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Analysis and Feasible Solution for Legislative Gaps in Notification Procedures in External Equity Transfer

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Abstract: In 2005, the Company Law stipulated the transfer of equity for the first time. However, in the subsequent amendments, the notification procedure for external transfer has always been unclear. As a result, there have been disputes about the time and method of the shareholder notification of the transferor in practice. This paper analyzes the disputes in case judgments before and after the entry into force of 2017 judicial interpretation, as well as the characteristics of asset and person compatibility of Limited Liability Company, and tries to find a feasible solution to alleviate the impact of legislative gaps and strengthen notification obligations. Lastly, the paper gives suggestions for improvement in the company's articles of association and for legislation, which is possible to strike a balance between the trust relationships within companies and the efficiency of business transactions.

Keywords: Limited Liability Company, Equity transfer, the Preemption Right, Notification Procedure

1. Introduction

Company-related disputes have always been the main part of civil disputes. *The Company Law* first came into effect in 1993, and so far, has been amended five times. Notably, in the 2005 Amendment, specific provisions for equity transfer in a Limited Liability Companies (LLC) were incorporated into the legislation. The law set up double-restriction rules of "the consent right + the preemption right" in the transfer of equity [1, 2]. After the fulfillment of the consent rules, other shareholders are entitled to purchase all the shares on the same condition, prior to anyone outside the company. Within the double-restriction rules, while the former has legislative regulation of notification obligation, the latter preemption one does not.

In 2017, relevant disputes that had been controversial over the right of preemption were also clarified in the form of judicial interpretation, which is issued by the Supreme People's Court, has legal effect, and can be cited by judges constituting as a legal source in China [3]. Article 17 stipulated that "the transferor shareholder should notify it of the equal conditions for the equity transfer in writing or in any other reasonable manner capable of acknowledgement", and Article 21 established a statute of limitations for the preemption right, i.e., a one-year period after an equity change or 30 days after the right-holder knows or should have known [4]. The act interpreted a more specific way in which the transferor communicates the same conditions to other shareholders in a "reasonable manner", set in the transferor's view as a duty of care. For other shareholders, when their cognitive

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state reaches the level of “should have known” by notification, they should not negatively exercise the preemption right.

Notification procedure serves a connecting role in conveying important information in the process of external equity transfer, involving the process of the negotiation between the transferor and the third party, the exercise of the preemption right by other shareholders, and the ultimate ownership of the equity. This paper intends to study the legislative vacancy in the notification procedure reflected in practical case judgments, and combine with the characteristics of Limited Liability Companies to propose feasible solutions from the legal and economic perspectives.

2. Disputes and Development in Legislation on Notification Obligation

2.1. Legislative Gap in the Notification Procedure Before Exercising the Preemption Right

It can be seen from the practical judgment that the notification procedure of the same conditions of the preemption right before the publication of the judicial interpretation in 2017 has not been paid attention to. In cases of Huanyi company v Chen and Zhou v Weifeng company ((2017)Z02MZNo.1283 & (2012)XSZZNo.0296), both judges treated the process when the transferor shareholder sent same trade conditions to internal shareholders as an “informing” behavior. In contrast, in the consent rule, the law uses the more serious word “notice” and adds written requirements in sending messages. Without the express provisions of the law, other shareholders could do barely things to protect their rights when the transferors have not fulfilled their reasonable obligations and failed to expose the same conditions they have settled with the external buyer, which was the basis for exercising other shareholders’ preemption rights.

2.2. The Advances of 2017 Judicial Interpretation

The 4th interpretation of company law supplemented the notification manner in which the transferor shareholder shall notify other internal shareholders, “in writing or in any other reasonable manner capable of acknowledgement” [4]. Huang commented on this legislative improvement that the provision of notice respected the repeated negotiation characteristics in commercial transactions, and avoided the passive acceptance of fixed prices by other shareholders, which was detrimental to themselves [5]. In other words, the act tried to strike a balance of interests between the protection of existing shareholders, the transferor and the third party. However, as for the above-mentioned “reasonable manner” stipulated in the act as well as the "should have known" to determine whether the preemption right is valid or not, there have been still problems of vague meaning in the notification method, leading to some practical problems.

2.3. The Remaining Problems after 2017

The 4th judicial interpretation in 2017 had defined the means of notification in two points, “reasonable manner” in the transferor’s view and the sufficient extent of “should have known” for other shareholders. However, the judgments of the cases after 2017 show that the judges' understandings of “reasonable” and “should” were still controversial and led to different decisions of the effectiveness of the preemption right.

