

## Research on Judicial Intervention in Company Governance in the Optimization of Business Environment under the Rule of Law\*

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**Abstract:** Xi Jinping, general secretary of the Central Committee of the Communist Party of China stressed that “Administer a Country under the rule of law is the best business environment”. As one of the World Bank’s Doing Business Indicators, legal environment holds an important role in business environment assessment. Promoting the healthy development of companies, one of the most important business entities, is a significance mission to optimize the business environment under the rule of law. For the good of the company, company autonomy is both efficient and effective in dealing with company internal conflicts, but when the internal conflicts are intensified to a considerable extent, the intervention or adjustment of external forces is also necessary. Meanwhile, the balance between company autonomy and social interests should be fully considered. Thus, judicial intervention should be prudently involved in resolving company issues. The hard question is how to intervene. Since there are many types of company issues, this paper mainly discusses the methods of judicial intervention in company issues like the company resolution revocation lawsuit and the solution of the deadlock dispute of the company.

### 1. Introduction

In the new era, optimizing the business environment has become a new need to accelerate the construction of a modern economic system and promote high-quality development. 2019 Government Work Report clearly proposed to “foster a law-based, international and convenient business environment”. As one of the World Bank’s Doing Business Indicators, legal environment holds an important role in business environment assessment. The impact of government legislation, judicial and law enforcement activities on business entities has become an important object of assessment practice. Judicial decisions that are fair, authoritative and efficient play an irreplaceable role in stabilizing social expectations, boosting social confidence, stimulating market dynamics and promoting economic development. Thus, the judiciary has much to offer in the process of enhancing the rule of law business environment. Promoting the healthy development of companies, one of the most important business entities in the market, is a significance mission to optimize the business environment under the rule of law. It is certain that corporate governance is more cost-efficient and effective through methods like the establishment of the articles of association or contract, the principle of equality of shares, business judgment rules and others to solve internal disputes. However, when the internal conflicts has intensified to such an extent that it cannot be solved by the company’s autonomy, the intervention of external forces is also very necessary. The balance between the company’s autonomy and the interests of society should be fully taken into account, and judicial intervention should be prudent and appropriate. The judiciary must not add subjective will to the company, but to make up for the shortcomings of the company’s autonomy.

## **2. The Necessity of Judicial Intervention**

The issue of company governance has been of great concern to Chinese academics since the 1990s. The principle of capital majority gives the majority or controlling shareholder the possibility to suppress the minority shareholders and abuse their rights. The resolution of the conflicts within the company has been the focus of both theoretical and practical attention. Company autonomy is the primary option for solving internal problems. Judicial intervenes only when corporate autonomy fails. This is because company itself is best qualified to speak on these issues. Judges, however, are not businessmen and their mission is the pursuit of social justice goals, not self-profit goals pursued by businessmen. Therefore, both legislators, when formulating commercial laws and regulations, and the courts, when resolve disputes about companies, should guarantee the reasonable range of rights in order to safeguard company autonomy.

At the same time, the intervention of external forces is very necessary in resolving company disputes. This external force is usually in the form of coercive force of state. If company autonomy is the internal regulation mechanism, then coercive force of state is the external correction mechanism. Company autonomy does not exclude state (judicial) intervention, this two methods are essentially complementary. Judicial intervention aims to address the unjust and equitable nature in the process of company autonomy. As the last line of defense for social remedies, the judiciary has an irreplaceable role to play in this process. The following part will mainly discuss judicial intervention in company governance from the perspectives of the company resolution revocation lawsuit and the solution of the deadlock dispute of the company.

## **3. Judicial Intervention in Company Resolution Revocation Litigation**

Article 22 of the Company Law of the People's Republic of China (Hereinafter referred to as the Company Law) establishes the action of revocation of defective company resolutions by shareholders, which refers to the action of revocation of a company resolution if the resolution is defective in procedure or content in violation of laws and regulations or the articles of association.

### **3.1 Three-Division System**

As one of the important elements of the remedy system for defective company resolutions in China, this article is set to protect the minority shareholder's rights and balance the interests of shareholders. However, this article seems too general for judicial practice in defining "defect", such as the resolution is defective in content or procedure, against law or against regulations, a minor defect or serious defect. Without careful divisions, there is a high risk of abuse in judicial intervention. Just like what happened in Germany before. The company resolution defect remedy system originated in Germany, which experienced serious litigation abuse in its early years. German scholars generally believe that the company resolution revocation lawsuit is overly tilted towards the protection of shareholders' interests, resulting in an imbalance between the interests of shareholders and the company as a whole.

