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STUDENT NOTE

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A Look into Protection of Preferred Stockholders’ Rights Under the Context of State-owned Enterprise Reform

Ling Tong*

ABSTRACT

In wake of severe financial distress and other troubles (such as the long-criticized monopoly dilemma) haunting many state-owned enterprises, Chinese government is now vigorously pushing forward the second round of state-owned enterprises reform, in which preferred stocks are encouraged to be used for achieving the “retreat” of state-owned capital.

Because of its hybrid features, preferred stocks are expected to play an active role in such so-called “hybrid-ownership” reform of state-owned enterprise. Under the first model where state-owned capital will retreat by gradually transferring controlling power to private capital, preferred stocks can be used to generate stable income for state-owned capital, achieving the objective of preserving and increasing the value of state-owned assets. Under the second model where state-owned capital retains absolute control, preferred stocks can be used to attract private capital to invest and thus maintain the hybrid-ownership of the enterprise.

However, under both models, horizontal conflicts of interest between common shareholders and preferred stockholders still exist or even intensify. How to protect the legitimate interests of preferred stockholders becomes a critical question relating to the success of the state-owned enterprise reform.

In the United States, under Delaware laws, the protection of preferred stockholders’ rights comes from both contract law and corporate laws. Under contract laws, preference rights of the preferred stocks are contractual in nature and should be respected. However, remedies granted by contract laws are not sufficient because preferred stock transactions are inevitably incomplete transactions due to its additional equity-like features. Under corporate laws, Delaware courts recognized

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that the preferred shareholders can protect themselves against opportunism by the common shareholders through breach of fiduciary claims. Besides, as the last straw, preferred stockholders can seek appraisal right protection despite that Delaware courts are reluctant to second-guess the board’s business judgment on determination of “fair value.”

Under Chinese laws, although the spirit of freedom of contract is generally respected, too many mandatory regulatory requirements deter parties from taking advantage of the flexibility of preferred stocks through contractual arrangements. Besides, it is still controversial whether preferred stockholders are entitled to appraisal right. Arguably, protection of preferred stockholders’ rights under Chinese laws can be strengthened through advancing ex post protection mechanism such as breach of fiduciary claims and appraisal right action.

Key words: State-Owned Enterprise Reform, Preferred Stock, Protection of Shareholder’s Right
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I. INTRODUCTION

According to a series of regulations, rules and policies promulgated by the central government and all levels of local governments, preferred stocks are expected to play an active role in the second round of state-owned enterprises undergoing through China. However, because of the rooted horizontal conflict of interest between common shareholders and preferred stocks, protection of preferred stockholders’ legitimate rights becomes critical to the success of using preferred stocks to achieving the “retreat” of state-owned capital.

This paper first tries to introduce various legal remedies preferred stockholders are entitled to under U.S. laws to protect themselves against opportunism by common shareholders. In the end, this paper also reviews legal remedies currently available under Chinese laws and tries to make some suggestions.

This paper contains six parts as below:

In Part I, this paper gives a brief introduction to basic concepts and features of preferred stocks, informing readers with basic know-how on this topic.

In Part II, a brief development history of preferred stocks in China will be introduced. For decades, de facto preferred stocks are used by venture capitals to mitigate risks associated with pre-IPO investments through complicated contract terms, enforceability of which are in doubt. The launch of preferred stocks pilot program in China represents the first steps towards a more pervasive concept of preferred rights similar to those in other jurisdictions.

Part III of this paper analyzes the expected role of preferred stocks under the context of Chinese state-owned enterprise reform. This paper argues that either under Model I where private capital takes control or under Model II where state-owned capital retains absolute control, horizontal conflicts between common shareholders and preferred stockholders remain or even intensify. The protection of preferred stockholders’ legitimate rights became a critical question.

In Part IV, this paper introduces the ongoing dispute over the nature of preferred stocks and the protection of preferred stockholders’ interest under overlapping regimes span over contract
laws and corporate laws in the United States. Arguably, several im-
portant legal mechanisms worked closely to protect the preferred
stockholders’ rights, contributing to the active preferred stocks
market in the United States.

Part V of this paper analyzes legal remedies currently avail-
able for protection of preferred stockholders’ right under Chinese
laws. This paper argues that Chinese laws should refrain from im-
posing unnecessary ex ante restrictions on the issuance of preferred
stocks. On the other hand, Chinese lawmakers should focus on
strengthening ex parte protections such as breach of fiduciary
claim and appraisal right claims.

Part VI gives a brief conclusion of this paper.

II. Basic Concepts and Features of Preferred Stocks

Preferred stocks are described as “hybrid between debt and
equity,” giving its holder constant payment stream similar to
bonds promised as a contract right while simultaneously allowing
issuer the flexibility to create a bundle of different rights concern-
ing voting, periodic returns preference payment in event of liqui-
dation.

A. Preferred Stocks Have Many Debt-Like Features

Preferred stocks have many debt-like features:

1. Both are the product of mutual bargaining. The dividend
payments (either at a fixed rate or a floating rate) and other rights
preferred stockholders are entitled to are determined through mu-
tual bargaining between the issuer and the holders ex ante and are
usually stipulated in an instrument called the certificate of desig-
nation. \(^2\)

Consequently, both preferred stockholders and creditors
have limited upside, meaning that their maximum return on invest-
ment is determined ex ante, normally as the interest or dividend
to be paid. \(^3\) In contrast, common shareholders who are residual

\(^{1}\) Stephen J. Lubben, Corporate Finance 161 (5th rev. ed. 2013) [hereinafter
Corporate Finance II].

\(^{2}\) Id., at 162.

\(^{3}\) See Ben Walther, Peril and Promise of Preferred Stock, 39 Del. J. Corp. L.
161, 168 (2014) [hereinafter Walther Article].
claimants on company assets have unlimited upside while have no guarantee of any constant payments.

2. Both are senior securities. Preferred stocks have seniority over common shareholders in a company’s capital structure, meaning that preferred stockholders are paid before the common over the distribution of company earnings such as dividends or claims on liquidation proceeds in the event that the company is liquidated.

3. Both have no voting rights under normal circumstances. Similar to creditor, preferred stockholders usually do not bargain for voting rights except for extraordinary circumstances such as merger, or upon default of dividend payments by the issuer for a specific period of time as provided in the contract. This may be explained by the fact that as a fixed income earner like a bondholder, preferred stockholder’s interest in management affairs of the company is not significant as a result of its limited claim on the earning of the going concern.4

4. Preferred stocks may be redeemed in some circumstances. Once preferred stocks are redeemed, payments similar to “principal” are paid by issuer to the holder, turning the preferred stocks investment into a fixed term with fixed yields resembling a debt investment.

B. Preferred Stocks Have Many Equity-Like Features

Preferred stockholders are considered as “owners” of “equity”5 because preferred stocks have many equity-like features:

1. Both preferred stockholders and common shareholders rank “next in line after creditors.” In the event that the company is liquidated for bankruptcy, preferred stockholders may together with common shareholders participate in distribution of liquidation proceeds after and only after creditors are satisfied.

2. Both get no absolute promise on dividend payments. Unlike debt securities which have absolutely enforceable contract right to interest payments unless the company is in severe financial distress like bankruptcy, dividend payments to preferred stocks and common stocks are contingent and not a “fixed income security at

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4 See William W. Bratton, Corporate Finance: Cases and Materials 611 (7th ed. 2012) [hereinafter Corporate Finance I].

