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# Shareholders' Rights & Shareholder Activism 2023

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## **China: Trends & Developments**

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T&C Law Firm



# CHINA

## Trends and Developments

**Contributed by:**

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services. T&C currently has five offices nationwide, located in Hangzhou, Beijing, Shanghai, Shenzhen and Ningbo, which together form an integrated service network. The legal service team consists of more than 500 professionals specialising in certain practice areas.

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# CHINA TRENDS AND DEVELOPMENTS

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## Shareholders' Rights and Shareholder Activism Under the Company Law of the People's Republic of China

The Company Law of the People's Republic of China (2018 Amendment) (the "Company Law") has provided a series of provisions on the exercise and protection of shareholder's rights, which not only safeguard the interests of shareholders but also promote the sustainable development of companies. Along with the market-oriented reform in the investment field, shareholder activism continues to grow. Investors are beginning to actively participate in corporate governance within the existing legal framework, which boosts the development of corporate governance practice in China.

### *Shareholder activism under Chinese law*

The pervasive problem of agency cost in corporate governance has sparked a rise in shareholder activism in recent years. Shareholder activism is typically manifested by external minority shareholders without seats on the company's board of directors, who formally exercise their statutory rights or engage in other informal proactive behaviours to influence corporate decisions and effectively improve corporate governance through supervision of the management, thus achieving a balance of power within the company.

Under the Company Law, shareholder activism is specifically manifested in when shareholders undertake the following actions.

### *Participate in the shareholders' meeting and exercise voting rights*

Shareholders have the right to participate in the shareholders' meeting, to put forward opinions and suggestions on company affairs, and to exercise their voting rights. The shareholders' meeting is the decision-making body for a com-

pany's major affairs. By presenting at shareholders' meetings, shareholders can participate in the company's decision-making process, including electing directors, reviewing and approving annual reports, and making profit distribution resolutions.

For public companies whose equity is comparatively more dispersed, minority shareholders can exercise their voting rights by soliciting votes in conjunction with other shareholders to maximise their common interest. Article 90 of the Securities Law of the People's Republic of China (implemented since 2020) stipulates a public solicitation system of shareholders, with a solicitation threshold under which the shareholder must hold more than 1% of voting right shares. In 2021, the China Securities Regulatory Commission formulated "The Interim Provisions on the Administration of Public Solicitations of Proxies from Shareholders of Listed Companies", which stipulates the conditions for solicitors and the solicitation procedures, and clarifies the information disclosure requirements. It provides institutional guidance for minority shareholders to actively participate in listed companies' governance.

There have been several cases of soliciting shareholder voting rights in listed companies. For example, in 2016, when the major shareholder of FAW Car Co., Ltd. (stock code SZ000800) violated its promise of horizontal competition, Mingyao Investment, a medium shareholder, actively solicited proposals and voting rights to protect its rights. Through a joint effort, the proposal regarding the change of the commitment performance period was ultimately not approved by the shareholders' meeting.

## *Put forward proposals to appoint or dismiss directors, supervisors and senior executives*

For non-listed companies, external investors can appoint their own directors through the cumulative voting system by dismissing directors, supervisors and senior executives who do not perform their duties properly, and appointing the person they approve. Therefore, they actively participate in corporate governance and protect their interests.

For listed companies, external investors can also use voting rights to concentrate the election of qualified directors, supervisors and senior executives in the election process for the board of directors, thereby defeating the candidates recommended by the company or major shareholders. For example, in the board of directors election of Gree Electric Appliances Inc. (stock code SZ000651) in 2012, Penghua Fund, in conjunction with Yale University Fund and other shareholders, actively recommended their own director candidates and, using their combined shareholding advantage, rejected the candidates recommended by the major shareholder.

## *Supervise the company's management and actively prosecute*

Shareholders have the right to supervise the behaviour of the company's directors, supervisors and senior executives to ensure that the company's decision-making and operations comply with laws, regulations and the company's articles of association. Shareholders can supervise the company's operation and management by participating in shareholders' meeting and reviewing the company's annual report and financial statements.

