

Shareholder Appraisal Remedy in China: Empirical and Comparative Perspectives

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1. Introduction

- **Concept: The appraisal remedy**
 - allows dissenting shareholders (usually minority shareholders) who oppose certain major corporate actions to sell their shares back to their company at an appraised fair price.
- **Function:**
 - protecting minority shareholders and
 - improving corporate governance

- Why study China?
 - The appraisal remedy was first developed in the US and now has been adopted by many jurisdictions around the world, including China.
 - In 2005, China introduced the appraisal remedy when overhauling its company law (2005 Company Law).
 - the appraisal remedy has a particularly important role to play in China, given the fact that the corporate ownership structure is highly concentrated in China and the main agency problem is the opportunism of controlling shareholders vis-à-vis minority shareholders.

- The core elements of shareholder appraisal remedy include
 - the scope of events which may trigger a shareholder's right to demand the remedy,
 - the procedure that the shareholder needs to go through in seeking the remedy,
 - the method that can be used to determine the fair value of relevant shares, and
 - the extent of exceptions to the remedy.
 - the relationship between the appraisal remedy and the capital maintenance doctrine in the Chinese law

- 2023 Company Law:
 - As far as the appraisal remedy is concerned, the revisions are relatively minor
- Several interesting questions may arise here:
 - has the 2023 reform paid sufficient attention to the appraisal remedy?
 - Does it represent a missed opportunity for China to enhance its regime for shareholder appraisal remedy?
 - How effective had the appraisal remedy been in China before the 2023 reform of the Chinese company law?
 - Whether, and if so, how should China's regime for shareholder appraisal remedy be further improved?
 - What can the Chinese experience contribute to the international discourse on shareholder appraisal remedy?

- a mixture of research methods, including
 - doctrinal analysis,
 - “law on paper”, namely China’s legal framework for shareholder appraisal remedy before the 2023 reform of company law and the revisions made in the reform.
 - empirical study and
 - “law in action” by way of an empirical study of relevant cases during a 15-year period from 2006 (when the appraisal remedy came into use in China) to 2020 (when the 2023 company law reform was initiated)
 - comparative analysis.
 - compare China with relevant jurisdictions, notably the US and Japan, and put forward suggestions for improvement

2. Background

■ 2.1 Historical Development

- In the 19th century and early 20th century, unanimous consent by shareholders was required for certain major corporate actions
- the appraisal remedy is developed to compensate minority shareholders for their loss of veto power
- originated in the case law of Ohio in 1851, and gradually expanded to other states in the US.
- has also been transplanted to many other jurisdictions, including common law jurisdictions (such as the UK, Australia, Canada and Hong Kong) and civil law jurisdictions (such as Germany, Japan, South Korea and Taiwan)
 - “oppression remedy” or “unfair prejudice remedy” in the Commonwealth jurisdictions

■ 2.2 2005 Company Law

- first introduced in China's 2005 Company Law and despite the two revisions of the company law in 2013 and 2018, it has remained largely unchanged
- shareholder appraisal remedies are regulated differently according to the type of companies concerned
 - limited liability companies (LLC)
 - joint stock limited companies (JSC)

- Article 74: three circumstances for LLC shareholders to seek the appraisal remedy:
 - (1) The company that has made profits for five consecutive years has failed to distribute any dividends to the shareholders for 5 consecutive years and conforms to the profit distribution conditions as prescribed in this Law;
 - (2) The company is going to merge with others, to be split up, or transfer the major properties of the company to others;
 - (3) When the business term as specified in the bylaw expires or other reasons for dissolution as prescribed in the bylaw occur, the shareholders' meeting makes the company exist continuously by adopting a resolution to modify the bylaw.
- Article 142: only one circumstance for JSC appraisal
 - If a JSC shareholder objects to a resolution of the shareholders' meeting to merge with others or to be split up.
 - corresponds to the second circumstance of Article 74 and is even narrower in that it refers to merger and split up transactions but not major property transfers.

- Article 74: Procedural rules
 - in order to seek the appraisal remedy, LLC shareholders need to vote against the relevant resolution of the shareholders' meeting
 - Further, the dissenting LLC shareholders should negotiate with the company first before filing a lawsuit for the appraisal remedy
 - If they fail to reach an agreement within 60 days after the adoption of the resolution of the shareholders' meeting that triggers the appraisal remedy, the LLC shareholder may file a lawsuit to the court within 90 days after the adoption of the resolution
- Article 142: Procedural rules
 - they disagree with the relevant resolution of the shareholders' meeting.
 - After the company buys back the shares of dissenting shareholders, those shares should be transferred or cancelled within 6 months.
 - NOTE: silent on whether JSC shareholders need to negotiate with the company before filing an appraisal lawsuit or whether there is a time limit for the shareholders to seek the appraisal remedy.