5 Id.
3. Preferred stockholders may have voting right as common shareholders. Although modern preferred stockholders usually give up voting right in exchange for priority over constant dividend payments, in some extraordinary circumstances they are entitled to vote. For example, preferred stockholders as a class may regain voting rights when several consecutive or nonconsecutive dividend payments are in default, e.g. some corporations may provide preferred stockholders with a class vote for electing a certain number of directors in the event of default on paying three consecutive dividend payments.

4. Preferred stockholders enjoy favorable tax treatment similar to common shareholders with respect to dividend payments. In the United States, venture capitalists as preferred stockholders have historically enjoyed favorable tax treatment when they receive dividends from portfolio corporations. Normally, U.S. companies that are subject to corporate income tax are allowed to deduct certain percentage of their dividend income from taxable income.

C. Different Categories of Preferred Stocks

By combining different rights and privileges characteristics together, a corporation may issue different preferred stocks which could be categorized mainly as following:

1. Cumulative vs. Noncumulative. The cumulative feature requires that if dividends have been skipped or omitted in the past, the skipped or omitted dividends will be accumulated and should be paid in priority before other subordinate preferred stockholders or common shareholders get paid any dividends. The cumulative feature of preferred stocks provides holders with additional protection because no dividends could be paid to common shareholders until all accumulative dividends not paid in the past have been paid.

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6 Corporate Finance I, supra note 4, at 607.
9 Id.
to the preferred.

2. Participating vs. Non-Participating. The participating feature entitles preferred stockholders to recoup their initial investment plus accrued dividends (if any) and proportionally the “common upside” value of the firm. However, holders of non-participating preferred stocks are only entitled to the greater of its initial investment amount plus accrued dividends (if any) OR proportionally the “common upside” value of the firm. In downside circumstances where the firm is liquidated with remaining assets amount less than the preferred stockholder’s initial investment value, the difference between participating and non-participating is not meaningful because both types could provide its holders with “downside protection,” meaning no liquidation proceeds are paid to common shareholders. In a normal or upside circumstance, the participating feature can have great impact on liquidation proceeds between preferred stockholders and common shareholders.

3. Convertible vs. Non-Convertible. The convertible feature entitles holder to convert preferred stock to a pre-determined number of common stock upon occurrence of a pre-determined event or after a pre-determined period of time. Normally, holders can decide whether to make the conversion upon satisfaction of pre-determined conditions. However, some convertible preferred stocks give the issuer the right to compel the conversion. A substantial percentage of modern preferred stocks are convertible.

4. Redeemable v. Non-Redeemable. Redeemable preferred stock is also called callable preferred stock. The redeemable feature allows the issuer to call or redeem the preferred stocks at a pre-determined price which is normally higher than the market value and then retire it, meaning the issuer can cancel the securities if its costs become too high. Issuers favor the redeemable feature because it allows the issuer to substitute preferred stocks with lower-cost ones if market interest rate becomes lower. However, the issuer is not obliged to redeem the preferred stocks if market

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11 Id.
interest rates remain steady or become higher. Apparently, redeemable feature favors the issuer.¹³

III. A BRIEF INTRODUCTION OF THE DEVELOPMENT HISTORY OF PREFERRED STOCKS IN CHINA

A. Early Preferred Stocks Issued Without Legislative Authority

China’s first modern shareholding company was established in 1980, after which shareholding companies spread out throughout China. In this early stage, shares issued by these shareholding companies have hybrid features of equity and debt because to-be-enlightened Chinese investors strongly favored a promise on fixed amount of return similar to interest payments promised by banks. Although these early stage shares contained some similar features, strictly speaking, they may not be called preferred stocks because relevant shareholding companies did not even realize the distinction between common shares and preferred stocks.¹⁴ Lacking clear definition and legislative authority, preference features are incorporated into common shares to accommodate risk-averse investors.

B. Early Preferred Stocks Issued with Vague Legislative Authority

In 1992, China National Committee for Economic System Reform issued the Opinions on Standards for the Companies Limited by Shares (the “Opinions on Standard”), clearly allowing companies limited by shares to issue both common stocks and preferred stocks that can have preference over the company’s dividend (at a fixed rate) and liquidation proceeds before common shareholders.¹⁵ Hangzhou Tianmu Pharmaceutical Limited once issued preferred stock according to the authority under the Opinions on Standard.¹⁶

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¹⁶ Preferred Stocks in China: Discussion on History of Development and
However, before long, in 1993, the Opinions on Standard was abolished and replaced by *Company Law of the People’s Republic of China (1993)* (the “Chinese Company Law 1993”). Article 135 of the Chinese Company Law 1993 provides a controversial authority on the issuance of class shares such as preferred stocks: “State Council of China may otherwise promulgate rules with respect to the issuance of other classes of shares other than [common] shares prescribed under this Company Law.”

Zhou Xiaochuan, governor of the People’s Bank of China, once explained that Chinese legislators did not usher in the concept of preferred stocks in the Chinese Company Law 1993 due to concern that such new concept was too forward-looking for Chinese capital market. Nonetheless, some Chinese scholars insist that Article 135 carves out a niche for the issuance of preferred stocks in China.

In the following twenty years after the controversial authority carved out by Chinese Company Law 1993, State Council of China promulgated no further detailed rules regarding issuance of other classes of shares. Although the mechanism of preferred stocks was widely used in venture capital investments in China through complicated contractual terms in order to circumvent restrictions under Chinese Company Law, preferred stocks, as an important financing tool, has not been officially adopted by Chinese companies (particularly large listed companies whose issuance of shares are subject to strict regulations) for financing due to the lack of clear legislative authority. This period is called the quiet era of preferred stocks.

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*Practice Guide, supra note 14.*


18 See 周小川 (Zhou Xiaochuan), 优先股能在处理危机中发挥独特作用 [Special Role of Preferred Stocks in Dealing with Financial Crisis], 中国金融时报 [CHINA METAL BULL.], issue 34, at 23 (2013).

19 See 汪青松 (Wang Qingsong), 优先股的市场实践与制度建构 [Market Practice and Rule Construction in Relation to Preferred Stocks], 证券市场报 [SEC. MKT. REP.], at 14 (Mar. 2014).

C. Preferred Stocks Issued with Clear Legislative Authority Since 2013

In November 2013, State Council of China issued the *Guiding Opinions on the Pilot Launch of Preferred Stocks* (the “Guiding Opinions”), on a trial basis, allowing public (both listed and unlisted) companies to issue, either through private placement or public offering, preferred stocks.\(^{21}\)

Several months later in March 2014, the long-awaited *Administrative Measures of the Preferred Stocks Pilot Program* (“Administrative Measures”) promulgated by China Regulatory Securities Commission (“CSRC”) came into effect, providing more practical rules for implementing the trial preferred stocks program in China.\(^ {22}\)

Under the Guiding Opinions and Draft Administrative Measures, preference stocks are defined as a class of shares prescribed under the Chinese Company Law other than ordinary shares whose holders shall have priority rights over common shareholders in relation to distribution of profits and residual assets which are essentially preferred dividend and liquidation rights.

