

# Effectiveness of Mandatory Share Repurchase Provisions Research

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**Abstract:** The compulsory share repurchase provision of the Company Law only provides for the share repurchase of dissenting shareholders, but does not make systematic arrangements for other share repurchase situations, which has led to frequent contradictions in the application of the law in judicial practice. The existing Company Law does not make specific provisions for the repurchase of the company's statutory initiative, nor does it make legal regulations for the repurchase of the shares agreed in the articles of association and agreement. The legislation should not prohibit the repurchase of equity in the limited liability company, and only set the conditions for not allowing the repurchase of equity can be. Through the institutionalized and systematic arrangement of the resolution authority, notification obligation and disposal of repurchased equity, a systematic and complete repurchase system is constructed. For the determination of the validity of the equity repurchase agreement, the three aspects of contractual rules, shareholders' meeting voting and operating conditions should be grasped comprehensively.

**Keywords:** Equity repurchase clause, Validity determination, Dissenting shareholder.

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## 1. Definition of Mandatory Equity Repurchase

Can the limited liability company through the articles of association to force the staff to take back the equity, which is commonly referred to as "people go shares stay", that is, the company law on the mandatory share repurchase provisions. Regarding the repurchase of the equity of the limited liability company, a considerable part of scholars and judges in theory and practice believe that Article 74 of the Company Law is the provision of the repurchase of the equity of the limited liability company. Some scholars analyze from the perspective of rights and obligations, that the company's active repurchase of equity is the object of the limited liability company equity repurchase study, the dissenting shareholders equity repurchase is the company's passive repurchase situation, should be recognized as the company's obligations. If the equity repurchase situation is limited to Article 74, the other circumstances identified as abstraction of capital is obviously inappropriate. Some scholars believe that the limited liability company share repurchase is from the company's point of view, for under certain conditions, the company for certain purposes, the initiative through certain procedures and the company's shareholders hold their own shares to retrieve the system. And this view is also the passive share repurchase excluded from the limited liability company share repurchase.[1] This article believes that from the formal point of view, the dissenting shareholder share repurchase subject is the company, the subject of the limited liability company share repurchase is also the company, only the reason for the repurchase may be different, the form of the essence of the company to repurchase equity.

This article believes that the limited liability company share repurchase that the limited liability company in the case of sufficient assets, based on legal or agreed reasons, in accordance with certain procedures, the repurchase of the company's equity behavior. The agreement is in line with the appearance and substance of the repurchase of equity, and reflects the principle of autonomy of the company as an

independent legal person, in addition, in practice, there are indeed a large number of by-laws or agreements to agree on the repurchase of equity, the judicial practice of the judge on the agreed equity repurchase of different attitudes, it is necessary to be included in the repurchase of equity to regulate the situation. Although the majority of the courts on the equity repurchase agreement is positive, but the law does not make clear provisions on the recognition criteria and practical operation of the agreed equity repurchase situation.

## 2. Current Status and Problems of the Effectiveness of the Equity Repurchase Clause

### 2.1. Current status of the effectiveness of equity repurchase provisions and problems

#### 2.1.1. Current status of legislation

Article 142 of our Company Law stipulates that a joint-stock company may not, in principle, acquire the Company's shares, but allows the repurchase of shares in cases such as reduction of the Company's capital, merger with other companies, rewarding employees, and exercise of the dissenting shareholders' right to request for share repurchase, and further refines them. In contrast, Article 74 of the Company Law in China provides for the legislator to construct a system for dissenting shareholders to withdraw from the Company and receive reasonable compensation under special circumstances from the perspective of shareholders. This provision differs from Article 142 of the Company Law, which allows for the repurchase of one's own shares in exceptional circumstances from the perspective of the joint stock company.

For the content of the claim, China adopts the way of enumeration to provide for this, the claim can only be exercised when the occurrence of matters that have a significant impact on the interests of shareholders of the company. Compared with other countries or regions, the

scope is narrower, and there is no provision for changes in the articles of incorporation, changes in the business status, structure or nature of the company, and other relevant situations that affect the interests of shareholders. Moreover, the provisions of Article 74 of the Company Law lack specific operational regulations, and there are certain imperfections in the applicable subjects, scope, procedures and disposition of repurchase.

