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To: Han Yi Clients and Friends

Different Classes of Shares Introduced by Proposed Company Law Amendments

On December 24, 2021, China released proposed amendments to its Company Law (*Draft for Comments*) (the “Draft Amendment”). The current law is mainly based on a version adopted in 2005 (with minor changes made in 2013 and 2018), which contains many provisions that are already obsolete and outdated, especially given the explosive investment activities and market developments during the past decade or so. Typical investment terms frequently seen in PE/VC transactions often conflict with existing Company Law provisions or simply cannot be found under any existing law or regulation, and the transaction parties would have to rely on shareholders’ agreements or other contractual instruments with certain level of enforceability uncertainties to stipulate their special rights and obligations. This has particularly been the case for a joint stock company or JSC.

The Draft Amendment has introduced different classes of shares for JSCs to accommodate such diverse shareholders’ rights as voting, pre-emptive, right of first refusal/offer, co-sale, other transfer restrictions, and liquidation preference. It also proposed an authorized capital structure and shares with different or no par value, providing a lot more flexibilities for corporate structuring than the existing law. These changes are expected to provide shareholders with more stable legal protections and will help make PRC companies a more popular choice in global capital markets.

This quick regulatory alert is a nutshell of some key points under the Draft Amendment mainly from PE/VC investors’ perspective for your general review and reference.

1. Different classes of shares

In general, the existing Company Law only provides for one class of shares under the long-held principle of “one share, one vote” for JSC (except for limited situations where some A-share listed companies and unlisted public companies may issue preferred shares in accordance with certain pilot rules issued by the State Council). In practice, JSC is not a popular organizational form unless for companies seeking to go public, in which case shareholders would have their preferred rights frequently structured in a shareholders’ agreement through contractual arrangement, with enforceability of some key provisions constantly subject to judiciary test and practical uncertainty.

The Draft Amendment has explicitly permitted JSC to issue different classes of shares. Specifically, it has proposed:

(a) Preferred shares involving profit distribution, liquidation preference, special voting rights, and limitation on share transfer

Under the Draft Amendment, a JSC may, in accordance with the provisions of the articles of association of the company, issue the following classes of shares that are different from the rights of ordinary shares: (i) shares with different distribution rights as to company profits or residual properties;¹ (ii) shares with different voting rights; (iii) shares subject to different transfer restrictions which require consent of the company;² and (iv) other types of shares prescribed by the State Council.

According to the above, it is possible that a JSC may structure preferred shares for its investors in terms of voting (protective or veto) rights, profit distribution, liquidation preference, among others.

Additionally, the Draft Amendment further provides a statutory protective right to preferred shareholders, under which if a shareholders' meeting proposes to adopt certain resolutions concerning amendments to the articles of association, increase/decrease of the registered capital, merger, separation or dissolution, or change of the company form that may undermine any right or interest of the preferred shareholders, such resolutions should not only be approved by more than 2/3 of the voting rights held by all shareholders present or represented at the shareholders' meeting but also be approved by more than 2/3 of the voting rights held by all such preferred class shareholders present or represented at the preferred class shareholders' meeting.

(b) Preemptive rights

Under existing law, pre-emptive rights are only available to LLC shareholders on a pro rata basis (unless otherwise agreed by all shareholders), but not to shareholders of JSC under the "one share, one vote" principle. The Draft Amendment has made preemptive rights available to JSC shareholders as well, so long as such rights are provided in the JSC's articles of association.

(c) Rights of first refusal/offer, Co-Sale, etc.

Allow for right of first refusal/offer, co-sale, and other transfer restrictions for JSC. Under existing law, except for certain special transfer restrictions applicable to public companies, there is generally no right of first refusal/offer, co-sale right, or the like available to a JSC shareholder as a matter of law. The Draft Amendment has clarified that JSC shareholders may spell out all such transfer restrictions in the JSC's articles of the association, providing legislative basis for all such restrictions.

Streamlined ROFR mechanism for LLC. The existing law has an odd and confusing mechanism for the priority right of all other shareholders in the case of an equity transfer by one shareholder (which ambiguously requires a consent by "the majority of all other shareholders" - if the required consent is obtained, all other shareholders will have a priority right to purchase under

¹ It is worth noting that neither the current Company Law nor the Draft Amendment has provided different distribution rights concerning an LLC's residual properties (which is mainly related to liquidation preference), thus a JSC will be clearly more flexible than an LLC for the purpose of structuring a liquidation preference term.

