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December 2018

## CHINA LEGAL AFFAIRS

### EXERCISE OF THE RIGHT OF FIRST REFUSAL BY SHAREHOLDERS OF A LIMITED LIABILITY COMPANY INCORPORATED IN THE PRC

The shareholder's right of first refusal is established based on the attribute of combination of people of the limited liability companies, and the purpose is to maintain the trust relationship between the shareholders. The direct legal basis is *Article 71 and Article 72 of the Company Law of the People's Republic of China*. That is, unless otherwise provided in the Articles of Association of the company, where a shareholder transfers its equity interests to a person other than the shareholder, it shall notify the other shareholders in writing of the transfer of equity interests and seek their consent. Under the same conditions, other shareholders have the right of first refusal. When a people's court transfers the equity interests of a shareholder pursuant to the enforcement procedures stipulated in law, it shall notify the company and all shareholders, and other shareholders shall have the right of first refusal under the same conditions.

The *Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China (IV)* which officially implemented on September 1, 2017 (hereinafter referred to as the "*Judicial Interpretation of the Company Law (IV)*") have stipulated more detailed regulations for the shareholder's right of first refusal.

#### 1. Notification Obligation

In accordance with the *Company Law of the People's Republic of China*, when a shareholder transfers its equity interests to a person other than the shareholder, it shall notify the other shareholders in writing of the transfer of equity interests. *Article 18 of the Judicial Interpretation of the Company Law (IV)* has specified such notification obligation in detail. Firstly, the shareholder that transfers its equity shall notify the other shareholders in writing of the transfer of equity interests or by any other reasonable means which can be surely received by the other shareholders, and seek their consents to the transfer of equity. If more than half of the other shareholders consent to the transfer, the shareholder that transfers its equity shall also notify the same conditions for the transfer of equity, which enable the other shareholders to decide whether to exercise the right of first refusal.

## 1. Notification Obligation (Cont'd)

In accordance with the above provisions, the transfer of equity to a person other than the shareholders requires two notices to all the other shareholders. The first notice is seeking consent from the other shareholder for the equity transfer. The second one is asking the other shareholders whether they are willing to purchase the equity under the same conditions. However, in practice, the notice is sent out in a two-in-one manner in most cases, that is the shareholder that transfer its equity notifies the other shareholders of its intent to transfer the equity and the same conditions for the transfer of equity at the same time. Whether a two-in-one notice will be deemed as a failure to complete its notification obligation shall be analyzed in accordance with the specific circumstances in judicial practice.

## 2. Identification of the Same Conditions

The basis for the other shareholders to exercise the right of first refusal is under the same conditions. Therefore, it is crucial to define the same conditions. In accordance with the provisions of *Article 18 of Judicial Interpretation of the Company Law (IV)*, when a people's court judges whether it meets the requirement for the “same conditions” as specified in the third paragraph of Article 71 of the *Company Law of the People's Republic of China*, the following factors such as the quantity, price, method and term of payment, and other factors etc. of the equity interests to be transferred, shall be taken into consideration.

Although the above provisions only listed out four factors, that is the quantity, price, method and term of payment, it is ending with a description of “and other factors etc.”, which means that the “same conditions” shall not be limited to the four factors listed in *Article 18 of Judicial Interpretation of the Company Law (IV)*. The various factors that parties to the equity transfer value and may have a substantial impact on formation of the equity transaction shall also be taken into consideration.

### 3. Term of Right

The term to exercise the shareholder's right of first refusal can be divided into three categories according to different situations.