Immediately after the Administrative Measures came into effect, Guanghui Energy (Stock Code: 600256) released its preliminary plan to issue preferred stocks for raising up to RMB 5 billion through private placements. Chinese companies finally entered into a new era when preferred stocks could be issued with clear legislative authority.

\(^{21}\) See *国务院关于开展优先股试点的指导意见* [Guiding Opinions on the Pilot Launch of Preferred Stocks] (promulgated by the St. Council, Nov. 30, 2013, effective Nov. 30, 2013) art. 2, CLI.2.213719 CHINALAWINFO [hereinafter Guiding Opinions].

IV. PREFERRED STOCKS’ ACTIVE ROLE IN THE CONTEXT OF STATE-OWNED ENTERPRISE REFORM

A. The Role of Preferred Stocks is Officially Recognized Under the Context of State-Owned Enterprise Reform

From early 1990s, many Chinese scholars started urging that China should usher in preferred stocks to facilitate reform state-owned enterprise. For example, in an early article published in 1994, one professor discussed the feasibility of converting state-owned shares into preferred stocks in China.23

Similar discussions are re-ignited as the second round state-owned enterprises reform was gradually launched in recent years. Professor Liu Junhai of Renmin University pointed out in 2012 that preferred stocks could be good remedy for troubles haunting state-owned enterprises.24 Another scholar also mentioned that preferred stocks should be a “important financing tool” in China’s second round state-owned enterprise reform.25

Particularly, after several concrete new policies announced by the Communist Party of China, preferred stocks are expected to play an active role in the state-owned enterprise reform currently undergoing throughout China. According to Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform, China will vigorously promote hybrid-ownership economic, encouraging more non-state-owned capital to invested in state-owned enterprises.26

According to Guiding Opinions of the CCCPC and State

24 See generally 刘俊海 (Liu Junhai), 优先股将根治国企、VIE 难题 [Preferred Stocks Will Solve State-Owned Enterprise and VIE Troubles], 董事会 [Dir. & Boards], issue 88, at 43–44 (May 2012) [hereinafter Liu Junhai Article].
25 See 冯威 (Feng Wei), 优先股市场实践与理论定位的背离及其制度完善 [Preferred Stock: Market Practice’s Deviation from Theory and System Improvement on Rules], 清华法律评论 [TSINGHUA L. REV.], issue 8, at 195 (2015).
26 State-owned enterprise is a broad concept which may be misunderstood as including all enterprises in which the central or local government directly or indirectly holds any equity interest. Therefore, state-controlled enterprise may be a more accurate concept. See generally 中共中央关于全面深化改革若干重大问题的决定 [Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform] (promulgated by the CCCPC, Nov. 12, 2013, effective Nov. 12, 2013), art. 6, CLI.5.213067 CHINALAWINFO.

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Council on Comprehensively Deepening State-owned Enterprise Reform 2015,\textsuperscript{27} for the purpose of diversifying the ownership structure of state-owned enterprises, the state will explore the solution of allowing partial state-owned capital to be converted into preferred stocks and establish special state-owned shares management system in a few particular areas.

In its later-promulgated \textit{Opinions on Development of Hybrid-Ownership Economic in State-Owned Enterprise} (the “Opinions on Hybrid Ownership”),\textsuperscript{28} State Council of China further emphasized that “state-owned shares are allowed to be converted into preferred stocks when state-owned capital is to hold interest in non-state-owned enterprise or non-state-owned capital is to hold interest in state-owned enterprise.”

Legally, the role of preferred stocks is officially recognized under the context of state-owned enterprise reform.

\textbf{B. Two Different Roles of Preferred Stocks in State-Owned Enterprise Reform}

Before long after the issuance of the above-mentioned state-level policies, almost all provincial governments announced their own proposals on state-owned enterprise reform, many of which mentioned preferred stocks. However, up to date, there is no uniform reform plan announced by the central government due to the extreme complexity of this task.

Based on these proposals from provincial governments,\textsuperscript{29} the development of hybrid-ownership requires that state-owned

\textsuperscript{27} \textit{See} 中共中央、国务院关于深化国有企业改革的指导意见 [Guiding Opinions of the CCCPC and State Council on Comprehensively Deepening State-owned Enterprise Reform] (promulgated by the CCCPC and St. Council, Aug. 24, 2015, effective Aug. 24, 2015), art. 7, CLI.5.256926 CHINALAWINFO.

\textsuperscript{28} \textit{See} 国务院关于国有企业发展混合所有制经济的意见 [Opinions on Development of Hybrid-Ownership Economic in State-Owned Enterprise] (promulgated by the St. Council, Sept. 23, 2015, effective Sept. 23, 2015), art. 3, CLI.2.257547 CHINALAWINFO [hereinafter Opinions on Hybrid Ownership].

\textsuperscript{29} \textit{E.g.}, 河北省人民政府关于地方国有企业发展混合所有制经济的实施意见 [Implementing Opinions of Hebei Provincial Government on Development of Hybrid-Ownership Economics in Local State-Owned Enterprises] (promulgated by the Hebei Provincial Gov., Dec. 9, 2015, effective Dec. 9, 2015), art. 3, available at https://www.baidu.com/link?url=n6ms-RimhXAJinWkrV8C4VadwJQFH Gn3B6Dc5QDGkXs_HkpPCdMC6c7sRyagz3fx3LYgjXWRdUIdRtfsjZKZy7KD a9xnyaJIIosdGcabYm&wd=&eqid=a36c0de6001026890000000656d48262 [hereinafter Hebei Implementing Opinions].
capital move in both directions, retreating from commercial industries while strengthening its absolute controlling position in “key industries.” Generally speaking, preferred stocks could be used to diversify the shareholding of state-owned enterprises mainly in the following two ways.

1. Model I: State-Owned Capital Gradually Transfer Controlling Power

For commercial enterprises which engage in fully competitive industries,30 state-owned capital can gradually retreat by converting state-owned common shares into state-owned preferred stocks to the extent that non-state-owned common stockholders can hold controlling power in the enterprise after such conversion (“Model I”).

State-owned enterprises to be reformed under Model I will be threw into a highly competitive market. Under Model I, preferred stocks may cause positive effects on such reform arguably in the following aspects:

a) Preferred stocks system can help return management power to private capital. As discussed above, under normal circumstances, preferred stockholders give up voting rights in exchange for preference, creating an opportunity to allocate the voting power among different class of shareholders. By converting state-owned common shares into state-owned preferred stocks, private capital, particularly long-term strategic investors, could be attracted to participate in managing the former state-owned enterprise.31

Before the conversion, essential management powers are exercised indirectly by all levels of State-Owned Assets Supervision and Administration Commission (“SASAC”) that is under direct supervision of all levels of central or local governments, ranging from appointment of directors and supervisors, executive compensation scheme, to even the training and entertainment activities for

31 See generally Liu Junhai Article, supra note 24.
employees.\(^{32}\)

After the conversion, management power could be separated from state-ownership. The management can independently operate the enterprise, in consistent with state-owned enterprises’ plan to gradually retreat from competitive industries.

b) Preferred stocks system can to some extent help minimize agency costs problems haunting state-owned enterprises in competitive industries. After nearly thirty years of the first round reform, Chinese state-owned enterprises still dominate the whole economy. By the end of January 2015, there are totally 2,635 companies listed on the main board in Shanghai Stock Exchange, 38% of which are state-controlled. These state-owned enterprises are reported to remain low-efficient and beset with serious financial troubles.\(^{33}\) Many scholars attribute this phenomenon to the so-called “double-agency” problem.