■ 2.3 2023 Company Law

□ Appraisal for JSC:

- Article 162 of the 2023 Company Law is a faithful copy of its predecessor, Article 142 of the 2005 Company Law

□ Appraisal for LLC:

- Article 89 of the 2023 Company Law is the successor to Article 74 and Article 142 of the 2005 Company Law, but adds one circumstance:
- If a controlling shareholder of the company abuses shareholder rights with prejudice to the interest of the company or other shareholders, the other shareholders have the right to request the company to acquire the controlling shareholder's equities at a reasonable price.

- Article 219: “simplified merger”
 - a parent company can merge with its subsidiary company in which it owns more than 90% shares, without the need to obtain approval by the shareholder meeting of the subsidiary company;
 - The minority shareholders of the subsidiary company have the right to request the company to buy its shares at a reasonable price.
 - NOTE:
 - essentially the appraisal remedy
 - Apply to both LLC and JSC

3. Empirical Findings

■ Methodology

□ Databases

- Chinainfo (北大法宝)
- Lawyee (法意)
- China Judgement Online (中国裁判文书网)

□ Study period: 2006-2020

■ Limitations

□ Only litigated cases

- Many disputes may be settled due to the concern over payment

□ Others:

- incompleteness of databases...

■ 3.1 General Statistics

- A total of 229 appraisal cases:
 - 225 LLC-related cases; 4 JSC-related cases
- Significant increase in the number after 2013
 - 2013 revision of the company law

Table 1: Temporal Distribution of Cases

Year	Total	LLC (Article 74)	JSC (Article 142)
2020	62	62	0
2019	34	33	1
2018	47	45	2
2017	20	19	1
2016	15	15	0
2015	17	17	0
2014	16	16	0
2013	7	7	0
2012	3	3	0
2011	2	2	0
2010	0	0	0
2009	3	3	0
2008	3	3	0
2007	0	0	0
2006	0	0	0
Total	229	225	4

- geographical distribution of cases
 - Jiangsu, Shanghai, Shandong, Guangdong, and Zhejiang are the top 5 provinces in terms of the number of cases, collectively accounting for 42.6% of all cases.
 - there are five cases appealed ultimately to the Supreme People's Court

Table 2: Geographical Distribution of Cases

Regional Distribution of Cases	Case Number
Provinces with more than 15 cases	Jiangsu (27); Shanghai (21); Shandong (18); Guangdong (15); Zhejiang (15);
Provinces with 1 to 14 cases	Sichuan (12); Liaoning (11); Anhui (10); Hubei (10); Fujian (9); Hunan (8); Henan (8); Xinjiang (7); Jilin (7); Gansu (6); Beijing (5); Yunnan (5); Inner Mongolia (5); Chongqing (5); Guizhou (5); Tianjin (4); Ningxia (3); Guangxi (2); Jiangxi (2); Shanxi (2); Heilongjiang (1); Qinghai (1); Hebei (1);
Total	225

- the shareholding level of the plaintiff shareholders
 - 36.44% of cases were filed by small shareholders with less than 10% shares in their company and 37.77% of cases by those with a shareholding between 10% and 30%.

Table 3: Plaintiff Shareholders' Shareholding Level[←]

←

Plaintiff's Shareholding Ratio (%) [←]	Case Number [←]	Percentage [←]	←
Less than 10 [←]	82 [←]	36.44 [←]	←
10 (inclusive) to 30 [←]	85 [←]	37.77 [←]	←
30 (inclusive) to 50 (inclusive) [←]	37 [←]	16.44 [←]	←
More than 50 [←]	3 [←]	1.33 [←]	←
Unclear [←]	18 [←]	8.00 [←]	←
Total[←]	225[←]	100[←]	←

■ 3.2 Statutory Grounds

- the plaintiff(s) may put forward more than one statutory grounds for the appraisal remedy in some cases
- the first grounds under Article 74, namely “no dividend distribution in five consecutive years of earning profits”, is the most-used grounds in the appraisal cases.