#### (1) Voluntary Transfer

The shareholder of a limited liability company who claims for right of first refusal, shall request to purchase the equity within the term stipulated in the articles of association upon receipt of the notice. If the articles of association does not stipulate the term or the provisions are unclear, it shall be subject to the term specified in the notice. If the term specified in the notice is less than 30 days or the term is not clearly defined, the term of right shall be 30 days. (*Article 19 of Judicial Interpretation of the Company Law (IV)*)

#### (2) Transfer via Enforcement Procedures

When a people's court transfers the equity interests of a shareholder pursuant to the enforcement procedures stipulated in law, the other shareholders shall exercise the right of first refusal within 20 days upon receipt of the notice from the court. (*Article 72 of Judicial Interpretation of the Company Law (IV)*)

#### (3) Listing Transfer of the State-owned Equity

When the state-owned equity of a limited liability company is transferred at a property rights trading place established in accordance with the law, it shall be subject to the term stipulated by the rules of the trading place. (*Article 22 of Judicial Interpretation of the Company Law (IV)* )

### 4. Remedies

*Articles 21 of Judicial Interpretation of the Company Law (IV)* clearly stipulates that if the transferor fails to seek the consents from the other shareholders, or infringes the other shareholders' right of first refusal by means of fraud, malicious collusion or other means, the other shareholders are entitled to request to purchase the said equity under the same conditions for the actual transfer, which shall be upheld by the people's court.

According to the above provisions, the other shareholders are entitled to the right of compulsory contacting and purchase the said equity under the same conditions, when their right of first refusal is infringed. The provisions do not distinguish the third person is bona fide or malicious. The third party cannot challenge against the shareholder's right of first refusal on the ground of bona fide acquisition, even if the equity transfer has already been registered with the competent government authorities.

Once the other shareholders successfully exercise the right of first refusal as a remedy, the legal effects include cancelling the change of equity that has occurred (not cancelling the equity transfer contract) and entitlement of the right of compulsory contracting with the transferor under the same conditions.

However, the exercise of the above right of remedy is restricted. Where the shareholder infringes other shareholders' right of first refusal, the other shareholders may file a lawsuit to exercise such right, within 30 days since it knows or should know the same conditions, or within 1 year since the equity transfer is registered. The court will not uphold a claim that exceed the foregoing time limit. But if the other shareholders are not able to exercise the right of first of refusal for the reasons other than their own sake, they may claim for compensation from the transferor.

If the court upholds the other shareholders' claim to exercise the right of first refusal, which cause the contractual purpose of the outside transferee of the equity transfer cannot be achieved. The outside transferee may request the shareholder who intends to transfer the equity to bear the corresponding contractual liabilities according to the law.

## **5. Situations that Right of First Refusal are not Applicable**

### (1) Inheritance of Equity

*Article 75 of Company Law of the People's Republic of China* stipulates that after the death of a natural person shareholder, the legal heir may inherit the shareholder qualification unless otherwise provided in the articles of association. According to the foregoing provisions, if there is no special provisions in the articles of association, when an equity transfer occurred due to inheritance, the other shareholders cannot claim the right of first refusal. *Article 16 of Judicial Interpretation of the Company Law (IV)* has further confirmed such rule.

(2) Internal Transfer between the Shareholders

The internal transfer of equity between shareholders does not involve the participation of new shareholders, and will not infringe the attribute of combination of people of the limited liability companies. Therefore, in case of internal equity transfer between the shareholders, the *Company Law of the People's Republic of China* does not allow other shareholders to claim the right of first refusal in principal, unless otherwise provided in the articles of association.

(3) Company Limited by Shares

The company limited by shares is a typical capital join company that follows the principle of transfer shares freely. The *Company Law of the People's Republic of China* does not stipulate a shareholder's right of first refusal for the share transfer of a company limited by shares. Therefore, the shareholder's right of first refusal is only applicable to the limited liability companies.

## 6. Exclusion of the Shareholder's Right of First Refusal

The articles of association are the company's autonomy regulations. In accordance with the *Company Law of the People's Republic of China*, special provisions on the shareholders' right of first refusal may be set forth in the articles of association. If the shareholders do not want to apply the shareholder's right of first refusal, with the unanimous consent of all shareholders, they may specify in the articles of association that the company's shareholders do not have the right of first refusal when a shareholder intends to transfer its equity to an outsider, and the shareholders can transfer their equity to anyone, which actually excludes the application of *Article 71 of Company Law of the People's Republic of China*.

***If you need further information or assistant, please refer to our firm's official website: [www.bycpa.com](http://www.bycpa.com) or you may contact our professional accountant by following methods:***

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