Some judges held the view that the transferor needs to adopt various notification methods to fully fulfill the obligation, such as in the first and second instances of Zhang v Dong & Xu case ((2022) L02MCNo.2890 & (2022) L02MZNo.5194) , both judges held that the notification-receiver should be able to know information by means of a separate notification on WeChat application. While other judges had a looser attitude towards it, requiring the transferor to send multiple viable ways of notification as in the case of Kesaiwei v Guijiu ((2021) H0120MCNo. 2029). It was considered that

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a single target-specific notification cannot be regarded as an active performance of the obligation when a variety of feasible notification methods such as WeChat, telephone, and short messages have not been exhausted.

Different understandings of how to achieve "should have known", led to diametrically opposed verdicts in the two types of cases. The latter one judged the mode of notification by analogy to "the doctrine of arrival" in the contract law, " an offer becomes effective when it reaches the offeree" [6]. Both Huang and Zhang believed that the preemption right's exercise mode applied to the offeror-acceptance mode [5,7]. That is to say, the transferor's notification of the same conditions is considered as an offer, while the purchase proposition when other shareholders exercising the preemption right is an acceptance. Therefore, in the transferor's notification procedure, it is reasonable to assume that the notification becomes effective upon arrival.

For another, person compatibility was the main factor taken into consideration for the former judgment. In LCC, shareholders are not only the investors of the company, but also the participants in the company's operation and major decisions [8]. Thus, to protect the stability of the company, the judge tended to enhance the transferor's notification obligation, ensuring that other shareholders would have timely access to the information of any external equity trades, and then make a decision on whether to prevent the untrusted third party from entering the company through purchasing act.

Moreover, given the basic nature of the offeror-acceptance mode between the transferor and other shareholders, the parties to the transaction shall bear the corresponding intensity of responsibility. Since there have been provisions about the time limit for internal shareholders to exercise the preemption right in effect, as a two-way obligation, the transferor's exercise of right could also be required in terms of time.

3. Analysis of The Importance of Notification

3.1. The Asset Compatibility: Transaction Costs and Efficiency

Essentially, LLC is an asset-compatible company with characteristics of person compatibility or partnership [9]. The nature of equity transfer restrictions is not to deter the free disposition of equity property rights, but to restrict the qualification of shareholders [10]. Free transfer of equity is one of the basic principles followed by the company law of modern countries. The transferability of equity embodies its value, since that the stronger the liquidity of equity is, the more valuable it would be [11].

However, when the interests of all parties are unbalanced, legislative gaps may need to be filled. According to Coase theorem, when transaction costs are zero, no law is needed [12]. So conversely, when transaction costs are very high, legislative gaps cannot continue. Zhang summarized the process of exercising the preemption right: first the transferor shareholder issues a notice of equal conditions, and then other shareholders claim their preemption rights [7]. Apparently, when exercising the preemption right, if the previous notice is not issued in time, it will affect the time when the right is claimed, and in combination with its limitation, subsequently affect the effectiveness of the right. The transferor is the initiator of an equity transfer event and holds the most comprehensive information in the two-way selection. Thus, the transferor should disclose the details of the negotiation with the other shareholders in the appropriate period, or the discovery cost could be heavy.

Inspired by Coase theorem, Cooter and Ulen proposed the concept of Normative Hobbes Theorem, which emphasizes "structure the law so as to minimize the harm caused by failures in private agreements" [12]. Besides internal shareholders' huge discovery costs, delayed notification will also cause damage to third parties' interests, reflecting the demand for legislative norms. For the external third party, notification is commonly the company's internal governance issue, but will bring uncertainty to them and increase the contracting cost. After the same conditions are determined, the

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deal may fall through at any time until the preemption right expires. Although the third party can claim damages through a valid contract, it will also bring litigation costs. Therefore, the lack of legislative notification time affects the interests of both parties and increases the transaction cost, contrary to the efficiency value of commercial transactions. Legislation should be adopted to regulate the time limit of notification and increase the urgency of the notification obligation.

3.2. The Person Compatibility: An Internal and External Fusion

Despite being an asset company, a LLC is also mostly positioned on person compatibility, with flexibility which allows personalized construction. The company's articles of association are entitled to exceed the legislative equity transfer restrictions, making it available for companies to set up rules that are more in line with their overall interests.

In the juridical, internal corporate governance and external circulation are often totally separated. On the one hand, the law determines the validity of the agreement signed between the third party and the internal shareholders of the company. On the other hand, the practice judgment often classifies the validity defects in equity changes as internal governance problems. In fact, as far as the notification obligation is concerned, the two should not be in complete segmentation, which is contrary to the legislative purpose of the preemption right. The preemption right could trace its source back to the company's closure and person compatibility, giving other shareholders the right to prevent the untrusted third party from entering the company by buying shares within a certain time.