To deal with that, careful division of defects should be adopted. Scholars suggest a "three-division" system of remedies for defects in company resolutions, including the invalidation of company resolutions, revocation and no formation of resolution. If the content is illegal, the resolution is invalid. If the procedural defects are serious enough to affect the existence of the resolution, the resolution should not be established. General defects are revocable, minor defects can be discretionary dismissal. Though the three-division clarify the extent of defect, the criteria of general and minor arises new controversies.

### **3.2 Minor Defect in China**

Article 4 of the Fourth Judicial Interpretation of the Company Law introduced the "minor defects" rule for company resolutions. It provides that "if a shareholder requests the revocation of a resolution

of a shareholder meeting or a board of directors, the people's court shall support the request if it complies with the provisions of paragraph 2 of Article 22 of the Company Law, but the people's court shall not support the request if there is only a minor defect in the convening procedure or the voting method of the meeting and the resolution has not been materially affected". The concept of "minor defect" mainly lean from Japan, where Article 831, paragraph 2 of the Japanese Company Law (Law No. 86) provides that "In the case of an action to revoke a resolution of a shareholder meeting, even if the procedure for convening a shareholder meeting or the method of resolution violates the law or the articles of association, the court could, if it finds that the fact of the violation is not material and does not have an effect on the resolution, dismiss the claim. In the cases relating to defects in company resolutions, there are some "procedural violations" that do not harm the rights and interests of the shareholders and the company, nor do they have an impact on the resolution, which are known as "minor defects". The withdrawal of such defect resolutions through judicial review is not justified, but interferes with the normal operation of the company. Therefore, it can be regulated by company autonomy, such as defect correction or self-healing rather than judicial intervention.

As neither the Company Law nor Fourth Judicial Interpretation specify the content of "minor defects", there is still a wide divergence of understanding on this issue in practice. The common practice in practice is a result-oriented analysis based on the judgment that "there is no material impact on the resolution".

### **3.3 Suggestion on Judgement Criteria in Judicial Intervention**

The "minor defects" in Article 4 of Fourth Judicial Interpretation specifically refer to defects in procedures that violate laws and regulations or the articles of association but do not have a substantive impact on the resolution. With the wide application of capital majority rule, the procedural flaws affect the interests of minority shareholders most. With result-oriented analysis method, judges would often dismiss requests for annulment of resolutions on the grounds that this defect is not material since it does not have an effect on the resolution. However, the author believes that this is not a proper basis for judgment. For example, if a resolution of A company involves engineering expertise. B, an expert in the relevant engineering direction, is a minority shareholder of A company. According to capital majority rule, not notifying B to attend the meeting will not have a substantive impact on the voting results. The actual situation may be like that: Since B is the engineering expert, his attendance and speech on the shareholder meeting would profoundly affect the judgement of other shareholders. In practice, this kind of result-oriented analysis approach will undoubtedly reinforce the notion of "substantive justice over procedural justice", which is contrary to the legislative intent of the Company Law and the requirement to "protect the legitimate interests of minority shareholders" in the construction of a business environment based on the rule of law.

The author suggests that, in judicial practice, judges should not simply understand the criterion of "the defect does not affect the substance" from the perspective of shares. A more rigorous standard should be adopted in determining whether a defect constitutes a minor defect. In this regard, we may refer to the standard adopted by the Chaoyang District People's Court of Beijing in the case of Ma Jun v. Yihe Spring Technology Co., Ltd. In this case, the criteria is whether the defect would result in the shareholders being unable to participate fairly in the formation of the majority intention and obtain the information required for this purpose. If so, this defect could not be considered as minor defect. In each individual case, a holistic view should be taken. For example, the Company Law provides that a limited liability company shall give 15 days' notice to its shareholders of a shareholder meeting. If a limited liability company only gives 10 days' notice, but all shareholders are present at the meeting, then such a defect can be considered as a minor defect; Whereas a limited liability company gives 14 days' notice, because of this one-day difference, some shareholders are unable to participate in the meeting, then such a defect should not be considered as a minor defect. A prudent judgement on the issue of dismissal for minor defects is of great significance to the protection of the interests of minority

shareholders. The idea of appropriate judicial intervention in company resolution revocation litigation does not mean it's better to dismiss the claims of shareholders, but to intervene carefully with due diligence in each individual case.