Double agency problem refers to two layers of delegation in state-owned enterprises which may increase agency costs. The first layer of delegation is between the state and SASAC, which is an institute agent delegated by the state to supervise state-owned assets. The second layer of delegation is between SASAC who functions the role as shareholder and the management of the enterprise.

Because of its nature as an organ of the government, SASAC is widely criticized for pursuing many political objectives while failing to fulfill its responsibilities as a shareholder.\(^{34}\) On the one hand, SASAC inclines to overly interfere with the enterprises’ daily management through regulatory-oriented rules to achieve many political objectives it carries;\(^{35}\) on the other hand, SASAC


\(^{35}\) *See* Deng Feng Speech, supra note 32. *See also* 郑志刚 (Zheng Zhigang),
is arguably not in a good position to make reasonable business decisions to pursue maximize economic interest for the enterprise because economic profit is merely one of its many objectives. Consequently, double-agency problem is exacerbated in Chinese state-owned enterprises because of SASAC’s role a “shadow” shareholder from corporate governance perspective.  

By returning management powers to private capital, double agency costs could be reduced to some extent.

c) Stable dividends generated by preferred stocks can help preserve and increase the value of state-owned capital. According to article 8 of Law of the People’s Republic of China on the State-Owned Assets of Enterprises, SASAC should establish effective evaluation and accountability system to ensure the preservation and increase of state-owned assets value. Some scholars observed that this “political” requirement puts pressures on SASAC to pursue short-term financial performance by closely monitoring the enterprise’s financing and investment activities, consequently restricting state-owned enterprises’ capability to compete with non-state-owned enterprise in the long run.  

Because of its preference feature, preferred stocks have priority over the enterprise’s dividends. It can generate long-term stable returns and is therefore favored by risk-averse investors, such as large insurance companies and pension funds. For example, Industrial and Commercial Bank of China’s recent issuance of preferred stocks, which promise an annual rate of return at six percent, are over-subscribed by foreign investors. Compared to Chinese
listed companies’ tradition of being reluctant to pay little or extremely low dividends, the stable return expected from preferred stocks are more likely to satisfy SASAC’s objective to preserve and increase the value of state-owned assets.

d) Preferred stock can arguably motivate the management to achieve better financial performance. Because of preferred stock’s preference over dividends, common shareholders are residual claimant who won’t get paid until promised dividends to preferred stockholders are paid.

Besides, the management usually “comes to view the preferred issue much as it would a bond, establishing the policy that the full preferred dividend must be paid as a matter of course . . . comes to view the preferred issue much as it would.”

Arguably, the management who are usually selected by common shareholders, has motivation to achieve better financial performance to pay the preferred stockholders and then create additional value for common shareholders.

In sum, under Model I, preferred stocks could be used to return controlling power from state-owned enterprise to private capital in competitive industries where state-owned capital is about to retreat.

2. Model II: State-Owned Capital Retains Absolute Control

For commercial or non-commercial enterprises which engage in key industries that have close relationship with national security or are vital to national interest, and public welfare enterprises which are focusing on providing public goods or services or undertaking special tasks, state-owned capital should maintain absolute or full control while allowing private capital to participate in equity-holding through hybrid-ownerships, such preferred stocks (“Model II”).

According to the Opinions on Hybrid Ownership, private capital is encouraged to participate in equity-holding in enterprises

41 See generally Hebei Implementing Opinions, supra note 29.
42 See Corporate Finance I, supra note 4, at 618.
under Model II for the purpose of providing financing and/or supporting services (such as repair service) to these state-owned enterprises.\textsuperscript{43}

For private capital, participation in these state-owned enterprises under model II looks attractive for at least two reasons:

i) to share stable profits earned by state-owned enterprises under model II which usually engage in monopoly business. Some risk-averse private investors favor preferred stocks “that have an investment grade rating as opposed to speculative grade” because such preferred stocks with investment grade rating arguably carry a lower investment risk than preferred stocks that have no such characteristics.\textsuperscript{44} Given grade rating on Chinese enterprises is not as popular and reliable as in the United States, a label of state-owned enterprise engaged in monopoly business is to some extent a reliable guarantee on the enterprise’s stable operation and profit-generating capability.

ii) to establish cooperation relationship with state-owned enterprises hoping to get business opportunities providing supporting services for these enterprises through outsourcing. This kind of cooperation chemistry between private capital and state-owned capital is also mentioned by the Opinions on Hybrid Ownership.

However, under model II, state-owned capital must hold absolute or full control over the enterprise. To achieve these goals, preferred stocks may contribute to reform state-owned enterprises at least in two particular ways:

a) The Issuance of Preferred Stocks Can Avoid Diluting State-Owned Capital’s Absolute Control

As discussed above, preferred stockholders can give up voting rights through contractual arrangements. This special feature of preferred stocks perfectly matches state-owned capital’ special desire to retain absolute control over enterprises under Model II.

\textsuperscript{43} See generally Opinions on Hybrid Ownership, supra note 28.

b) Preferred Stocks Financing Can Help State-Owned Enterprises Optimize Their Debt-Equity Ratio

In the United States, large corporations such as financial institutions and public utilities favor the issuance of publicly listed preferred stock because of the tax advantages associated with dividend payments.\(^{45}\) Although the issuer cannot deducts dividend payments before tax as interest expenses on bonds, corporate receivers pay tax on only thirty percent of preferred dividends received, offering a more attractive investment opportunity than bonds to institutional investors like insurance companies that are subject to federal corporate income tax. Such a corporate preferred issue could sell at a lower yield than the same company’s bonds.\(^{46}\) Therefore, large corporations such as financial institutions and public utilities which are in need of large-scale financing favor the issuance of preferred stocks.

Chinese corporate taxpayers enjoy more favorable tax advantages on dividend payments. According to Provisions on Accounting Treatment and Distinction Between Debt Financing Instrument and Equity Financing Instrument promulgated by the Ministry of Finance in wake of state authorization to issue preferred stocks under the Guiding Opinions, once preferred stocks are recognized as equity financing instrument in light of its contractual arrangement, corporate taxpayers who receive relevant dividend payments can enjoy ZERO corporate income tax.\(^{47}\)

Many state-owned enterprises such as public utilities need large-scale of funds for preliminary construction and operation. Traditionally, these state-owned enterprises heavily rely on low-cost financing through bank loans by taking advantage of its high credibility.\(^{48}\) However, many state-owned enterprises nowadays


\(^{46}\) See Corporate Finance I, supra note 4, at 620.


are trapped with high debt-equity ratio and are under pressure to deleverage to avoid financial risks associated with huge bank loans.\textsuperscript{49} Preferred stocks, which could be designed as equity financing tools that,\textsuperscript{50} can effectively help indebted state-owned enterprises to manage debt-equity ratio while allowing their corporate investors to enjoy tax advantages.\textsuperscript{51}

In sum, under Model II, preferred stocks could be used to attract private capital’s participation in state-owned enterprises that engage in key industries while allowing state-owned capital to retain absolute control.