To strike a balance between the free circulation of commercial value and the protection of the trust relationship within the company, the law also needs to endow shareholders with certain obligations in order to preserve corporate integrity. As a shareholder of a LLC, the transferor could not bear obligations as simple as an offeror in the free trade relationship. The common model of offering-acceptance contracting is that two equal and free parties conduct a transaction. Nevertheless, in the case of equity transfer, the process not only brings the transfer of property rights, but also closely involves in the granting of shareholder qualifications. As a shareholder, the transferor has the responsibility to maintain an internal trust relationship and strictly control the granting of shareholder qualifications. Other shareholders have the right to block untrusted outsiders from entering the company by buying up all the shares. If the equity is transferred externally, the third party, as a potential shareholder, should also be responsible for the interests of the company. Thus, it's necessary to leave both some room for corporate autonomy, and sufficient obligations to ensure that all parties are responsible for the interests of the company. In order to protect the interests of both internal shareholders and external third parties, the notification obligation, as a necessary procedure of equity transfer to outside the company, should be appropriately strengthened.

4. Viable Solutions in Notification Procedure

4.1. Recommendation on Formulating Company's Articles of Association

In order to emphasize the strengthening of the notification obligation, while not going against the original intention of the judgment and legislation leaving a loose space for the notification procedure, the notification obligation can be stipulated to a certain extent in the articles of association of the LLC.

The fixed provision set in the articles of association provides predictability for all shareholders of the company as well as for outsiders, not only maintaining the cooperative relationship, but also reducing the transaction cost in commercial activities. As to the transferors, they could foresee the increased procedural burden before initiating the equity transfer, and the notification obligation has the function of controlling the reasonable delivery time of the expression of intention in the consultation, thus speeding up the process, facilitating the transaction, and aligning with their interests. From the perspectives of other internal shareholders, the notification obligation guarantees their right

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to know the information in time and greatly reduces their discovery costs, so whether to achieve the effect of exercising the preemption right depends more on their will rather than procedural losses. In addition, this regulation could speed up the transaction process and reduce the contracting cost of the third party.

In sum, corporate autonomy is expected to address the transaction costs and play a similar role in filling legislative gaps, while leaving flexibility to adapt to different commercial activities and complex situations.

4.2. Legal Interpretation: The Redefinition of Notification Method

The way of notification and how to be considered as “should know” are understood differently in practice judgment, which leads to great differences in judgment. Thus, in terms of legislation, “should know” can be understood by combining the adoption of the “doctrine of arrival” with non-single reasonable notification ways. In other words, more than one form of notification should be adopted, but each form is sufficient to fulfill the notification obligation as long as it reaches a specific receiving target. On the one hand, this way takes into account both the consideration of person compatibility and the intention of free transfer embodied in the "doctrine of arrival". At the same time, it will not bring excessive notification burden and damage the interests of the transferor shareholders. In the process of equity transfer, the notification procedure potentially includes the preparation of the notice, sending the notice to all other shareholders and other trivial work. In this case, if the transferor is asked to exhaust all possible means or wait for the exact reply as the way to judge the completion of the notification obligation, the transaction costs would be too great. On the other hand, merely adopting the “doctrine of arrival”, without regard to the possibility of acceptance, is not sufficient. Therefore, the "doctrine of arrival" of a variety of reasonable notification methods can reasonably avoid the shortcomings of the two, not impeding the transfer willingness of the transferor shareholders while adding enough obligations required during the deal.

Notably, the provisions mentioned will not lose the interests of the third party. The validity of an equity transfer contract is the ultimate guarantee of the third party’s trading interests. On this basis, the third party would expect either a successful transaction or the certainty of a transaction. In the case when the transferor is facing parallel transactions with an internal shareholder or a third party, what the legislation needs to do is not to ensure that the third party’s transaction can be concluded, but to promote the efficiency of negotiation so that the transaction can reach a stable state as soon as possible, so as to avoid the third party's delay in a transaction that cannot be completed for too long.

5. Conclusion

By analyzing judgments differences arising from cases before and after the 2017 judicial interpretation came into effect, this paper summarizes the legal basis behind the judgments and the legislative gap reflected in the notification procedure. The legislative gap exists in the process of noticing the other shareholders before exercising the preemption right, and measures need to be taken. This paper advises the company to set fixed provisions in articles of associations or the legislature to give more specific regulation about means of notification, that is, non-single notifications and adopting the “doctrine of arrival” for each. The measures would improve the legislation on external equity transfer in LLCs, help the actual exercise of the preemption right, and balance the interests of all three parties in the equity change event. This paper only summarizes and analyzes the minor aspects of the cases, and these cases discussed above are not comprehensive. Future research can conduct a comprehensive case study on relevant cases, summarize the rules of judgment, and further explore the legal issues reflected in the disputes.

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