CSCanada
Canadian Social Science
Vol. 15, No. 1, 2019, pp. 8-14
DOI:10.3968/10942

ISSN 1712-8056[Print]
ISSN 1923-6697[Online]
www.cscanada.net
www.cscanada.org

Shareholders' Agreement and Articles of Association of Limited Liability Companies Under Context of China: Resolution of Conflict of Shareholders' Will

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Received 13 October 2018; accepted 25 December 2018
Published online 26 January 2019

Abstract

As a vital instrument for the governance of limited liability companies in China, the shareholder agreement has been approved by the *Company Law* of a great number of countries by virtue of its positive significance in building the private order of the governance of limited liability companies and protecting the legitimate rights and interests of shareholders in the company. However, there is still a lack of clear and systematic norms in the legal system of China. Currently, in practice, a number of shareholders of limited liability companies have established shareholder agreements to adjust their rights and obligations stipulated in the *Company Law* and articles of association. Under such circumstance, both as the embodiment of the will of shareholders, in case of a conflict between the shareholder agreement and the articles of association on the governance structure or regulations of the company, the solution to the conflict is the object of this paper.

Key words: Shareholders' agreement; Articles of association; Limited liability companies; Chinese company law

Tang, Y. Y. (2019). Shareholders' Agreement and Articles of Association of Limited Liability Companies Under Context of China: Resolution of Conflict of Shareholders' Will. *Canadian Social Science, 15*(1), 8-14. Available from: http://www.cscanada.net/index.php/css/article/view/10942
DOI: http://dx.doi.org/10.3968/10942

INTRODUCTION

As essential tools and approaches for shareholders to realize their rights and interests in the company as well as the corporate governance in the company, despite that both are the manifestation of shareholders' will, the effectiveness of shareholder agreement and articles of association are significantly different. Different from the articles of association, there is no specific provision on shareholder agreement in the Chinese *Company Law*, which leads to various debates on the applicability of shareholder agreement in practice among Chinese scholars (Xu & Wang, 2016. p.3). Generally speaking, the rights and obligations of shareholders are regulated by the *Company Law* and the articles of association, and given that in a public company, shareholders are free to transfer their shares and usually do not know each other, the method seems appropriate. However, in the limited liability companies with a characteristic of human joining, this approach fails to fully meet the demands of shareholders to participate in the management of the company. In practice, a number of shareholders of limited liability companies adjust their rights and obligations stipulated in the *Company Law* and articles of association through the establishment of shareholder agreement, which shall affect the governance structure of the company. Having been actually widely adopted in the current practice of corporate governance in China, shareholder agreements have even suspended or replaced the articles of association thoroughly in some cases (Chen, 2013, p.3). Under such circumstance, both as the embodiment of the will of shareholders, in case of a conflict between the shareholder agreement and the articles of association on the governance structure or regulations of the company, the solution to the conflict is the object of this paper.

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1. THE DIFFERENCE BETWEEN THE SHAREHOLDER AGREEMENT AND THE COMPANY'S ARTICLES OF ASSOCIATION UNDER THE PROVISIONS OF THE CHINESE COMPANY LAW

1.1 The Difference of Legal Nature

With the dual nature of autonomy and contractual at the same time, in addition to the contract between the company and shareholders in a simple sense, the articles of association of the company also has the nature of "constitution" to regulate the small group within the company (Stepthen, 2010, p.106). Therefore, the articles of association of the company are endowed certain meaning of "Law" by greatly breaking through the relativity of a contract, and thus becomes a "rule of autonomy" (Wu, 2015, p.5). On the contrary, the nature of shareholder agreement is generally considered to be a contract quite similar to partnership agreement, that is, a long-term contract signed by most parties to reach an agreement on the relationship between the internal operation and management of the company and the distribution of economic interests and control rights between shareholders (Li, 2018). Therefore, as a contract in which the parties express the same will, it should be under the adjustment of the contract law. Nevertheless, since what the shareholder agreement involves is the management of related matters such as corporate governance between shareholders rather than the general contract, its content should also be subject to the restriction the *Company Law* (Cadman, 2004, p.3).