\textit{C. Horizontal Conflict of Interest Between Common Shareholders and Preferred Stockholders Remain Severe in the Context of State-Owned Enterprise Reform}

Despite its hybrid features, preferred stocks are traditionally regarded as stocks and preferred stockholders are traditionally regarded as “owner” with “equity interest,” like a common shareholder. By virtue of this ownership interest, preferred stockholders are also corporate constituency who has a bite on the pie of company wealth, involving in a zero-sum game playing.\textsuperscript{52} Consequently, preferred stockholders may have direct conflicts with other corporate constituents and director/officers of the company who actually operate the business.

\textsuperscript{50} See 陈金祥(Chen Jinxiang), 优先股发行转换、回购等财务处理详解 [The Issuance, Conversion And Repurchase of Preferred Stocks: A Detailed Financial Analysis], 财会信报 [ACCT. MESSENGER], June 23, 2014, at B03.
\textsuperscript{51} See generally 甘德龙 (Gan Delong), 基于优先股改善国有上市公司治理 [Use Preferred Stocks to Improve the Governance of State-owned Enterprises], 现代企业 [MOD. ENTER.], issue 2, at 40–41 (2015).
\textsuperscript{52} See Lawrence E. Mitchel, \textit{Puzzling Paradox of Preferred Stock and Why We Should Care about It}, 51 BUS. LAW. 443, 446 (1996) [hereinafter Lawrence Article].
1. There are Generally Two Types of Conflict of Interest Involving Preferred Stockholders

   a) Vertical conflicts. Vertical conflicts exist between the enterprise’s directors/officers and preferred stockholders, where the latter’s interests are subject to the former’s exercise of management powers. Vertical conflicts generally occur between director/officers and any corporate constituents group, which are the root of duties of care and duties of loyalty.

   Vertical conflicts are not the focus of this paper because preferred stocks generally have the same rights as common shareholders to bring derivative actions against directors/officers in cases of such vertical conflicts. Preferred stockholders have the same right as common shareholders to sue directors if directors/officers enriched themselves at the expenses of preferred stockholders.  

   However, because vertical conflicts may sometimes overlap with horizontal conflicts (as discussed below) in the same cases, particularly when a board member holds substantial amount of common shares under employee stock ownership plans that are designed to align directors’ interest with that of common shareholders, the vertical conflicts may also be taken into account when this paper discusses horizontal conflicts.

   b) Horizontal conflicts. Horizontal conflicts exist between common shareholders and preferred stockholders, the two classes of corporate constituents who have direct conflict of interest with each other because as a result of its preferential rights, such as preference over declared dividends, preferences proceeds, and under particular circumstances the right to redemption at a premium price. Preferred stockholders get the first bite on the pie until promised privileges are satisfied, which come at the expense of common shareholders.

   Horizontal conflicts root in its feature of preference. Theoretically speaking, common shareholders who are entitled to only

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53 Id., at 449.
54 According to Article 151 of PRC Company Law (2013 Amended), shareholder has the right bring derivative actions against directors/officers of the company who are in breach of his/her duty of care and duty of loyalty owe to the company. However, whether preferred stockholders can bring derivative actions against directors/officers under Chinese laws is still a pending question, to be clarified by further legislative rules or judicial cases.
residual assets tend to bet on the unlimited upside, but preferred stockholders who tend to be risk-averse rarely allow the enterprise to take excessive risks to pursue the unlimited upside.\textsuperscript{55}

The question of whether to declare dividends is a good window for looking into horizontal conflicts. When the enterprise is on the upside with sufficient earnings to pay dividends, horizontal conflicts may not be severe but still exist. As to preferred stockholders, declaration of dividends matches their desires to secure fixed and stable return. In stark contrast, common shareholders who pursue long-term interest tend to reserve earning in the enterprise for operation expanding. Declaration of dividends will constrain their bet on the unlimited upside unless.\textsuperscript{56}

When the enterprise is on the downside lacking sufficient earnings to pay dividends, horizontal conflicts will escalate, particularly when the dividends are not even sufficient to satisfy preferred stockholders’ fixed amount. If to declare dividends, all earnings go to preferred stocks, common shareholders, who get no benefit from declaration of dividends, would instead prefer to reserve the earnings in the enterprise to whether to financial distress.\textsuperscript{57}

2. Horizontal Conflicts Remain Severe or Even Intensify When State-Owned Interests Are Involved in The Context of State-Owned Enterprise Reform

a) Under Model I, preferred stockholders represent state-owned interests, which still carry on at least in near future both economic and political functions.\textsuperscript{58} “To preserve and increase the


\textsuperscript{56} However, this incentive may be weakened if the enterprise has excessive working capital, either as a result of increasing intrinsic value of equity or from outside financing, for business operation. Like Alibaba. See Walther Article, supra note 3, at 169.

\textsuperscript{57} See 周鹏 (Zhou Peng), 优先股制度中的利益冲突研究 [Studies on Conflict of Interest in Preferred Stocks Systems], 上海师范大学 [Shanghai Normal Univ.], at 17 (2015).

\textsuperscript{58} For example, state-owned capital carries on the task to make up the shortfall of social pension funds. It is reported that a consensus is reached among ministers under the leadership of the central government and rules are being promulgated to implement a plan to gradually transfer ownership of state-owned shares to social security funds. By 2030, at maximum 40% of state-owned shares will be transferred. See 国资委划拨社保全科细则, 万亿国资划社保 [Implementing Rules Are Under Promulgation Related to Transfer of State-
value of state-owned assets” is not only an economic objective but also an objective related to the stability of the whole society. State-owned preferred stockholders are somehow under political pressure to make sure the preferred investment can generate state return.

Another concern is about how to prevent the loss and erosion of state-owned assets. It is widely reported that in the first round state-enterprise reform, state-owned assets were disposed to private parties at under-value price, causing significant losses to state-owned assets. Although the risk of under-value disposal no longer exists, there might be other tricky ways to erode state-owned assets, say the board which is controlled by private common shareholders keep declaring no dividends despite the enterprise has sufficient legally available funds. State Council of China keeps emphasizing that the bottom line of reform is to prevent loss of state-owned assets and has recently issued the Opinion on Strengthen and Improve Supervision on State-Owned Enterprise to Prevent the Loss of State-Owned Assets.59

Given its special identity, state-owned preferred stockholders, who are directly or indirectly under supervision of the central government or all levels of local governments, have more political power to set the rules to guarantee its claims on stable dividend streams. However, political interference will go against the goal to return controlling power to private capital, which of course includes to discretion to declare dividends.

b) Under Model II, preferred stockholders represent private capital, giving up controlling powers in exchange for stable dividend streams. Because the enterprise is under the controlling shareholder’s absolute control, preferred stockholders are arguably under threat of abuses by the controlling shareholder through “tunneling,”60 which are not uncommon among state-controlled listed


companies.\textsuperscript{61}

It is said that the biggest obstacle deterring private capital’s participation in state-enterprise reform is the threat of tunneling by the controlling shareholders through related-party transactions, fund misappropriation, inter-enterprises loans or guarantee and the likes.\textsuperscript{62} In state-owned enterprises, tunneling is reported to be conducted by directors/officers (particular the ones who are founders of the enterprise) for personal benefits, such as the famous Yunnan Copper case, in which the listed company was once trapped with serious financial troubles.\textsuperscript{63} Consequently, such tunneling may have undesirable effect on the state-owned enterprise’ financial capability to pay constant dividends to preferred stockholders.