Table 4: Statutory Grounds for the Appraisal Remedy

Statutory Grounds	Case Number	Percentage
No dividend distribution in five consecutive years of earning profits	95	39.25
Corporate merger, split-up	11	4.54
major property transfer	64	26.44
Charter amendment to continue the existence of the company	72	29.75
Total	242	100

- 3.3 Judicial Reasons for Case Dismissal
 - Out of the total 225 cases, plaintiff shareholders failed in 144 cases or 64% of all cases.
 - as the court may give more than one reason to dismiss the case, the number of dismissal reasons is higher than that of failure cases.

Table 5: Judicial Reasons for Dismissing the Case

Judicial Reasons for Dismissing the Case	Case Number	Percentage
1. The plaintiff failed to demonstrate statutory grounds for seeking the appraisal remedy	74	40.21
2. The plaintiff failed to comply with procedural rules	77	41.83
3. The plaintiff's standing to sue is flawed	18	9.78
4. There is no longer a need for seeking the appraisal remedy	5	2.71
5. It is difficult to implement the appraisal remedy	6	3.26
6. Others	4	2.17
Total	184	100

- First, in about 40.21% of all dismissed cases, the plaintiff's failed to meet substantive rules
 - information asymmetry is a major obstacle
 - The dissenting shareholders filed a lawsuit of inspection rights to obtain relevant information
 - it can be hard for the minority shareholder to prove that the company made profits for five consecutive years and were eligible to distribute dividends.
- Second, in even more cases, failed to comply with procedural rules
 - not meet the requirement of voting against the relevant shareholder resolution
 - the Supreme People's Court issued a guidance case, holding that the procedural requirement of "dissenting vote" can be exempted under certain circumstances
 - could not prove that they had negotiated with the company
 - sought the appraisal remedy after the 90-day time limit
 - not complete the capital reduction procedure

- Third, there are problems with the plaintiff shareholder's standing to sue.
 - some plaintiffs no longer had the status of shareholder, failed to pay up registered capital, or withdrew capital from the company
 - the plaintiff shareholders were their company's employees who indirectly held shares through the vehicle of "shareholding committee" (or "trade union") and thus were not recognized as shareholders by the court
- Others
 - the company resolution opposed by the dissenting shareholder had been declared invalid or revoked
 - the materials provided were not audited
 - the company charter or shareholder agreements excluded the exercise of appraisal remedy

■ 3.4 Stock Valuation Mechanisms

- 81 success cases; the practical difficulty is to determine a fair price
- in 40 cases or almost half of all cases, the court commissioned specialists to value the shares of dissenting shareholders
- In almost 1/3 cases, the court evaluated stock itself, usually using the “net asset” value.
- The court used the method suggested by one party if the other party failed to come up with its own method

Table 6: Stock Valuation Mechanisms



Stock Valuation Procedure	Case Number	Percentage
1. The court entrusted specialists to evaluate the stock	40	49.38
2. The court evaluated stock itself, usually using the “net asset” value	26	32.10
3. The court simply accepted the plaintiff’s claim to value the stock because the defendant did not cooperate	7	8.64
4. The court simply accepted the defendant’s claim to value the stock because the plaintiff did not cooperate	1	1.23
5. Unclear	7	8.64
Total	81	100

4. Critical Evaluation: Comparing with the US and Japan

- Why choose these two jurisdictions:
 - First, the Chinese company law has been significantly influenced by the relevant experiences of the US and Japan;
 - Second, they are representative of the common law system and the civil law system respectively.

■ 4.1 Comparing the Law on Paper

Table 7: International Comparison of Appraisal Remedy Systems

	Statutory Grounds	Procedural Prerequisite	Market Exception
China	no dividends in five consecutive years of earning profits; corporate merger, split-up, major property transfer; charter amendment to continue the existence of the company	dissenting vote; negotiate repurchase with the company	No
U.S. (Delaware)	merger, consolidation	no affirmative vote; request in writing	Yes
Japan	merger, business transfer, restricted share transfer, transformation, share exchange, company split-up, shareholder non-voting small transaction	submission of written objections; dissenting vote; requesting to exercise appraisal remedy	No

- ❑ there are more statutory grounds for appraisal remedy in China and Japan than in Delaware.
- ❑ the “market exception” rule in Delaware while no such rule in China and Japan
- ❑ Two types of exit cases:
 - the case of voluntary exist (the dissenting shareholders requests to withdraw from the company)
 - the case of compulsory exist (the majority shareholders compulsorily purchase the shares of minority shareholders)
 - the appraisal remedy in the US can apply to both
 - 2005 Company Law only applies to the first case, but 2023 Company Law adds the “simplified merger” provision for the second case
- ❑ all stipulate procedural requirements for shareholders to exercise the appraisal remedy

■ 4.2 Comparing the Number of Cases

- 4.2.1 The difference in the number from 2009 to 2018
 - Overall, the number of appraisal cases in China is significantly less than those in the US and Japan.

