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A Study on the Application of Preemptive Right

By David Yu and Bernie Liu

The concept of "preemptive right" with respect to the share transfer of a limited liability company usually consists of two different concepts under PRC law: (a) a shareholder's privilege to subscribe for the newly increased capital in an amount proportionate to the shareholding structure in order to avoid dilution of the shareholder's equity interests; or (2) a right of first refusal to a proposed but not yet completed transfer of shares.

This article aims to address on the application of the second definition of the "preemptive right", i.e., the right of first refusal for sale of shares. To exercise such Preemptive Right, the relevant provisions of share transfer shall be agreed by the transferring shareholder and the non-shareholder purchaser, and the parties, including shareholders or such party entitled to contractual preemptive right shall determine whether to accept the transfer of the shares pursuant to the terms and conditions established.

Concept of the Preemptive Right

Article 72 of the PRC Company Law provides that "Where a shareholder transfers its shares to a person other than a shareholder, the consent of more than half of all other shareholders shall be required. Where the shareholders consent to the share transfer, other shareholders shall have the preemptive right to purchase the shares to be transferred on equal terms and conditions. Where the articles of association stipulate otherwise, such stipulations shall apply". In other words, unless otherwise provided in the articles of association, the exercise of the preemptive right consists of the following three elements: (1) consent of more than half of all other shareholders (not the shareholders holding more than 50% interests in such company); (2) transferring shareholder and non-shareholder purchaser have reached agreement on the terms and conditions of such transfer; and (3) the existing shareholder chooses to exercise its preemptive right based on equal terms and conditions.

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In addition to the statutory preemptive right, the PRC Contract Law provides the principle of "Freedom of Contract", which allows the shareholder to grant a contractual preemptive right to a non-shareholder third party. Such contractual preemptive right shall be exercised pursuant to the specific provisions of the contract and is inferior to the statutory preemptive right. If the shareholder granting contractual preemptive right breaches, it will be difficult for the party entitled to the contractual preemptive right to enforce such right.

Practical Application of the Preemptive Right

The statutory preemptive right sets stringent restrictions on shareholders. Regardless of whether the transferring shareholder is a controlling shareholder or a minority shareholder, the share transfer by the transferring shareholder will be subject to the statutory preemptive right unless such sale is made to another shareholder. Such provision constricts the flexibility in disposing of shares, and may affect the shareholder's ability to realize the true value of the shares and the commercial achievements of the transaction. To avoid the negative impacts caused by the statutory preemptive right, especially in a situation of specific commercial arrangement, some transferring shareholders adopt special arrangements to procure the waiver of the statutory preemptive right from other shareholders, or to ensure the other shareholders are unable to exercise such right. Commonly adopted measures include exclusive cooperation conditions, but such arrangement will cause dispute over the share transfer and may render it more difficult for the transferring shareholder to realize the commercial achievements.

The controversy over statutory preemptive right focuses on the definition of "equal terms and conditions". No statutory laws or judicial interpretations have given a concrete answer to what "equal terms and conditions" means. Shanghai Higher People's Court (Civil Court II) issued the *Opinions on the Issues involving Shareholders' Preemptive Right in Limited Liability Companies* in 2008 which provides: (1) "equal terms and conditions" shall refer to the key terms and conditions underlying the share transfer between the transferring shareholder and the non-shareholder purchaser; (2) the terms and conditions agreed by the transferring shareholder and the non-shareholder purchaser, such as investment, business cooperation, succession of indebtedness, etc. should be identified as the key terms and conditions for the share transfer. Based on the foregoing, if the transferring shareholder and the non-shareholder purchaser have agreed on the exclusive provisions of the cooperative conditions, and such conditions are usually not deemed as the key conditions for share transfer, such as providing an option to the transferring shareholder to acquire certain assets exclusively owned by the non-shareholder purchaser, the transferring shareholder may be deemed to have circumvented the statutory preemptive right and thereby damaging the other shareholders' interest. Under such circumstance, the other shareholders can exercise their statutory preemptive right without following those conditions irrelevant to the share transfer. Similarly, "equal terms and conditions" for the share transfer include, but are not limited to, equal purchase price, congruent payment schedule, and other reasonable commercial terms.

The contractual preemptive right shall be exercised pursuant to the provisions of the contract. Thus, its exercise requires a clearly stipulated arrangement. If the provisions of the contract are vague, it may be easy for the transferring shareholder to circumvent the relevant requirements without being held liable for breach of contract.

Conclusion

From commercial perspective, a share transfer between a transferring shareholder and a non-shareholder purchaser that is subject to a preemptive right (whether contractual or statutory) carries uncertainty, and that uncertainty could further affect the realization of the business achievements of the transferring shareholder. Under the current Chinese legal regime, except under special circumstances[1] or otherwise provided in the articles of association, the transferring shareholder of a limited liability company is unable to ensure the certainty of a share transfer through an appropriate structure.

Based on the above, to avoid the negative impact of the preemptive right on the parties' commercial intent, we propose that shareholders consider the following in a share transfer deal:

- to stipulate the specific terms of the preemptive right in the articles of association to avoid uncertainty; or
- to expressly stipulate in the articles of association that the shareholders do not enjoy a preemptive right, and to instead introduce the right of first offer[2] to protect the rights of the other shareholders without affecting the commercial arrangements of the transferring shareholder; and
- to structure the shares of the project company to be held by a pure holding company, under which the shareholder may consider a direct transfer of its shares in the holding company to avoid the application of the preemptive right.

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1 Supreme People's Court's provisions on the auction, sale of the assets during civil execution by people's courts promulgated as of 1 January 2005, "During an auction process, if there is a ceiling price, the person with the right of first refusal can purchase the auctioned item at the ceiling price; if there is not bidder with higher price, the person with right of first refusal will win the bid; if there is bidder with higher price, and the person with right of first refusal keeps silent, then the bidder with the highest price will win the bid".

2 A contractual obligation by the owner of an asset to a rights holder to negotiate the sale of an asset with the rights holder before offering the asset for sale to third parties. If the rights holder is not interested in purchasing the asset or cannot reach an agreement with the seller, the seller has no further obligation to the rights holder and may sell the asset freely.