Investors can also directly file lawsuits to exercise shareholder rights against the company for its violations of laws and regulations, thereby

indirectly participating in corporate governance. For example, on behalf of the minority shareholders of Great Wisdom (stock code SH601519), China Securities Investor Services Center Limited filed a shareholder derivative lawsuit against the controlling shareholder and director of Great Wisdom on the grounds that the directors, supervisors and senior executives harmed the company's interests, which finally helped the listed company obtain compensation.

## *The dilemma of shareholder activism under the current Company Law*

### *Minority shareholders with dispersed shareholdings find it hard to compete for control*

Most enterprises in China are still primarily controlled by the founders or major shareholders, which leads to a centralisation of power, while investors' shareholding is more dispersed. Even through joint voting, minority shareholders are unable to override the voting rights of major shareholders. In addition, the dispersion of shareholding will inevitably lead to a divergence of interests. When shareholders cannot form a consensus, shareholder activism becomes harder to practise.

### *The cost of exercising activism is high*

The practice of shareholder activism requires a lot of time and resources. Shareholders need to study the company's financial status, strategic planning and decision-making process in depth, then actively participate in shareholders' meetings, the board meetings, make suggestions, and perform active supervision. All the above will inevitably require an input of time and energy.

Moreover, external investors are constrained by internal controls and financial requirements, making it difficult for them to incur substantial

costs for safeguarding their rights. In addition, investors often refuse to become selfless contributors because of the huge cost of rights protection and considering that the benefits obtained from active actions will eventually be shared by all shareholders. Investors are often unwilling to be selfless contributors in response to free-riding behaviour.

### *Laws and regulations are still lacking*

At present, the protection of shareholders' rights in China is primarily stipulated in the Company Law. However, there is still a certain level of ambiguity in the legal framework regarding the protection of shareholder rights. This has made it difficult for shareholders to protect their rights through legal means, which creates reluctance among shareholders to engage in shareholder activism and indirectly increase the inertia of exercising such activism. The reasons are as follows.

- Stringent provisions on the right to convene an extraordinary shareholders' meeting: Article 100 of the Company Law stipulates that only shareholders who individually or collectively hold more than 10% of the company's shares have the right to request an extraordinary shareholders' meeting. The standard of 10% of shares will undoubtedly raise the threshold for minority shareholders to practise their rights. In listed companies where shareholders' shareholdings are more dispersed, setting the threshold at 10% undoubtedly raises the bar for minority shareholders to convene a general meeting.
- Stringent provisions on the right to submit interim proposals: Paragraph 2 of Article 102 of the Company Law stipulates that a shareholder or a group of shareholders who holds 3% or more of the shares of the company may submit a written proposal of an agenda item ten days before a shareholders' general meeting to the board of directors. The board of directors shall inform other shareholders of the proposal within two days of receiving the proposal, and shall submit the interim proposal for deliberation at the general meeting. As mentioned above, the standard of 3% of shares is not conducive to motivating minority shareholders to exercise their proposal right. In addition, the smooth exercise of the right to submit interim proposals is also subject to the constraints of the board of directors.
- Inadequate provision on shareholder online voting system: at present, the regulations regarding the online voting system of shareholders' meeting are scattered across regulatory documents issued by the China Securities Regulatory Commission and Stock Exchanges. In the absence of explicit regulations in the Company Law, the online voting system lacks legitimacy, systematisation and reliability.
- Insufficient information disclosure regulations: the Securities Law, the regulations issued by the China Securities Regulatory Commission and the rules of Chinese stock exchanges have formed a relatively comprehensive system for information disclosure of listed companies. But the information disclosure of non-listed companies can still only be found in Article 97 of the Company Law on shareholders' right and Article 102 of the Company Law on the notification procedure of the shareholders' meeting. These provisions fall far short of meeting the needs of minority shareholders to supervise their companies' governance.
- Unclear provisions on related transactions: in terms of related transactions, Article 16 of the Company Law stipulates that related transactions should be resolved by the shareholders' meeting in which related shareholders need



to be withdrawn. The lack of regulations on unfair related transactions makes it difficult for minority shareholders to effectively oppose or stop related transactions that may damage the interests of the company.