Table 8: International Comparison of Number of Appraisal Cases[←]

[⌘]	[←]	China[←]	US (Delaware Chancery Court)[←]	Japan (Tokyo District Court)[←]	[←]
2009 [←]		3 [←]	15 [←]	69 [←]	[←]
2010 [←]		0 [←]	18 [←]	55 [←]	[←]
2011 [←]		2 [←]	19 [←]	41 [←]	[←]
2012 [←]		3 [←]	21 [←]	53 [←]	[←]
2013 [←]		7 [←]	34 [←]	72 [←]	[←]
2014 [←]		16 [←]	41 [←]	41 [←]	[←]
2015 [←]		17 [←]	52 [←]	40 [←]	[←]
2016 [←]		15 [←]	76 [←]	37 [←]	[←]
2017 [←]		20 [←]	60 [←]	41 [←]	[←]
2018 [←]		47 [←]	26 [←]	40 [←]	[←]
Total[←]		130[←]	362[←]	489[←]	[←]

■ Delaware

- The number of Delaware cases has grown substantially in recent years, compared with a low number prior to 2000.
 - Before 2000, the relevant rules in Delaware were complex and costly.
- In 2018, there was a sudden and sharp decline in the number of appraisal cases in the US,
 - mainly because of the Dell case which led to the raising of the threshold for the appraisal remedy.
- the plaintiffs of appraisal lawsuits have gradually changed from individual shareholders to professional hedge funds.
- the cases are mainly filed against mergers where there are obvious conflicts of interest, including privatization deals and squeeze-out mergers.
- brought considerable remedies or benefits to dissenting shareholders (average annualized return is up to 32.9%)
 - this has given rise to the issue of appraisal arbitrage

■ In Japan

- the number of appraisal cases also showed a significant and stable increase after 2005.
- the main reason being that Japanese courts have taken the initiative to create various stock valuation methods to bring share premiums to dissenting shareholders.
 - about 20%
- thanks to various institutional factors, such as the well-designed litigation mechanism, the premium incentives have not caused serious problems of appraisal arbitrage

- 4.2.2 Explaining the difference
 - The first factor concerns the rules on the substance of the lawsuit, including the scope of statutory grounds and the method of stock valuation.
 - Unlike the US and Japan, Chinese courts typically do not provide any premium in valuing the stock of dissenting shareholders.
 - The second factor is related to the procedural rules of litigation.
 - the two procedural prerequisites of “dissenting vote” and “negotiating with the company” have seriously hindered the bringing of appraisal lawsuits.
 - “non-statutory appraisal cases” or “contract-based appraisal remedy”
 - the grounds for seeking the appraisal remedy are based on relevant contracts between the dissenting shareholders and the company/majority shareholders
 - 43 cases

- The first category of contract-based grounds is similar to the statutory grounds
- The second category of contract-based grounds goes beyond the statutory appraisal remedy. The SPC has issued judicial interpretation and gazette cases to support this.

Table 9: Number of Contract-based Grounds for Appraisal

Contract-based Grounds for Appraisal	Case Number
1. Contract-based Grounds which are <u>similar to Statutory Grounds</u>	15
1.1 No profit distribution	5
1.2 Sale of major operating assets	5
1.3 Mergers & acquisitions and major transactions	5
2. Contract-based Grounds which go beyond Statutory Grounds	21
2.1 Disputes on the distribution of corporate management power	10
2.2 Disputes related to the corporate legal capital	8
2.3 Disputes relating to the operation of the company	3
3. Unclear	20
Total	56

- 4.3 Comparing the Type of Companies involved
 - 4.3.1 Reasons for the scarcity of JSC-related cases
 - First, as discussed earlier, there are many more statutory grounds for seeking the appraisal remedies in relation to LLCs than JSCs.
 - Further, compared to LLCs, JSCs generally have a more mature corporate governance system, so that there is a lower chance of having shareholder conflicts that need to be addressed through the appraisal remedy.
 - Finally, there are more than 40 million LLCs, compared to about 100,000 JSCs or 0.3% of all companies.