1.2 The Difference of Legal Status

As a legal document reflecting the demands and characteristics of the company that is formulated in accordance with the mandatory provisions of the *Company Law* and a written document manifesting the common will of all promoters and even all shareholders, and prepared by the promoters, the articles of association is a requisite document for the establishment of the company. Article 11 and article 25 of the *Company Law* are the legal source of articles of association in the *Company Law* of China. Conversely, a shareholder agreement is a voluntary agreement between shareholders, rather than a necessary condition for the establishment of a company. It may express the common will of all shareholders or only part of the shareholders. In spite of the different opinions on the legal source of shareholder agreement in China's *Company Law*, it is stipulated by article 34 of the law that a limited liability company may not receive dividends or give priority to capital contribution in line with the proportion of capital contribution after being "agreed by all shareholders"; It is also stated in Article 41 of the law that in a limited liability company, "unless otherwise agreed by all shareholders", the requirement to give notice 15 days prior to the shareholders' meeting shall not be complied with. In accordance with the above provisions, the shareholders of a limited liability company may at least make agreements in the form of agreement in the case of dividend distribution, capital increase and share expansion as well as the notification of shareholders' meetings, which are suitable for the actual situation of the company (Zhang, 2010, p.7). It is thereby believed by this paper that though the term "shareholder agreement" does not appear in the *Company Law*, the provisions of Chinese *Company Law* that allow shareholders to agree on their own can still serve as the legal source in the determination of the effectiveness of shareholder agreements in practice, and provide certain legal support for the existence of shareholder agreements in practice.

1.3 The Difference of Binding Object

The articles of association of the company, as a requisite document for the establishment of the company, have a larger number of restraining objects exceeding that of the shareholder agreement. As stipulated by article 11 of the *Company Law* of China, in addition to the restraining force on the company, shareholders, directors, supervisors and senior managerial personnel, the articles of association are also restrictive for the shareholders who join the company after its establishment. Due to the relativity nature of contracts, however, the restraining force of the shareholder agreement only applies to the shareholders who have signed the agreement instead of being restrictive for other shareholders, and those shareholders who have joined later, may become parties to the shareholder agreement by making a commitment of willing to be bound by the agreement.

1.4 The Difference of Methods to Formulate and Amend

As major change items of the company, the formulation and amendment of the articles of association shall be jointly decided by all shareholders, and its approval shall only be based on the principle of "Majority Rule" (approved by shareholders representing more than two-thirds of the voting rights) rather than obtaining the unanimous approval of all shareholders.[1] By comparison, the formulation and amendment of the shareholder agreement shall be subject to the unanimous consent of the shareholders who have signed the agreement. Might be concluded by partial or by all shareholders, the shareholder agreement is only valid for the shareholders who have signed it, while the amendment of the shareholder agreement shall be unanimously agreed by all shareholders who have signed it.

1.5 The Difference of Publicity Level

The articles of association have the nature of publicity.

[1] Article 43, Chinese Company Law.

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According to the *Company Law*, the articles of association of a company should be registered with the industrial and commercial administration authorities and shall be available for inspection by shareholders and other stakeholders according to law.[2] On the contrary, the shareholder agreement has the nature of privacy. It can only bind the parties to the agreement and has no obligation to disclose it to others. Confidentiality obligations are also covered by certain shareholder agreements.

2. DISPUTES ON THE EFFECTIVENESS OF SHAREHOLDER AGREEMENTS IN CHINA'S PRACTICE

2.1 Relationship of Shareholder Agreement and Articles of Association: Supplement or Replacement

Recently, shareholder agreements have been increasingly used in Chinese corporations and corporate judicial practices that have led to the emergence of "agreement replacing governance" (Chen, 2013, p.2). Although the shareholder agreement can be used to fill the gaps in of the articles of association of company, it, which represents the will of the shareholders, cannot replace the will of corporation represented by the organizational structure of the company, and beyond the background of "corporate legal person independence".