### *The Company Law Amendment's response to shareholder activism*

Compared to the existing Company Law, the Company Law of the People's Republic of China (Revised Draft) (Second Review Draft) (the "Company Law Amendment") further strengthens the protection of minority shareholders' interests, and provides a more robust legal basis for shareholder activism. The specific provisions are as follows.

### *Lower the threshold for interim proposal rights of shareholders*

Compared to the 3% shareholding threshold for proposing an extraordinary shareholders' meeting in the current Company Law, Article 115 of the Company Law Amendment lowers the threshold to 1%. In addition, Article 115 of the Company Law Amendment adds an exception clause regarding the obligation of the board of directors to notify and submit proposals. It stipulates that if the interim proposal submitted by shareholders violates laws, administrative regulations or the company's articles of association, or if it does not fall within the scope of the shareholders' meeting, the board of directors is no longer obliged to fulfil the notification and submission obligations for the interim proposal.

While the Company Law Amendment encourages minority shareholders to actively make proposals, it also protect the company's interest in that shareholders may abuse their right to make proposals, thereby harming the company's decision-making efficiency and interests.

### *Add the regulation of related transactions*

The Company Law Amendment enriches the disclosure and voting procedures of related transactions and adds a reporting system for related transactions. Article 183 stipulates that the directors, supervisors and senior executives shall report related transaction matters to the board of directors or the shareholders' meeting, prior to the decision of the board of directors or the general meeting of shareholders. Based on the above provisions, the decision-making body can more effectively assess whether there is a direct or indirect interest relationship between the directors, supervisors and senior executives and the proposed transaction, so that they can judge whether or not the related transaction is fair.

While the current Company Law does not clearly define the related parties, the Company Law Amendment adds regulations on the scope of related transactors. It clearly lists that the directors, supervisors and senior executives themselves and their close relatives shall all be deemed related parties, as shall the companies directly or indirectly controlled by the above people. By providing illustrative examples, the Company Law Amendment clarifies the scope of related parties to some extent.

### *Strengthen the inspection rights of the shareholders of limited liability companies and ensure their right to be informed*

Article 110 of the Company Law Amendment adds that the shareholders of a limited liability company can inspect the accounting books and accounting vouchers if they meet the period limit of holding shares for more than 180 consecutive days and hold more than 3% of the company's equity individually or jointly. The shareholders can also entrust intermediary agencies such as

accounting firms and law firms to exercise the right of inspection.

Compared with the current Company Law, the Company Law Amendment has made major changes to shareholders' inspection rights in terms of limited liability, providing a legal basis for shareholders to be informed and indirectly promoting improvements in the system of internal information disclosure.

*Add regulations on the joint liability of controlling shareholders and actual controllers for abuse of power*

Article 191 of the Company Law Amendment adds that any controlling shareholder or actual controller of the company who instructs directors or senior executives to engage in acts that will damage the interests of the company or shareholders shall bear joint liabilities with the actor. The article provides a basis for the damaged shareholders to claim rights against the controlling shareholders and actual controllers who abuse their power, and strengthens the protection of minority shareholders.

*Conclusion*

Shareholder activism embodies the active exercise of shareholders' rights, where shareholders can actively participate in corporate governance through active means, such as voting by their own hands, and can also effectively supervise the company's management. However, shareholder activism also means shareholders' liability, and the laws and regulations should clarify the boundary of shareholders' acts. The essence of this lies in requiring shareholders to refrain from abusing shareholders' rights and harming the interests of the company and other shareholders, and to require shareholders to bear liability for their improper behaviour.



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