Therefore, under both Model I and Model II, horizontal conflicts such as different opinions on declaration of dividends become evident, particularly when the enterprise in on the downside. Whether preferred stocks can play its role as expected in the state-owned enterprise reform to a large extent depends on the protection of preferred stockholders’ legitimate interests.

\section*{V. Legal Theories for Protection of Preferred Stockholders’ Rights in the United States}

Under contractual arrangements, preferred stockholders are normally entitled to fixed amount of constant dividend payments and preference over liquidation proceeds. However, such preferences are vulnerable to exploitation by the common shareholders. By virtue of their natures, preferred stockholder’s claims on predetermined dividend payments lose value if they are subject to high variance risks while common shareholder’s claims on residual assets benefit from taking high variance risks. Therefore, if common shareholders bet on the unlimited upside by pushing the firm to invest in high variance projects, their equity investments will ben-


\textsuperscript{62} See Zheng Zhigang, \textit{supra} note 35, at 3.

\textsuperscript{63} See generally 许淑贤 (Xu Shuxian), 公司治理、关联交易与 “掏空” 行为——基于云南铜业的案例研究 \textit{[Corporate Governance, Related Transactions, and Tunneling―A Case Study Based on Yunnan Copper]}, 中山大学 [Sun Yat-sen Univ.] (2010).
efit because all the upside goes to common shareholders at the expense of the other corporate constituents such as preferred shareholders who only make fixed claim but share the increased risk with common shareholders.

Therefore, both bondholders and preferred stockholders “seek to protect their fixed claims on the firm’s assets against opportunism by common shareholders.” However, bondholders and preferred stockholders’ ability to protect themselves against opportunism differs greatly.64

In the United States, creditors such as bondholders can rely on remedies granted by contract laws. “A contract is a contract is a contract,” meaning that creditor’s legal remedies are limited to what they have bargained-for in the contract.

What kind of remedies preferred stockholders are entitled to, however, is still a controversial question even in the United States. Because of its hybrid characters, it has been long recognized that “legal treatment of preferred stockholders straddled the dividing line between corporate laws and contract laws.”65 So the protection of preferred stockholders’ rights come from both contract laws and corporate laws.

A. Preferred Stockholders Are Entitled to Protection Under Contract Laws Which is Not Sufficient

In Jedwab v MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986), Delaware Chancery court lay down the general rule concerning protection of preferred stockholders’ rights, which held that preference rights enjoyed by preferred stockholders are contractual in nature unless it is a right shared equally with common shareholders.66 It is worth citing the classic reasoning here again:

With respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropri-
ately defined by reference to the specific words evidencing that contract.

Compared to common shareholders, preferred stockholders obtain their preference rights through explicitly negotiated contract terms. The law of Delaware governing contracts is less controversial than the law governing shares. Under the concept of freedom of contract, a valid contract term mutually agreed by parties will be enforced unless the contract violates public policy or positive law, or unless a party’s non-performance is excused.

Generally, preferred rights articulated in the contract will be respected in a similar way as debt-like rights. However, it is difficult, if not impossible, to specify every preferred right beforehand, preferred stock transactions are inevitably incomplete transactions. Additionally, the good faith doctrine, which is supposed to protect parties’ legitimate expectations from the contract, is narrowly applied to only limited situations where the substance should also be drawn from explicit contract terms. Therefore, lacking a specific contract term regarding rights asserted by preferred stockholders, contractual protection became limited and protections under corporate laws are necessary.

B. Preferred Stockholders Are Also Entitled to Limited Protection Under Corporate Laws

No matter how similar preferred stocks and debts could be in terms of economic similarities, preferred stocks are stocks and could be distinguished from junior debts securities like a subordinated debenture because of its distinct characteristics of stocks. Thus, as illustrated by Judge Allen in his opinion in Jedwab v. MGM Grand Hotels above, with respect to rights asserted by preferred stockholders that are “shared equally with the common,” the existence and the scope of such right should also be examined under general corporate law standards.

Under corporate laws, Delaware courts traditionally respect

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69 Brattont & Wachtert, supra note 67, at 1839.
70 See Cane et al., supra note 68, at 403.
71 See Corporate Finance I, supra note 4, at 608.
board of directors’ business judgments, including discretion to declare or not payment of dividends unless mandatory dividends are contractually specified. The corporate laws’ role as gap-filler seems to be limited due to courts’ reluctance to interfere with the board’s decision, unless special circumstances such as conflict of interest arise.

1. Corporate Laws Can Protect Preferred Stockholders Through Fiduciary Duty Theory

Delaware courts have long agreed that majority shareholders owe fiduciary duties to minority shareholders and the entire or intrinsic fairness test is appropriate for determining whether the majority shareholders elect to take advantage of their controlling powers to further their own interest at the costs of minority groups. Similarly, preferred stockholders’ interest may be exploited by majority common shareholders who control the board. Board members, most of whom owe their directorships to majority common shareholders, tend to maximize the value of majority common shareholders at the expense of minority groups including preferred stockholders. Arguably, majority shareholders who control the board owe fiduciary to preferred stockholders.

Admittedly, it is still an ongoing argument whether and how directors owe fiduciary duty to preferred stockholder in the context of horizontal conflicts. However, in cases where directors themselves own common shares, courts are more willing to grant fiduciary duty protection to preferred stockholders. In *HB Korenvaes Investments, LP. v. Marriott Cwp.*, the court recognized that directors may owe fiduciary duties to preferred stockholders where preferred stockholders are placed in a weak position due to the lack of specific contractual provisions. In *Re FLS Holdings, Inc. Shareholders Litigation* (1993 WL 104562 (Del.Ch.Apr. 2, 1993)), the court further noted that directors who were selected by common shareholders owed fiduciary duties to common shareholders as

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72 Id., at 621.
73 See Cane et al., supra note 68, at 388.
74 See Corporate Finance I, supra note 4, at 667.
75 See Brattont & Wachter, supra note 67, at 1835.
76 See Lawrence Article, supra note 52, at 468–69.
77 See Cane et al., supra note 68, at 396.
well as preferred stockholders and should treat preferred stockholders fairly in distributing the consideration in a merger.\(^{78}\)

If fiduciary duties are confirmed and the fairness test is applied, the court will examine both the substance and procedures. However, the court of *In Re Trados Inc. Shareholders Litigation*\(^{79}\) noted “the entire fairness standard is not a bifurcated test as between fair price and fair process, the two components of an entire fairness analysis.”\(^{80}\) But the court did reassure preferred stockholders that on matters for which preferred stockholders failed to negotiate for preference rights, the board owes preferred stockholders fiduciary duties in relation to allocation of merger consideration between common shareholders and preferred stockholders, a matter not specifically addressed by contract in the case.