In fact, signing a shareholder agreement as a supplement should be regarded as normal in the case that the shareholders of a limited liability company tend to avoid the shareholders' meeting and the board of directors fails to play their roles as predicted, which is because this actually reflects the affirmation of the company's organization in a sense. On condition that all shareholders reach the "unanimity" without convening a general meeting of shareholders, it may be deemed that the procedural rules of the organization for making a resolution (voting) on the matter have been amended and the unanimous opinion on the matter itself have been achieved as well. The article 38, paragraph 2 of the *Company Law* of China actually directly grant the effectiveness of such shareholder agreement with that of the company resolution, that is, the company can directly adopt the form of shareholder agreement on company affairs and make decisions by unanimous consent of all shareholders without convening the shareholders' meeting and the board of directors. Whereas, some shareholder agreements often contain other key issues related to corporate governance, such as the authority of shareholders' meeting, the authority of board of directors and even the candidates of directors and managers (Bebchuk, n.d., pp.833-914), which usually result in conflicts between shareholder agreement and the articles of association. Under such context, normally shareholder agreements cannot replace the articles of association. Nevertheless, Chinese companies are more likely to achieve corporate governance by directly substituting resolutions of the board of shareholders with agreements of shareholders. Such pattern of behavior, which almost completely neglects the organization and procedure of the company, has overridden the *Company Law* to some extent. In addition to replacing the resolution formed through the formal procedures stipulated by the *Company Law*, in order to avoid the constraint of articles of association, the shareholder agreement in some cases also directly agrees that it will be included in the article of association as a part of it, which, due to the great sacrifice of the of the values of company organization such as efficiency and fairness, makes the articles of association become an insignificant decoration. The difference between agreement and collective decision lies in the relationship between consensus and majority rule. An agreement is about individual consent to be bound, while majority rule is about group and company consent. Both of them demonstrate significant functional differences in the efficiency and fairness of organization. In the case that all company procedures are ignored and substituted with agreements of shareholders, matters and differences that should be decided and solved by the voting mechanism of the company will evolve into endless contract disputes and conflicts due to the failure of reaching the consensus through negotiation. This mode of operation, which is of no distinct difference from the external market of enterprises, leads to the loss of decision-making function and efficiency function of organizational mechanism and rules, which is also one of the frequent agreement disputes between shareholders arising in recent years. From the perspective of fairness, despite that the approach of shareholders' s agreement on the surface ensures that the will of all shareholders is respected, considering the different degrees of disclosure of information and procedures in the process of consultation, negotiation and signing, in fact, small and medium-sized shareholders are more likely to be squeezed by large shareholders due to individual consultations and information asymmetry in the agreement negotiation. Even if an agreement is reached, it is doubtful whether it can truly fully reflect the will of all shareholders and fairly safeguard the interests of them. For all that these issues may not be noticeable in companies with a small number of shareholders, in companies with a large number of shareholders where the will of shareholders differs greatly from that of the company rather than being consistent, and the company is not equal to the sum of the will of all shareholders, the articles of association cannot be replaced by the shareholder agreement. The agreement reached by

[2] Article 20 of Regulations of the People's Republic of China on Administration of Registration of Companies

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consensus of all shareholders can be regarded as a supplement to the articles of association of the company only upon there is no provision on the matter agreed in the shareholder agreement in the articles of association of the company.

2.2 The Influence of Force of Shareholder's Agreement on Corporate Governance Structure

Corporate governance structure is generally considered to be the company's advantage over other enterprises. With the deepening understanding of the human joining of limited liability companies in recent years, the reform of the system of limited liability companies has been carried out in a number of countries and regions, which grants limited liability companies more autonomy. The provisions of the *Company Law* on the establishment of company organs and the division of the authority of various company organs are generally considered to be mandatory (Xu, 2017, p.2). However, one of the common contents of shareholders' agreement of limited liability companies is to change the authority range of shareholders' meeting and board of directors as well as strengthen or reduce the responsibilities or obligations of some shareholders (Worthington, n.d.). For example, how effective is a management agreement when the shareholders of a limited liability company hand over the company to a certain shareholder through a private agreement and completely suspend the board of directors? In fact, this kind of agreement not only changes the governance structure and authority arrangement of the shareholder meeting, board of directors and board of supervisors in the company, which is stipulated in the *Company Law* in advance, but also violates the principle of limited liability of shareholders. People's doubt for the existence value of the *Company Law* will be inevitably caused by such management and operation agreement between shareholders. At present, there are mainly two opinions among Chinese scholars on this. One of them holds that although it is an essential principle of the Company Law, the principle of company legalism is not necessarily violated when shareholders transfer the management right of the company to shareholders after the establishment of the company. That is to say, the contract operation agreement of the company is merely a partial modification of the company's daily management right and dividend distribution, which will not bring the complete collapse of the corporate governance system. Therefore, it is unreasonable to generalize the effectiveness of the management and operation contract signed between shareholders. The other opinion is that the company contracted to some certain shareholders in the form of contract is essentially agreed to replace the board operation with contracted operation, which shall be considered null and void in that it violates the specific provisions on the authorities of the board of directors in the *Company Law* and the company's articles of association, eliminate the company's independent personality, increase the risks faced by creditors and infringes the right of shareholders to request profit distribution. The influence of these two different views on the judge's discretion in the face of shareholder agreement disputes leads to different results in the judgment of Chinese courts on shareholder agreements.

