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Commentary on Guiding Case No. 8 and Corporate Deadlock Issues

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After releasing its first batch of guiding cases in 2011, the Supreme People’s Court released a second batch of guiding cases on April 13, 2012. This release included a total of four guiding cases, of which two were administrative cases and two were civil cases. This article is mainly aimed at providing a brief commentary on the corporate deadlock issue touched upon in Guiding Case No. 8.

The so-called “corporate deadlock” refers to the situation when shareholders, directors, or other key personnel having considerable power or influence in a company are in disagreement and are unable to compromise or make effective operating decisions, putting the company business into paralysis. Although “corporate deadlock” was initially a concept unique to Anglo-American law, it is, as a matter of fact, also widespread in countries with continental law systems and other countries.

In China, corporate deadlock generally includes the following three types:

1. Shareholder meeting deadlock

There are serious differences among shareholders, resulting in a failure to reach consensus on resolutions concerning a company’s operation. This type of deadlock can be divided into the equal voting rights deadlock and the veto deadlock. The former refers to the deadlock that results when opposing shareholders who have equal voting rights refuse to compromise when voting, thus preventing any resolution from passing with a majority of votes. The latter refers to the deadlock that results when an opposing side has the votes to exercise a veto (or has a veto vote) and vetoes all resolutions supported by another side.

2. Board of directors deadlock

There are serious differences among directors, resulting in a failure to reach consensus on resolutions concerning a company’s operation, and shareholder meetings cannot resolve the stalemate. This type of deadlock is relatively common in Sino-foreign equity joint ventures, particularly in those consisting of only two or three parties. As equity joint ventures do not convene shareholder meetings, their highest organ of authority is the board of directors, which is vested with ultimate decision-making authority over all important matters. A board of directors deadlock occurs when conflicts arise among the parties to the joint

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4 See 《中国公司法修改草案建议稿》(PROPOSALS ON THE DRAFT AMENDMENT TO CHINA’S COMPANY LAW), 517 (Social Sciences Academic Press, WANG Baoshu ed., 2004). The shareholder meeting the deadlock described here also includes a specific situation, that is, one in which there are serious differences among shareholders, resulting in the failure to elect succeeding directors in two consecutive shareholder meetings. As a result, the board of directors does not have the quorum to adopt effective operating resolutions.
venture and the board cannot convene for a long period of time or pass any resolutions.

3. **Deadlock caused by mere business disagreements or personal factors**

The occurrence of mere business disagreements will not inevitably lead to corporate deadlock because the company’s nature as an association of its members has not been destroyed. However, corporate deadlock may result if, over a long period of time, such disagreements prevent the parties from reaching consensus on the company’s operational decisions and the company’s normal operations come to a standstill. Corporate deadlock caused by personal factors typically occurs in limited liability companies whose shareholders are family members or close relations and the deterioration of such relationships destroys the company’s nature as an association of its members, and thus causes the company to fall into a deadlock.

Corporate deadlock suggests that substantive obstacles occurred in the management or operation of the company and can negatively impact the company in a serious manner. Specifically, such negative effects may be manifested in the following three ways:

1. **Effect on the company**

   The normal operation of a company is achieved through the exercise of the shareholders’ rights and of the corporate management body’s authority. When a company falls into deadlock, the shareholders, directors, and other senior officers are mutually antagonistic and confrontational. Additionally, shareholder meetings and board of directors meetings cannot be convened because an opposing party refuses to attend such meetings. Even if such meetings could be held, no effective resolution could be passed due to the parties’ mutual opposition to one another’s proposals. In such a case, the normal operation of the company will inevitably be affected or even brought to a standstill and the company will be unable to actively compete in the market. This may lead to unnecessary waste of assets and massive accumulation of debt, doing considerable harm to the company’s interests, and could even cause the dissolution of the company and the loss of its qualification as a legal person.

2. **Effect on the shareholders**

   The ultimate victims of corporate deadlock are shareholders. As investors of the company, shareholders establish the company for the purpose of earning profits through its continuous operation; but amidst deadlock, the shareholders’ expectations for gains on their investment will fall flat. In addition, shareholders exercise their rights by attending shareholder meetings and voting on company issues; but when a company falls into deadlock, either shareholder meetings cannot be effectively convened or resolutions cannot be passed. This causes the shareholders to be partially or wholly deprived of their rights and renders the shareholder meetings meaningless.
3. Effect on the stakeholders

Corporate deadlock will also damage the immediate interests of the company’s stakeholders, especially those of its employees and creditors. As to the employees, corporate deadlock may mean suspension or termination of operation, resulting in a large number of job losses, affecting the daily lives of employees who lost jobs. As to the creditors, corporate deadlock may lead to damage or the loss of the company’s abilities to act and to take responsibilities, which would directly affect the creditors’ realization of their rights. Even if the creditors initiate litigation against the company, they will be unable to recover their losses because of difficulties created by the corporate deadlock.