2. Corporate Laws Can Protect Preferred Stockholders Through Appraisal Rights Actions

Appraisal right refers to the statutory right of a corporation’s dissenting minority shareholders to have a fair stock price be determined by a judicial proceeding or independent valuator, and the obligation for the corporation to pay minority shareholders at that price.\(^ {81}\) Such an appraisal right is to protect the interest of minority shareholders who raise objection to a fundamental corporate action which the majority shareholders approve.\(^ {82}\)

Under Delaware laws, preferred stockholders who are normally in the minority groups, can make appraisal right claim equally as common shareholders. In *In Re Appraisal of Metromedia International Group, Inc.*, dissenting preferred stockholders sought a judicial determination of the fair value of their cumulative convertible preferred stocks after a merger vote even though what the preferred stockholders claimed exceeded what the certificate of

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\(^{78}\) *See In re FLS Holdings, Inc. Shareholders Litigation, No. 12623, 1993 WL 104562, at 4 (Del. Ch. 1993).*

\(^{79}\) *In re Trados Inc. S’holder Litig., 73 A.3d 17 (Del. Ch. 2013).*


\(^{81}\) *See DENG FENG, COMMON COMPANY LAW 380 (2009) [hereinafter Deng Feng Book].*

\(^{82}\) *See Byron F. Egan, Asset Acquisitions: Assuming and Avoiding Liabilities, 116 PENN ST. L. REV. 913, 923 (2012).*
designation determines as their right upon occurrence of a merger.

However, the Chancery court recognized that due to the contractual nature of preferred stocks, in determining the fair value of preferred stocks, the court must look to the contract upon which the preferred stock’s value is based, meaning the valuation of preferred stock must be viewed through the contract unless the contract is ambiguous or conflicts with positive law. Therefore, when a contract fixes the precise value to be paid to the preferred stockholders upon a merger event, dissenting preferred stockholders can initiate appraisal right action against majority common shareholders/preferred stockholders for a fair price that is set ex ante. Under such appraisal right actions, preferred stockholders are entitled to what they have bargained for, rather than an uncertain amount determined by the court traditionally using a liberal approach by considering “all relevant factors involving the value of a company.” In LC Capital Master Fund, Ltd. v. James, the Chancery court also implied that in absence of a contractual arrangement, preferred stockholders have no right to demand additional value (if to deem a merger as a liquidation event which could qualify preferred stockholders for liquidation preference) from merger even though the board owes duty to make a “fair” allocation of merger consideration between the common and preferred stockholders.

In sum, under Delaware corporate laws, appraisal right action can function as the last straw for the protection of preferred stockholders’ legitimate rights provided that the court is reluctant to second-guess the board’s business judgment in absence of extraordinary circumstances such as conflict of interest.

VI. REFLECTION ON PROTECTION OF PREFERRED STOCKHOLDERS’ RIGHTS UNDER CHINESE LAWS

A. Chinese Laws Generally Respect the Spirit of Freedom of Contract Involving Preferred Stocks

Generally, Chinese laws allow the parties to set the terms of

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83 See Corporate Finance II, supra note 1, at 174.
84 Id., at 173.
85 LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 436-8 (Del. Ch. 2010).
preferred stocks contract through bargaining.

However, as shown in the table below, Chinese laws do not grant as much freedom to the parties as Delaware laws, particularly in public offering (compared to private placement\textsuperscript{86}) of preferred stocks.

<table>
<thead>
<tr>
<th>Items</th>
<th>Delaware Laws</th>
<th>Chinese Laws</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope of issuers</td>
<td>No restriction</td>
<td>Must be joint stock limited companies,\textsuperscript{87} either listed or unlisted. Private companies\textsuperscript{88} are not allowed to issue preferred stocks.</td>
</tr>
<tr>
<td>Dividend preference</td>
<td>Allowed</td>
<td>Allowed</td>
</tr>
<tr>
<td>Liquidation preference</td>
<td>Allowed</td>
<td>Allowed</td>
</tr>
<tr>
<td>Condition to declare dividends</td>
<td>Has “legally available funds”</td>
<td>As long as there are after-tax profits.</td>
</tr>
<tr>
<td>Price</td>
<td>Free to negotiate</td>
<td>Free to negotiate</td>
</tr>
<tr>
<td>Rate of dividend</td>
<td>Free to negotiate; floating rates are allowed</td>
<td>In private placements, the rate of dividend should not exceed weighted average rate of return on equity in the preceding two accounting years. In public offering, the rate of dividend must be fixed amount. In public offerings, listed companies are not allowed to issue preferred stocks that carry conversion rights, either for the issuer or the investor.</td>
</tr>
<tr>
<td>Conversion right</td>
<td>Allowed</td>
<td>Free to negotiate</td>
</tr>
<tr>
<td>Redemption right</td>
<td>Free to negotiate</td>
<td>Free to negotiate</td>
</tr>
<tr>
<td>Voting right</td>
<td>Not compulsory, free to negotiate</td>
<td>Generally, no voting right. However, preferred</td>
</tr>
</tbody>
</table>

\textsuperscript{86} Private placement refers to offering to no more than 200 specific subscribers. \textit{See} 中华人民共和国证券法 [Securities Law of the People’s Republic of China] (promulgated by the Nat’l People’s Cong., amended Aug. 31, 2014, effective Jan. 1, 2006) art. 10, CLI.1.233280 CHINALAWINFO.

\textsuperscript{87} There are merely two types of company forms under Chinese Company Law, limited liability company (whose total number of shareholders should not exceed fifty) and joint stock limited company (established by more than two but not more than two hundred shareholders. After its establishment, a joint stock limited company can become a public company through public or private offer if the total number of its shareholders exceeds two hundred). Joint stock limited company is the form normally adopted by large companies which raise funds through capital market. Limited liability company is the form normally adopted by closed company.

\textsuperscript{88} Including domestic private companies in the form of limited liability companies, as well as foreign invested enterprises such as wholly foreign-owned enterprises, equity joint ventures and cooperative joint ventures.
For the purpose of protecting public investors, the Guiding Opinions requires all preferred stocks issued through public offering must be at fixed rate of dividend, cumulative, non-participating and mandatory payment of dividend as long as the issuer has after-tax profits. However, these mandatory regulatory requirements seem unwelcomed by market players.

By March 21, 2015, there are 21 companies in total that circulated their proposal to issue preferred stocks, all of which are proposed to be issued through private placement rather than public offering arguably to circumvent the aforesaid mandatory regulatory requirements.

Compared to common shares, preferred stocks are touted for its flexibility for the issuers and the investors to bargain for different contractual arrangements on voting, dividend payment, liquidation, redemption right and so on. As discussed in Part IV, state-owned enterprise reform involved the movement of state-owned capital in both directions, under which the relationship between common shareholders and preferred stockholders are much more delicate. On the one hand, mandatory regulatory requirements restrain relevant parties to bargain for special protection mechanism; on the other hand, market players find other ways to circumvent these requirements. Ultimately, it goes against the legislative intent to protect preferred stockholders.

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89 According to the Guiding Opinions, preferred stockholders are entitled to vote on significant matters such as merger, increase or reduction in registered capital over ten percent, liquidation, amendment to articles of associations which may affect preferred stockholder’s interest. Besides, preferred stockholders can automatically regain pro rata voting rights if the issuer failed to pay dividend as agreed for two consecutive accounting years or three accounting years in aggregation.

