask for their consent. Failure to reply by any of the other shareholders within 30 days upon receipt of the written notice shall be regarded as consent to the transfer.

The 4<sup>th</sup> Interpretation sets out the following more detailed guidance regarding the exercise of these procedures and rules:

- (1) The transferring shareholder can notify other shareholders of the terms of the proposed equity transfer in writing or other reasonable ways where receipt can be confirmed. This provides more flexibility and efficiency to the notification process;
- (2) The shareholder of a limited liability company that wants to exercise the pre-emptive right shall file the request for purchase within the period of time prescribed by the company's articles of association. Where the articles of association fail to provide a time period, or where such time period is not sufficiently clear, the time period specified in the notice shall prevail. If the notice specifies a time period of less than thirty days, or fails to specify any time period at all, the time period for the exercise of the pre-emptive rights shall be thirty days.
- (3) Shareholders must be offered the "same terms", taking into account the amount, price, payment method and payment terms of the transferred equity interest.

The 4<sup>th</sup> Interpretation sets limits on the operation of pre-emptive rights. Unless the articles of association specify otherwise, transferring shareholders can change their mind and refuse to

transfer their shares after other shareholder(s) have exercised their pre-emptive rights. The other shareholder(s) cannot force the transfer, but they can seek compensation from the transferring shareholder for reasonable losses resulting from the transferring shareholder's withdrawal.

The 4<sup>th</sup> Interpretation also provides remedies for cases, where pre-emptive procedures are not complied with. If the transferring shareholder transfers his equity interest to a third party without consulting other shareholders on their pre-emptive right, or if shareholders' pre-emptive rights are prejudiced by way of fraud or malicious collusion, such shareholders may request for purchase of the transferred equity interest under the same terms (subject to certain time periods). The third-party transferee of the equity is entitled to claim damages from the transferring shareholders.

#### **E. Shareholders' derivative actions**

The PRC Company Law stipulates that a shareholder may submit a written request to the board of directors, to the board of supervisors, or to directors and supervisors directly. A shareholder can also in his own name directly file an action at the competent people's court for the interest of the company, in cases where a director or senior management person or a supervisor cause irreparable damage to the interests of the company. However, Company Law does not specify who shall be the plaintiff, who shall be the beneficiary from winning the case, and who shall have to bear the expense.

The 4<sup>th</sup> Interpretation clarifies that if supervisors claim against directors or senior management for breach of obligations, the company shall be the plaintiff, with the supervisors handling the litigation on the company's behalf. The same principle applies to a director's claim against the supervisors for breach of their obligations. That means in such cases the company shall be the plaintiff, with the director handling the litigation on the company's behalf.

#### **F. Conclusion**

The 4<sup>th</sup> Interpretation provides further clarification and guidance on various aspects of disputes among shareholders and the corporate governance structure, from both substantive and procedural perspectives. It also strengthens protection for minority shareholders.

However, a lot of issues and ambiguities remain to be addressed. For example, where any of the other shareholders files a request for confirmation that the equity transfer contract and the equity change have come into effect, he has to file at the same time for the purchase of the equity and for transfer on equal terms and conditions. It is not easy to define such "equal terms and conditions".

Judicial practice is expected to provide further clarification in the future.

## **2. Announcement of the State Administration of Taxation on the Record-filing of Tax Exemption of Cross-border Taxable Activities and Other Value-added Tax Issues**

A number of problems arose during the implementation of the program to replace business tax with value-added tax in all of China. The State Administration of Taxation published an announcement on record-filing of Tax Exemption of Cross-border Taxable Activities and Other Value-added Tax Issues ("Announcement") on 14 August 2017, in order to clarify certain issues. The Announcement came into effect on September 1, 2017.

This Announcement focuses on value-added tax ("VAT") issues, including the record filing for tax exemption of cross-border taxable activities, and states the following:

- (1) Record-filing for cross-border taxable activities. The Announcement declares that if a taxpayer has gone through the procedures for record-filing for tax exemption of cross-border taxable activities in accordance with laws and regulations, the taxpayer is no longer required to go through record-filing procedures again for the same cross-border taxable activities occurring subsequently, provided that the taxpayer keeps all the relevant tax exemption supporting materials for future reference.
- (2) Tax deductions from the output tax in the transportation industry. Where a taxpayer, in the capacity of the carrier, signs a transportation service contract with a consignor, thus collects freight and bears carriers' liabilities, and thereafter entrusts an actual carrier to complete all or part of the transportation services, the input tax on refined oil products that are purchased by the taxpayer on its own and given to the actual carrier for use, as well as the input tax on the road, bridge and gantry tolls paid by the taxpayer, will be deductible from the output tax in certain circumstances. This would, for example, be the case where the taxpayer obtains legal and valid VAT deduction certificates.
- (3) VAT invoices issued by individuals. Where other individuals entrust real estate agencies, housing rental enterprises and other entities to rent out real estate, and need to issue VAT invoices to lessees, the entrusted entities may, on behalf of such individuals, apply to competent local tax authorities for issuing VAT invoices in accordance with relevant provisions.
- (4) Issues regarding VAT invoice in discount or rediscount business. Starting from January 1, 2018, where financial institutions need to issue invoices in respect of discount interest when carrying out bills discount or rediscount business, a discount selling institution will issue ordinary VAT invoices based on the full amount of bills discount interest to a

discount applicant, while a rediscount institution shall issue ordinary VAT invoices to the relevant discount selling institution based on the full amount of rediscount interest.

### **3. Action Plan for Better Protecting Foreign-invested Enterprises' IPRs in China**

Twelve Chinese authorities jointly issued an Action Plan for the Protection of Intellectual Property Rights Owned by Foreign-Invested Enterprises on August 9, 2017. The issuing authorities include the Office of the National Leading Group for Crackdown on the Infringement of Intellectual Property Rights and the Production and Sale of Counterfeit and Shoddy Goods, the State Intellectual Property Office ("SIPO") and the Ministry of Commerce ("MOFCOM"). The purpose of the Plan is to create a market environment of fair competition and a favorable investment climate, to further promote the growth of foreign investment and improve the quality of foreign investment utilization. Another goal is to curtail the illegal and criminal activities of infringing upon intellectual property rights ("IPR") of foreign-invested enterprises, and to effectively protect the legitimate rights and interests of foreign-invested enterprises.

The Plan proposes eleven missions, which call for a severe crackdown on a series of violations and offences, such as the infringement of trade secrets, trademarks, patent copyrights, and new plant varieties. It further targets the import and export of IPR-infringing goods, the improvement of security regulation in the dispatching and delivery stage, the curbing of counterfeiting, the strengthening of procuratorial supervision, the reinforcement of judicial adjudication, and the improvement of external publicity.

The plan contains a schedule for its execution. The plan provides for intensive efforts to be made nationwide for four months, starting from September 2017, in order to crack down on illegal and criminal acts that infringe on intellectual property rights owned by foreign-invested enterprises. A special work report will be submitted to the Office of the National Leading Group on the Fight against IPR Infringement and Counterfeiting by December 31, 2017.

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