### **2.1.2. Current status of justice**

Throughout the recent years, there are very few cases involving share repurchase between shareholders and companies, and most of them are in civil and commercial cases. There are no specific provisions in the law for cases related to equity repurchase, and the case guidance issued by the Supreme Court is limited in its guiding effect.

## **2.2. Problems of the legal system of share repurchase of limited liability companies in China**

### **2.2.1. Unclear regulations on the applicable subjects of the share repurchase system**

First of all, whether the successor shareholder is entitled to the main qualification. A successor shareholder is a shareholder who acquires an equity interest in a company by transfer, inheritance or gift. Whether the successor shareholder can have the right to claim the time of acquisition of equity is generally discussed, focusing on whether the successor shareholder has the possibility of expectation of benefit failure. Secondly, whether the shareholders in name are entitled to the main qualification. Although the name is not registered in the register of shareholders and the registration documents of the registration authority, the shareholders enjoy the rights of shareholders. In China's judicial practice, hidden shareholders often exist in the company, whether the hidden shareholders enjoy the right to repurchase equity, China's legislation has not made precise provisions for the time being. As the actual capital contributor of the company, no matter it wants to transfer the equity to the registered shareholder within the company or the hidden shareholder, or wants to transfer the equity to the company, it will not damage the capital maintenance of the company and will not lead to the loss of the company's capital. Therefore, it can be considered as the subject of equity repurchase request right.[2] However, considering the relationship between the hidden shareholders and the actual registrant, if the visible shareholders want to exercise their right to request, how they exercise their right and in what way they exercise their right are worth further analysis and clarification. Third, whether shareholders without voting rights are entitled to the subject matter. Theoretically, there are different opinions on the issue of whether shareholders without voting rights are entitled to subject matter status, with Korean and Canadian scholars holding a positive view and the United States holding an opposing view. Korean and Canadian scholars argue that non-voting shareholders are not entitled to only voting rights, while the right to repurchase shares is a right other than voting rights, and they also argue that non-voting shareholders are not required to attend meetings, as long as they raise objections in advance. According to the U.S. Standard Company Law, only those shareholders who vote against the proposal at the shareholders' meeting are entitled to the proposal, so non-voting shareholders do not have the right to vote, and therefore do not have the right to repurchase the

shares. As to whether the non-voting shareholders in China are entitled to this right, it should be analyzed in the context of the specific situation in China.

### **2.2.2. The scope of application of the equity repurchase system is too narrow**

At present, the operation of companies in China often appear in the situation of the majority shareholder abuse of dominant position to oppress the small and medium shareholders, resulting in the interests of small and medium shareholders are not absolutely protected. As mentioned above, there are three ways for shareholders of limited liability companies to withdraw from the company, and when they want to choose to withdraw by way of buyback, they are limited by the three situations stipulated in the legislation, and if they do not comply with the legislative regulation, the shareholders will lose the opportunity to withdraw from the company by way of buyback. This for the current market changes in China's diverse forms of development, diversified development of limited liability companies, will have a certain hindering effect, while not conducive to the protection of shareholders' property interests.[3]

Limited liability company as a person with the nature of the company, the purpose of the repurchase of equity and the scope of application need not be too strict limits: the company's capital, there must be its constitution and capital, shareholders to strictly comply with the principle of true payment of capital and maintenance principle; the company's person, the number of shareholders is generally small, the shareholders manage the company, emphasizing the freedom of the constitution and flexible operation. Therefore, as long as it does not infringe on the basic capital maintenance of the company, it can give more freedom to the limited liability company, so that shareholders can achieve their purposes more easily through the equity buyback system. At the same time, in order to meet the needs of the international development of the economy, the Company Law should be open and internationalized for the share repurchase of limited liability companies, so as to provide support for the growth of small and medium-sized companies.