#### **4. Judicial Intervention in Company Deadlocks**

Company Deadlock refers to the stagnation of business activities caused by the disagreement of shareholders or directors on certain policies of the company. Article 182 of Company Law states that "company deadlock refers to serious difficulties in the operation and management of the company, the continued existence of which will cause significant losses to the interests of shareholders and cannot be resolved through other means". If that happens, "shareholders holding at least ten percent of the voting rights can request the people's court to dissolve the company". This judicial dissolution is the ultimate solution, which completely deprives the company of the possibility of operating again. In practice, however, for most companies in a deadlock, the performance of the company has not been reduced to the point of bankruptcy. Dissolution will result in the termination of the company's operations, which will inevitably cause a series of negative effects. It is certain not the most efficient way for company and society to solve company deadlock in this way. In addition to being too harsh in its approach to resolution, section 182 is too vague and lacks practical application in determining company deadlock. There is a lack of provisions on what exactly is meant by "business management", "serious difficulties" and "other means". The provisions of the existing law do not provide the judiciary with a good basis for their application.

##### **4.1 Extraterritorial Laws**

There are two main approaches regarding company deadlock in extraterritorial laws. One is to set the provisional director system in US law. The other is shareholder expulsion in German law. Section 41(a) (7) of the US Model Business Corporation Act states that the court may order "the appointment of a provisional director (who has all the rights, powers, and duties of a duly elected director) to serve for the term and under the conditions prescribed." However, the statute is not clear as to the criteria for selecting provisional directors. The absence of detailed standard is deliberately intended to prevent excessive restrictions on the discretion of the court. It has been adopted in states like Georgia, Missouri, Southern California and etc. Other states have also adopted the practice of provisional directors, only specifying the criteria for the selection of the court in terms of content.

As for Germany, The GmbH Law's solution to the close company deadlock problem is court-ordered dissolution of the enterprise. Section 61 of the GmbH Law provides that: The Company may be dissolved by a court decision in case it becomes impossible to accomplish the purpose of the company or when there are other substantial causes (wichtige Grund). The dissolution remedy itself has been criticized in Germany since dissolution leads to a loss of business and a loss of jobs. German courts have sought over a seventy year period to fashion their own remedies. Modern German courts have recognized a new remedy for the resolution of intractable disputes in addition to dissolution-shareholder expulsion. When a shareholder raises a matter that threatens the continued existence of the company and violates fiduciary duty, which comprises factors such as disloyalty, self-dealing, oppression, and bad faith, it can lead to the initiation of an expulsion procedure. The extremely vague and open-ended language of the applicable German concepts has given judges wide discretion in resolving deadlock disputes. The expulsion resolution should be made by the shareholder meeting and the expulsion will not take effect until the removed shareholder has been paid the corresponding price.

In simple terms, the United States is breaking the existing deadlock by addition, while Germany by subtraction. Although the specific approaches are different, there are commonalities in their internal logic. In comparison, the author prefers the US system of provisional directors. It's obvious that the expulsion procedure values company autonomy more than direct dissolution, but when the company is

in a deadlock, the shareholder meeting is often unable to form an effective resolution. The expulsion procedural relying on the shareholder meeting resolution to make a nomination. This action could be difficult to carry out in practice. Considering that, the intervention of a neutral third-party provisional director is more practicable.

## **4.2 System Design in China**

As discussed above, the set of “provisional director system” could be useful in solving deadlock problem in China. It can be designed as follows: when a company is in a deadlock, the shareholders can apply to the court to intervene, and the court then appoint provisional directors, whose qualifications can be set by the court. The provisional director has the same rights and powers as the ordinary director when voting on the board. The value of the provisional director is to upset the balance and encourage both parties to consider new approaches and to resolve disputes amicably. Under this system, there is judicial involvement - the court appoints provisional directors, but the intervention is not to a great extent. Besides, this arrangement is an effective and appropriate form of judicial involvement compared to a dissolution action, as it preserves the company's subject matter and breaks the current stalemate.

## **5. Summary**

Modern companies can achieve a considerable degree of autonomy through the design of their articles of association, internal adjustments and rules of business judgement. For example, in the case of a company deadlock, this problem could be easily solved through company autonomy with the introduction of a designated third party to break the deadlock if agreed in advance in the articles of association. However, if the company has not designed in advance, and internal conflicts are intensified to a certain extent, the necessary external intervention is also indispensable for the benefit of the company. Judicial intervention has therefore been adopted by many countries. This article mainly discuss how to achieve appropriate judicial intervention in situation like company resolution revocation litigation and company deadlock to ultimately achieve the protection of the interests of the company and the pursuit of constructing a more healthy business environment under the rule of law.

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