- NO appraisal cases relating to listed companies.
 - First, the public trading market provides a convenient exit mechanism, while it would be very costly to seek the appraisal remedy.
 - Second, even if a lawsuit is brought for the appraisal remedy, the court will likely adopt the market price as the fair price to buy back shares of the dissenting shareholders.
 - Third, there are also securities law provisions that may achieve the same effect of the appraisal remedy for listed companies.
 - CSRC takeover regulation (compulsory buyout)
 - CSRC regulation on the voluntary delisting of listed companies
 - Finally, there is a widely-used practice in the merger transaction, known as the “cash option” clause, which can act as a substitute for the appraisal remedy

- ❑ 4.3.2 No need to introduce the Market Exception Rule
 - First, despite the lack of formal market exception rule in the Chinese company law, similar effects are achieved through the use of substitute mechanisms in practice
 - Second, the Chinese securities market is currently not mature enough to underpin the market exception rule.
 - Finally, even in Delaware, the market exception rule is not absolute.
 - ❑ it depends on the type of consideration that shareholders receive in a merger transaction.
 - ❑ Stock for stock: NO appraisal
 - ❑ Cash: Yes (the main form of consideration used for merger transactions in China is cash instead of stock)

5. Suggestions for Improvement: Combining International Experiences and Local Conditions

- 5.1 Expanding the Grounds for Appraisal Remedy
 - 5.1.1 Theoretical debate on application scope
 - Compensation for the loss of veto power (Manning, 1962)
 - classical theory (Brudney and Chirelstein)
 - 'wealth appropriation theory' (Fischel, 1983)
 - Three functions (Kanda & Levmore, 1985)
 - two characteristics (Gilson and Black, 1995)
 - coordinate shareholders' interests (Letsou, 1998)

- 5.1.2 Reform Suggestions for China
 - The appraisal remedy can be particularly valuable in protecting minority shareholders and improving corporate governance
 - First, the provision about making profits for five consecutive years without distributing dividends is too rigid and should be made more flexible
 - Second, the grounds of “major property transfer” can be made clearer with more guidance to be provided on what may constitute “major property” and what is meant by “transfer”.
 - Third, it is desirable to learn from the Delaware law to introduce the compulsory acquisition rule with a built-in appraisal remedy
 - Finally, we can learn from the experiences of other states in the US which have a broader scope of application of appraisal remedy than that in Delaware

- 5.2 Addressing the obstacles to appraisal remedy
 - 5.2.1 Capital maintenance doctrine
 - After the company buys back the shares of the dissenting shareholder as required under the appraisal remedy, those shares will usually be cancelled, resulting in a reduction of the company's legal capital
 - However, the capital reduction procedure in China is very costly and difficult to follow.
 - some courts exercised judicial discretion to order majority shareholders (rather than the company) to purchase the shares of dissenting shareholders.

□ 5.2.2 Contractual restrictions

- can the company limit or even exclude the appraisal remedy through its charter or shareholders' agreement?
- This paper believes that such judicial attitude is inappropriate. Appraisal remedy is a statutory right stipulated by the Company Law, and it should not be restricted or even excluded through charter.

□ 5.2.3 Corporate Social Responsibility

- the courts in some cases denied the application of statutory appraisal remedy on the ground of safeguarding social interests.
- This paper argues that the court's use of the fairness principle to exclude appraisal remedy needs to be handled with care.

- 5.3 Enhancing Stock Valuation Mechanisms
 - 5.3.1 Clarifying the Methods for Stock Valuation
 - Chinese courts usually use the “net asset value” (NAV) method to determine the shareholders’ stock interests
 - By contrast, Delaware General Corporation Law empowers courts to consider “all relevant factors” when evaluating a dissenting shareholder’s shares.
 - Japanese courts have developed a series of methods for evaluating shares, which can be used flexibly according to different circumstances
 - In order to enhance the utility of appraisal remedy, China should consider adopting valuation methods which can provide proper premiums for dissenting shareholders.

- 5.3.2 Avoiding the Issue of Appraisal Arbitrage
 - Japanese courts have tried with success to promote the application of appraisal remedy while avoiding the issue of appraisal arbitrage
 - On the one hand, Japanese courts developed a series of methods to calculate the fair value of shares.
 - On the other hand, the procedural rules of the Japanese court to hear appraisal remedy cases are also conducive to preventing the appraisal arbitrage problem
 - Worthy of consideration for China

6. Conclusion

- TBA