The issue of corporate deadlock has received considerable attention from the Chinese legislative and judicial organs in recent years. The Company Law, promulgated by China in 1993, did not contain any provisions on corporate deadlock. While the 2005 amendment of the Company Law also contained no clear-cut provisions regarding corporate deadlock, it stipulates in Article 183 that shareholders may apply to a people’s court for the dissolution of a company when there is serious difficulty in operation or management of the company (including, of course, instances of corporate deadlock). This provision is a breakthrough. It is the first time that a piece of legislation has provided a judicial remedy for dealing with serious difficulties in a company’s operation or management, including corporate deadlock. But because of the general nature and simplicity of this provision, a judge must examine the specific situations of each case to determine the seriousness of the deadlock and apply the law. In judicial practice, when confronted with disputes involving corporate deadlock, on the one hand, the courts may either rule to not accept the case based on the reasoning that similar disputes fall within corporate autonomy or reject the litigation claim based on the serious destructiveness of corporate dissolution. Consequently, such disputes cannot be properly resolved by judicial means. On the other hand, courts at all levels may make different judgments based on differing understandings of the relevant concepts, which often results in an awkward situation where “the same [type of] cases are decided differently”.

Guiding Case No. 8, released by the Supreme People’s Court, provides clear and powerful guidance to judges on the full understanding of Article 183 of the Company Law, accurate determination of the seriousness of a company’s operation or management difficulties, and proper handling of corporate deadlock problems. Guiding Case No. 8 is a typical corporate deadlock case. In this case, the two shareholders of Kailai Company each held 50% of the company’s shares. But they were in disagreement and could neither convene a shareholder meeting nor pass any effective shareholder resolutions (i.e., resolutions passed by shareholders holding more than half of the voting rights). Although the company continued to operate and remained in a profitable state, one of the shareholders

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5 Company Law of the People’s Republic of China, passed on Dec. 29, 1993, first amended on Dec. 25, 1999, and amended a second time on Aug. 28, 2004. The Company Law was last amended and passed at the 18th Meeting of the National People’s Congress Standing Committee on Oct. 27, 2005, and has been effective since Jan. 1, 2006. Article 183 of the Company Law of the People’s Republic of China stipulates: “[W]hen there is serious difficulty in operation or management of the company and the continued existence of such difficulty will cause the shareholders to suffer serious losses, a shareholder or a group of shareholders holding 10% or more of the shares of the company may, in the absence of any other means, request that a people’s court dissolve the company.”
believed that the company’s operation or management was already experiencing serious difficulties and applied for dissolution of the company based on those grounds. The court opined: “[T]o determine whether or not there was serious difficulty in operation or management of a company, the operational state of the company’s shareholder meetings, board of directors or executive directors, and board of supervisors or supervisors should be comprehensively analyzed.” Although the company was still in a profitable state, the shareholder meeting mechanism had not functioned for a long period of time and internal management had encountered serious barriers, causing the company to fall into deadlock, and making it possible to determine that there was serious difficulty in operation or management of the company. Therefore, under circumstances where the two shareholders could not reach a compromise after a number of mediations, the court ordered the dissolution of Kailai Company.

As a guiding case, Guiding Case No. 8 has remarkable significance.

First, it affirms the necessity of judicial intervention in instances of corporate deadlock.

From the shareholders’ point of view, when a company falls into a deadlock, the shareholders’ purpose in establishing the company cannot be achieved, their expectations for gains on their investment fall flat, and their rights are subject to varying degrees of limitation, even, in fact, complete deprivation. If shareholders are not allowed to seek a judicial remedy in such a case, this will necessarily lead to serious unfairness among opposing shareholders.

From the courts’ point of view, the nature and responsibility of judicial organs determine that courts have the duty and capacity to provide relief to shareholders, and that courts cannot refuse to adjudicate on the grounds that there are no explicit legal provisions. Moreover, Article 183 of the Company Law now provides a legal basis for judicial intervention in instances of corporate deadlock, and courts should follow the law to accept these cases when the statutory conditions are met.

From the point of view of Sino-foreign equity joint ventures, judicial intervention is of greater significance. When domestic limited liability companies fall into a deadlock, shareholders may withdraw from the company through transferring their shares in accordance with the provisions of the Company Law concerning equity transfers. However, for shareholders in Sino-foreign equity joint ventures, pursuant to Article 20 of the Implementing Rules for the Sino-Foreign Equity Joint Venture Law of the People’s Republic of China, a joint venture party wishing to transfer all or part of its equity interest to a third party shall obtain the consent of the other parties to the joint venture, and shall apply to the examination and approval authority for approval. This means that it is nearly impossible for parties to

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6 See Company Law of the People’s Republic of China, supra note 5, art. 72.
[this kind of] joint venture to withdraw from the company by way of transferring their equity interest once the joint venture falls into a deadlock. Therefore, it seems especially necessary at such a time to allow the parties to apply to a people’s court for dissolution of the joint venture in accordance with the *Company Law*.