90 See 王会敏&耿利航 (Wang Huimin & Geng Lihang), 上市公司优先股发行实践和制度反思 [Reflection on the Practice and Issuance System of Preferred Stocks by Listed Companies], 东岳论丛 [DONG YUE TRIB.], issue 12, at 128 (2015).
B. Dissenting Preferred Stockholders’ Appraisal Rights Have Not Yet Been Recognized Under Chinese Law

Appraisal right is a useful mechanism that can afford adequate ex parte remedies, properly balancing the interest of the majority and the minority. \(^{91}\) It respects minority preferred stockholders’ right to refuse excessive risk-taking activities and does not overly constrain majority shareholders’ right to take corporate actions to maximize its interest under the principle of capital majority representation.

As mentioned above, under Delaware laws, dissenting preferred stockholders are entitled to appraisal right unless specifically excluded in the contract ex ante and the methods to measure fair value could be stipulated in the contract. Appraisal right claim is an important weapon to deter majority common shareholders/ preferred stockholders from depriving minority preferred stockholders’ legitimate interests.

However, under current Chinese law regime, preferred stockholders cannot effectively assert appraisal right to protect themselves against opportunism by majority shareholders as discussed below.

1. The Role of Appraisal Rights Under Chinese Law

Appraisal right was formally introduced into Company Law of the People’s Republic of China in 2005. Under Article 74 and Article 142 of PRC Company Law (2005 Amended), a “shareholder” of both a limited liability company and a joint stock limited company can make appraisal right claim against several fundamental corporate actions, which include merger and split-up of the company. \(^{92}\)

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\(^{91}\) \textit{See} 叶陶冶 (Ye Tao'ye), 中国发展优先股制度研究 [\textit{Theory Studies on How to Develop Preferred Stocks in China}], 上海交通大学 [Shanghai Jiaotong Univ.], at 79 (2008) [hereinafter Ye Article].

\(^{92}\) However, the scope fundamental corporate actions related to a limited liability company are broader than that of a joint stock limited company. Fundamental corporate actions related to a limited liability company include merge with others, to be split up, or transfer substantial assets of the company to others. A shareholder of a joint stock limited liability company has no appraisal action against transfer of all or substantial assets. \textit{See} PRC Company Law, \textit{supra} note 17, at art. 74.

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2. Standard for Determining the Fair Value of Appraised Shares is Not Clear under Chinese Law

PRC Company Law does not impose any mandatory requirement on the standard for determine “reasonable” of appraised shares. For listed companies, the market practice is to follow the Stock Exchange’s guiding opinion by making reference to the average of trading price in the preceding 20, 60 or 180 trading days.\(^93\)

One noteworthy point is that DGCL\(^94\) carves out certain exceptions to dissenting shareholders’ appraisal right. The major exception is so-called “market-out exception,” pursuant to which appraisal rights are not available to any classes or series of stock listed on a national securities exchange or held by more than two thousand holders.\(^95\)

However controversial it is, the current PRC Company Law does not recognize the “market-out exception.” Whenever a trigger happened, dissenting shareholders of even a listed company are entitled to exercising appraisal right. According to the administrative rules enacted by CSRC to implement Article 142 of PRC Company Law, listed company are required to remind, through public announcement within seven days upon approval of any merger or split-up, dissenting shareholders to exercise their appraisal rights. Many examples can demonstrate that this requirement is uniformly followed by listed companies, and the market practice is offering dissenting shareholders a “fair price” by reference to the average of trading price in the preceding 20, 60 or 180 trading days.\(^96\)

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\(^93\) See 深交所上市公司现金选择权业务指引 [Guiding Opinions on Appraisal Right in relation to Listed Companies] (promulgated by the Shenzhen Stock Exch., Sept. 6, 2011, effective Sept. 6, 2011) art. 15, CLI.6.158164 CHINALAWINFO.

\(^94\) DEL. GEN. CORP. LAW § 262(b)(1).


However, few dissenting shareholders would choose to exercise their appraisal rights because the trading price of their shares after the announcement of merger or split-up is usually higher than the “reasonable price” determined by reference to the previous trading price. Only in some exceptional cases where the trading price of shares is drawn down by the announcement of merger or split-up, dissenting shareholders might choose to exercise their appraisal rights.

In sum, compared to Delaware court’s deference to the board’s business judgment on fair price, standard for determining the fair value of appraised shares is not clear under Chinese law. The market practice is following Stock Exchange’s regulatory requirements.

3. What Appraisal Right Means to Preferred Stockholders Under Chinese Law

In addition to “fair value” determination standard, another issue is that it is still unclear whether preferred stockholders can rely on appraisal right action or not for two major reasons:

a) The legal identity of preferred stockholders has not been officially recognized under PRC Company Law. Although Chinese scholars incline to believe that preferred stockholders are other “class shareholders” which shall be entitled to equal right to appraisal rights as common shareholders. This controversial issue needs to be solved by further legislation or judicial decisions.

b) Even though a preferred stockholder is qualified as a “shareholder” to make appraisal right claim, their interests may not be fully protected given the limited scope of fundamental corporate actions defined by PRC company law.97

97 Fundamental corporate actions defined by PRC Company Law are limited to 1) merge with others, 2) to be split up, and 3) transfer substantial assets of the company to others. Although, preferred stockholders’ class vote allowed by the Administrative Measures also broadly covers amendments to terms of articles of association related to preferred stocks, more than 10% reduction of registered capital in one event or in aggregation, issuance of preferred stocks and other matters as agreed in the articles of association, which may also be used by majority common shareholders/preferred stockholders to fundamentally change the expectation of minority preferred stockholders, such matters do not constitute fundamental corporate actions. See 中华人民共和国公司法(2014) [Company Law of the People’s Republic of China (2014)] (promulgated by the Nat’l People’s Cong.,
Merger and acquisition is one of the most important tools to reform state-owned enterprises. From 2008 to 2014, there were more than 1,700 merger and acquisition (excluding internal connected transaction) cases related to state-owned enterprises. The number and transaction amount of merger and acquisition in relation to state-owned enterprises are expected to continue soaring. Under such trend, for the purpose of protecting preferred stockholders (either state-owned capital or private capital), their appraisal rights should be legally recognized both on traditional fundamental corporate actions that are tailored for protecting the interest of common shareholders and on other matters that may fundamentally change the expectation of minority preferred stockholders.

In sum, appraisal right system under Chinese laws needs overhauls to properly balance horizontal conflicts that are intensified after state-owned enterprise reforms. It is in urgent need to recognize preferred stockholders’ appraisal right and amend the “fair value” value determination standard.

VII. Conclusion

Under U.S. laws, remedies granted by both contract laws and corporate laws focus on ex post protections. Bargained-for preference rights are respected unless violating public policy or positive law. This is consistent with courts’ tradition not to second-guess the parties’ bargained-for results and the board’s independent business decisions. As some scholars observed, these legal principles arguably contribute to the flourishing of preferred stocks in the U.S., compared to some continental legal system countries such as France where the issuance of preferred stocks and protection of preferred stockholders’ right are regulatory-oriented.

Unlike U.S. laws, Chinese laws focus on ex ante restrictions which arguably overly interfere with parties’ freedom to negotiate...
contract terms whereas ex post protection such as appraisal right remedies are underemphasized. Arguably, protection of preferred stockholders’ rights under Chinese laws can be strengthened through advancing ex post protection mechanism such as breach of fiduciary claims and appraisal right action.