### **2.2.3. Insufficient specificity in the procedures for the application of the share repurchase system**

The second paragraph of Article 74 of the Company Law of China only mentions the time to sue the dissenting shareholders, the content is too simple, resulting in the limited liability company share repurchase system in the application of the procedure is not specific enough, so that the occurrence of such cases can not play a full role, basically need to rely on the judge's discretion, so that the operation of the system brings a certain degree of instability. In the long run, it will affect the shareholders to exercise the right and increase the cost of the company in the repurchase of equity.

## **3. Countermeasures to Improve the Application of Mandatory Equity Repurchase Provisions**

### **3.1. Corporate capital system level**

Due to the macroeconomic situation, the company may have fallen into operating difficulties, the buyback of employee equity is likely to infringe on the company's solvency. And the lack of financial review rules of the "people leave the stock", there is the possibility of malicious collusion of company insiders to empty the company's assets. In view

of this, "the person leaves the stock to stay" dispute financial source review rules are indispensable. According to whether or not the capital reduction, "the share repurchase" disputes are divided into non-reduction type repurchase and capital reduction type repurchase, the two have commonalities and differences.

The company shall conduct a "solvency test" before deciding to repurchase, and the people's court shall review the solvency of the company when hearing such disputes. If it is found that the repurchase of the employee's equity will lead to the impairment of the company's solvency, then the equity repurchase agreement is not performable; if the company has paid the repurchase price, the legal liability rules prohibiting capital evasion may be applied by analogy, and the employee shareholder shall be ordered to return the repurchase money at the request of the company or other shareholders, or the employee shareholder shall be ordered to pay the repurchase money within the scope of the principal and interest of the repurchase money for the company's debts that cannot be satisfied at the request of the creditors. Part of the supplementary liability.

First, non-capital reduction buybacks have a high degree of commonality with the economic substance of profit distribution and should be subject to the same financial resources limitation standard. Developed countries or regions that adopt the principle of capital maintenance also generally apply the same criteria of financial resources restriction to both, i.e., "only distributable surplus can be used, and equity cannot be eroded". According to the relevant legal provisions of each country, it can be concluded that the use of capital reserve to buy back employees' equity in special circumstances should also be allowed. Secondly, for the capital reduction buyback, if the capital reduction procedure is carried out, the capital can be used to buy back the employee's equity. The special feature of this type of repurchase is that, after obtaining the consent of creditors for the capital reduction, it can be regarded as not causing damage to the company's solvency, and the company does not need to conduct additional "solvency test" and make "solvency statement".

## **3.2. Internal corporate governance level**

### **3.2.1. Respecting the need for equity incentive autonomy.**

In Case No. 96, the People's Court held that the purpose of the "share retention" clause in the case was justified by the closed company's need to maintain its own human nature of governance.[4] Since then, the relevant cases have continued to be heard, basically the purpose of the justification of the idea. The logic of this review argument, from the company law over the years formed a kind of thinking inertia, that is, all involved in the restriction of shareholders' rights, the theory of practice will subconsciously resort to the maintenance of the company's human nature of the legitimate purpose, without looking into whether there is a real sense of relevance between it and the human nature. In view of the above case can get, maintain the limited liability company's personhood, has not enough to carry the purpose of the mandatory share repurchase clause justification needs. In fact, the majority of companies that are keen to adopt mandatory share repurchase clauses in practice are restructured companies and Internet companies, which have a common governance need for the adoption of this governance strategy - equity incentives. The implementation of equity incentive, by granting employees the status of shareholders, will be

deeply tied to the company's management and development, and employees can avoid the inefficiency of shareholders' governance by leaving the company, which is not only justified but also worth promoting. Therefore, the autonomous demand of equity incentive is the basis of the purpose of the mandatory share repurchase clause. The significance of the ruling is that the people's court can exclude the legality of some of the compulsory share repurchase clauses with improper purposes.[5] In practice, some companies in the lack of funds to employees for equity financing, employees in real money into the shares, once the company developed, that is, to engage in the so-called "people leave the shares to stay", expel the staff shareholders, a few head shareholders to enjoy the company's surplus value, should not have the purpose of legitimacy.