The release of Guiding Case No. 8 indicates that the Supreme People’s Court recognizes the necessity of judicial intervention in corporate deadlocks. This will not only help to unify and correct the attitude of the courts at all levels when handling similar disputes, but will also help courts provide timely relief for shareholder rights, and end the company’s deadlock as soon as possible.

Second, [Guiding Case No. 8] provides microscopic guidance on courts’ adjudication.

1. [Guiding Case No. 8] clarifies the standard for determining when “there is serious difficulty in operation or management of the company”.

   Article 183 of the *Company Law* stipulates that one of the conditions under which shareholders may file a lawsuit for dissolution is when “there is serious difficulty in operation or management of the company”. However, neither the *Company Law* nor relevant judicial interpretations further explain how to determine when “there is serious difficulty in operation or management of the company”; in practice, courts usually adopt the cessation of the company’s operations as the specific standard. If the court had applied this standard to the situation in Guiding Case No. 8, it would have decided to not accept the case on the grounds that the shareholders did not meet the requirements to bring an action, because in this case Kailai Industry Co., Ltd. was operating normally at that time, it had not yet sustained losses, and its business had not ceased or come to a standstill. Therefore, the Supreme People’s Court stated clearly in the “Main Points of the Adjudication” section of Guiding Case No. 8:

   To determine “whether there is serious difficulty in operation or management of the company,” the operational state of the company’s organizational structure should be comprehensively analyzed. Although a company may be in a profitable state, if it has long-term failure in its shareholder meeting mechanism and serious impediments in its internal management, plunging it into a state of deadlock, it can be identified as having serious difficulty in operation or management.\(^8\)

   2. [Guiding Case No. 8] defines the conditions under which shareholders may lodge a corporate dissolution suit.

   The “Reasons for the Adjudication” section of Guiding Case No. 8 combines the *Company Law*, the *Provisions (II) of the Supreme People’s Court on Several Issues Concerning the Application of the “Company Law of the People’s Republic of China”*,\(^9\) and

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\(^8\) See supra note 2, at 2.

\(^9\) *Provisions (II) of the Supreme People’s Court on Several Issues Concerning the Application of the*
the specific conditions of the case to define the conditions under which shareholders may lodge a corporate dissolution suit: “Kailai Company’s internal operational mechanism had already failed”, “shareholder rights and supervisory rights had been in an inoperable state for a long time”, the shareholder’s “purpose of investing in Kailai Company could not be realized and his interests were seriously damaged”, and “Kailai Company’s deadlock was unable to be resolved by other means for a long time.” The four conditions were met at the same time. On the basis of these four conditions, the Court then made its final judgment to dissolve Kailai Company according to law. The Court’s requirements with respect to these four conditions, in particular the fourth condition requiring that “the deadlock was unable to be resolved by other means for a long time”, reflect the Court’s prudent attitude toward corporate dissolution: Corporate dissolution is merely a measure of last resort for resolving deadlock.

In summary, the release of Guiding Case No. 8 provides guidance for the courts to intervene in corporate deadlocks and to use corporate dissolution to resolve the deadlocks so long as certain conditions are met. However, corporate dissolution is only one of the measures to resolve corporate deadlock, and this measure must be strictly limited due to its destructiveness. In other countries, the United States for example, legislation usually strikes a balance between the development of the corporate deadlock and the stringency of the measures for handling the deadlock, and thus offers a series of gradual approaches from which courts may choose. In Germany, in order to deal with corporate deadlock, the law also has systems that allow a shareholder to withdraw from the company or allow a troubled company to request a court order for expelling a shareholder from the company. Although Guiding Case No. 8 also points out the use of mediation and stipulates that a company may only be dissolved if “the deadlock [cannot] be resolved by other means for a long time”, given the inherent limitations of the case, it cannot offer other approaches for resolving corporate deadlocks. Therefore, the relevant laws concerning corporate deadlock in China await further improvements so as to embrace other approaches to settling corporate deadlocks. We eagerly await these improvements.

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10 These measures include mediation, arbitration, appointment of an interim director, appointment of a manager or guardian of the company, compulsory equity acquisition, dissolution, etc.; the gravity of these measures increases gradually, and the courts may choose therefrom according to the specific situation of the deadlock. See Cheryl J. Lew, The Custodian Remedy for Deadlocks in Close Corporations, 13 U.C. DAVIS L. REV. 498 (1979-1980).