2.3 The Influence of Force of Shareholder's Agreement on Creditors

Despite that it is conducive to the construction of the private order of corporate governance and is the embodiment of the spirit of judicial autonomy, the shareholder agreement is after all a change to the order stipulated in the *Company Law* and will affect the interests of the third party of the company. For all that the creditors of the company tend to focus on merely whether their creditor rights can be paid off by the liability property of the company rather than the company's internal operation process, the company is not in the form of partnership merely relying on "agreement" to stipulate its governance structure and management (Wang, 2017, p.5). It is worth noting that the biggest difference between a company and a partnership is the limited liability system. In the case that the company's decisions fail to be made by the effective corporate governance organization, namely the general meeting of shareholders and the board of directors, but is agreed to be managed by all or part of shareholders or a third party in the form of agreement, creditors may not necessarily know the situation considering the privacy nature of the shareholder agreement. However, once there are problems in the operation and management of the company, the creditors of the company can only request the company to assume the liability for debt repayment, while the company can only bear the limited liability with its independent property, which may increase the possibility of piercing the corporate veil of the company and lead to a considerable impact on the creditors due to their rights and interests without be well protected.

3. AFFIRMATION OF THE FORCE OF SHAREHOLDER'S AGREEMENT

It is believed by this paper that the following steps should be followed in determining the effectiveness of an agreement between the shareholders of a limited liability company other than the articles of association:

First of all, it should be confirmed that the shareholder agreement is a private agreement between shareholders or a corporate governance agreement (Wang, 2017, p.4). The so-called private agreement between shareholders refers to a private agreement concluded by two or more shareholders for the purpose of agreeing on the rights and obligations of each other and not directly related to corporate collective governance. For example, a binding agreement on voting rights concluded between

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some shareholders within a company can generally be considered as a private agreement between shareholders, which is because that, as an approach for shareholders to compete for control rights in essence, the agreement mainly affects the balanced relationship between shareholders' control rights and will not significantly change the overall interests and governance structure of the whole company. Given that it is generally considered not to have a significant impact on the company's overall interest and governance structure, the shareholder's private agreement is valid for shareholders concerned. In contrast, the corporate governance agreement refers to the agreement concluded by the company's shareholders with the aim of managing and operating the company, which is usually formulated by all shareholders and will generally affect and change the overall interests and governance structure of the company. In spite that the signing subject of the corporate governance agreement is limited to shareholders, the possible impact of the agreement on the corporate governance structure, the interests of collation and even the interests of third parties such as external creditors leads to its complexity and greater judgment difficulty. The disputes about the determination of the force of shareholder agreement mainly occur in this type of shareholder agreement. The following two aspects should be taken into consideration in case of such agreements.

Secondly, it is necessary to identify whether a mandatory legal provision has been violated (Chad, 1957, pp. 68-79). The so-called mandatory provision refers to the standard that has to be applied in accordance with the law and shall not be subject to change and exclusion of the application by personal will. Its purpose is to set the bottom line for the behavior of shareholders or the company, so as to ensure that the shareholder agreement is not easily recognized as invalid in the case that the internal agreement between shareholders is not violating the prohibitive provision of the *Company Law* and is in line with the provisions on the formation and effectiveness of the contract in the contract law. Where the key is whether the contract refuses to apply to the mandatory provision in corporate governance and accounting systems or the like in the *Company Law,* such rejection might be deemed invalid if it is applicable to these mandatory provisions, which otherwise will be regarded as valid.