² The Draft Amendment provides however that no listed company may issue the types of shares provided for under items (ii) and (iii), except for those shares that have already been issued before its public offering. (Article 157)

same terms and conditions and if the required consent cannot be obtained, other shareholders should purchase the selling shareholder's equity interest presumably only based on their negotiation and agreement with the selling shareholder since the law doesn't provide any further guidance for such situation). The Draft Amendment removed this requirement and replaced it with a more clear right of first refusal mechanism, which requires the transferring shareholder to notify other shareholders in writing of the amount, price, payment method and timing of the proposed transfer, while all other shareholders will have a right of first refusal under the same terms and conditions with respect to the proposed transfer.

(d) Lockup for controlling shareholders and investors

Removed the 1-year statutory lockup period for promoters of JSC. The Draft Amendment proposes to remove the existing Company Law provision requiring that "shares held by the promoters of a JSC shall not be transferred within 1 year from the date of the JSC's establishment", so that investors participating in the establishment of a JSC will no longer be subject to the statutory 1-year lockup when they transfer their shares.

Added 3-year statutory lockup period post IPO for controlling shareholders. The Draft Amendment has added that "shares issued by a JSC held by its controlling shareholder(s) before IPO of such JSC shall not be transferred within 3 years from the IPO date". This new restriction will generally affect controlling shareholders of a JSC that intends to effect an overseas IPO since listing requirements for the domestic A-share market already contain such a restriction.

(e) Information & inspection rights

The Draft Amendment has explicitly expanded the scope of shareholders' information right to the inspection of the company's accounting documents, in addition to the accounting books and other information rights (in the case of a JSC, this information right to accounting books and other accounting documents is limited to "shareholders holding more than 1% of the company's shares for more than 180 consecutive days who have reason to suspect the company's noncompliance with applicable laws, regulations or its articles of association").

2. JSC: authorized (but not issued) shares; shares issued with/without par value

The Draft Amendment allows a JSC to issue only part of the total number of shares, and the articles of association or the shareholders' meeting may authorize the board of directors to decide on the issuance of the remaining shares of the company, and may impose restrictions on the time period and proportion of authorized shares to be issued.

Additionally, the Draft Amendment makes it possible to issue shares without par value, or with par value but with the amount to be specified in the articles of association. Under current PRC practice, shares are generally issued at the par value of RMB1 per share.

The aforesaid amendments are expected to make the issuance of shares more efficient and flexible. For example, this will make it easier for future ESOP issuance, capital adjustment in connection with anti-dilution, and share-based valuation adjustment, without the need to go through the more complicated capital increase process.

3. Other noteworthy points

- (a) *Confidentiality concern for JSC.* As mentioned above, JSC is allowed to have different classes of shares with different rights and obligations according to the Draft Amendment, yet such rights and obligations are generally required to be provided in the articles of association. The JSC's articles of association is however, generally a publicly available document. In the case of an LLC, however, except for a few shareholders' rights such as voting rights and transfer restrictions which should be set out in its articles of association, most shareholders' rights may in principle be agreed separately by all shareholders under a confidential shareholders' agreement.
- (b) *Other preferred rights.* The Draft Amendment is silent on some other commonly seen investors' rights for a JSC, such as redemption and anti-dilution right. It is yet to be seen as to whether the preferred rights spelt out in the Draft Amendment are intended to be conclusive, or if there will be some leeway under future practice.
- (c) *Enhanced fiduciary duties for D&Os.* The Draft Amendment has beefed up fiduciary duties for directors, supervisors, and senior officers (D&Os) by explicitly requiring D&Os to act in the best interest of the company as part of their duty of loyalty and duty of care to the company and to maintain the company's capital adequacy. D&Os may be held liable to indemnify the company and its shareholders if they fail to exercise their fiduciary duties for failed or unfunded capital contribution, illegal profit distribution or capital reduction in violation of company law, and financing others to acquire company shares in violation of company law, among others. Investors will need to be more cautious about potential directors' liabilities in their future portfolio management activities and ensure adequate D&O insurance coverage if they will be appointing any director, supervisor or senior management team member to their portfolio companies.

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