### **3.2.2. From a typology of initial articles and amendments to an integrated review.**

Although there are several arguments in Case No. 96 on the level of internal corporate governance, the reason for the decision that the mandatory share repurchase clause is stipulated in the initial articles is the core argument. The recent cases also hold such logic, and this article also holds the position that the articles of association apply as one. Specifically: first, "the mandatory share repurchase clause itself should not be used as the basis for determining its validity; second, the abandonment of the logic of the typology of the articles of incorporation means that it is not justified by the provision in the initial articles of incorporation and the existence of the shareholders' consent mechanism. The reasoning of the initial articles of incorporation can still be used as a basis for the People's Court to determine the validity of the articles of incorporation, but it cannot be used as a criterion to disprove the invalidity or diminished validity of the mandatory share repurchase clause in the amendment of the articles of incorporation. Third, abandoning the logic of differentiation between types of articles of incorporation means that as long as the amendment procedure of the articles of incorporation is legal and there is no other violation of laws and administrative regulations in the content, the clause will not be considered invalid or have other defective effects because it is stipulated in the amendment.[6]

To achieve the purpose of retention of equity has a variety of options, only to meet the purpose of justification is not enough to support the company to compel the repurchase of employee equity, the company to take back employee equity should also be in line with the principle of proportionality to ensure the minimum harm to the employee's right to free transfer of equity. This way of thinking in the company dissolution dispute rules are also reflected, such as the "Supreme People's Court on the application of the Company Law of the People's Republic of China (V)" Article 5 provides for the buyback, capital reduction, separation and other alternative programs as the dissolution of the company, the purpose is to resolve the deadlock while trying to avoid dissolution of the company, to guide the parties to find the least harmful to the company solution. Similarly, under the premise of ensuring that the employee's equity stays in the company, the employee shareholder has the right to decide whether to transfer the equity to other shareholders or to be bought back by the company, and the company's mandatory buyback of the equity should be the underwriting means in the event that the employee shareholder refuses to transfer the equity. In this way, a set of "price competition mechanism" can be formed between the company and other shareholders,

"so that the equity to be transferred by the closed company can obtain the best and fair market price, and overcome the shortcomings derived from the lack of an open market for the equity transactions of the closed company." This is conducive to breaking corporate deadlock, maintaining the company's human and closed nature, reflecting the will of the company, and protecting the rights and interests of shareholders." However, in order to respect the company's autonomous arrangement of internal governance and equity incentive, the company should enjoy the right of first refusal over other shareholders for the transferred equity of the departing employees under the same conditions.[7]

#### 4. Conclusion

The provisions of the equity repurchase of limited liability companies reveal the problems of the existing legislation, which does not directly affirm that the company can repurchase the equity other than the equity repurchase of dissenting shareholders, and also lacks clear and specific provisions in terms of procedures, prices, conditions to be met by the company and the equity, etc. The remedies in the equity repurchase are limited. Through the analysis of the existing judgment based on the law and theoretical aspects of the investigation, it is believed that the principle of capital maintenance as a reason to oppose the repurchase of equity is not sufficient, and the provisions of the joint-stock company is too harshly applied to limited liability companies. Drawing on the experience of overseas legislation, the repurchase of shares of limited liability companies should not be prohibited, and the legislation should only set the conditions for not allowing the repurchase of shares. Through the institutionalized and systematic arrangement of the share repurchase resolution authority, notification obligation and disposal of repurchased shares, a systematic and complete repurchase system is constructed. For the determination of the validity of the equity repurchase agreement, the three aspects of contractual rules, voting at shareholders' meetings and

operating conditions should be grasped comprehensively. The directors should bear certain supplementary compensation liability within the scope of negligence for the shareholders' acts against the interests of the company in the equity repurchase, while the shareholders' meeting should bear the guarantee liability for the other shareholders' acts of not repurchasing the equity based on the resolution of improper purpose. By giving the company and creditors the right of revocation, the rights of the company and creditors shall be protected, and the shareholders who have been harmed may request the company to pay the full amount of the share repurchase due to them within a certain period of time from the time they know or should know that the company has infringed their rights in bad faith.

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