Thirdly, it should be confirmed whether there is any provision infringing on the interests of creditors. The determination of the effectiveness of the shareholder agreement requires the examination of whether the agreement will change the interests of the company's creditors. That is to say, in addition to the possible stuntedness of the discussion functions of the shareholders' meeting and the board of directors, shareholder's agreement may not have negative external effects on the distribution of management power within the company. The effectiveness of the shareholder agreement shall be admitted as long as it doesn't change the nature of the company's independent personality and shareholder limited responsibility, in the case that the company's management power distribution matters and profit distribution does not actually damage a third person or the interests of the creditors or lead to imbalance of negotiation capacity between the parties involved in a contract, when the creditors can still request the company to take the debt liquidation responsibility. The effectiveness of a contractual operation contract between shareholders should be recognized as long as the contract between shareholders of the company does not do harm to the interests of the company's creditors.

4. SETTLEMENT RULES OF THE CONFLICT OF SHAREHOLDER'S WILL IN THE ARTICLES OF ASSOCIATION AND SHAREHOLDERS' AGREEMENT

The current corporate governance in China depends mainly on the articles of association and the resolutions of the shareholders' meeting. Shareholders can agree on their rights and obligations that are different from the *Company Law* through the articles of association or the shareholder agreement. Considering that the contents of the shareholder agreement tend to overlap with the two, effectiveness conflicts occur all the time. The judgment of such conflicts should take into account the positioning of the articles of association and resolutions of the shareholders' meeting in the *Company Law* as well as the possibility of conversion between the shareholder agreement and the two on the one hand. On the other hand, it should also take into account the contractual attribute of the shareholder agreement, which, even if being not in line with the provisions of the *Company Law,* may possess certain contractual effectiveness. The specific analysis should be conducted in the following situations:

On condition that the conflictive item is the absolutely necessary record item in the articles of association, the articles of association will definitely be subject to as the shareholder agreement has violated the provisions of the law (Li, 2017, p.4). The absolutely necessary records of the articles of association refer to the basic matters that must be included in the articles of association, which are usually related to the establishment or organization of the company, such as the agreement on the registered capital of the company, the domicile of the company, the business scope of the company, the establishment of the company's institutions, etc. If the shareholders' agreement contains an agreement on the items absolutely necessary to be recorded in the articles of association of the company, it can be interpreted in accordance with the contract interpretation rules of the contract law in the case that it is a supplement and refinement of the absolutely necessary

record items. Therefore, despite that in some cases a shareholder agreement may involve absolutely necessary record items in the articles of association, it might be construed as a further supplementary agreement to the articles of association. If it is amendment to the absolutely necessary record items of the articles of association, the shareholder agreement will not be binding on the company and the third party, but only impose obligations on the parties in the debt law. The parties concerned are obliged to make the resolution of the shareholders' meeting on amending the articles of association and file the articles of association with the industrial and commercial registration authority in accordance with the agreement before the external effectiveness is generated.

In the case that the conflicting matter is a relatively necessary record item or arbitrary record item in the articles of association, it is necessary to consider whether the item involves the interests of a third party. Some legal acts concerning the corporate organization must take a specific form of being recorded in the articles of association in accordance with the law, that is, these items are invalid unless they are recorded in the articles of association of the company, which thereby can be simply referred to as the items that can be "agreed" in the articles of association by the company as required by the *Company Law* of China. For example, it is stipulated by article 42 of the *Company Law* of China that shareholders shall exercise the voting right at the shareholders' meeting in accordance with the proportion of their capital contribution, unless otherwise specified in the articles of association of the company. In essence, the requirement of the form that certain items must be included in the company's articles of association is the requirement of transparency, the guarantee of transaction safety and the protection of the interests of third parties. As an institution with rights and behavioral abilities established by shareholders through the formulation of articles of association, the company's profitability determines that it will be involved into a transaction relationship with a third party. In the transaction, the third party is suggested to fully understand the situation of the company, understand whether the person who transacts on behalf of the company has actually obtained the appropriate authorization and understand the legitimacy of the transaction decision. Therefore, it is believed by this paper that the ultimate purpose of "relatively necessary record items" in the articles of association is to meet the requirements of transparency and the protection of transaction security, so as to ensure the realization of the legal relations' stability. For shareholders, such mandatory provisions require them to include "relatively necessary items" in the articles of association, while those that are only recorded in the shareholder agreement shall have no legal effect but merely generate obligations in the debt law between shareholders to conclude the articles of association according to the content of the shareholder agreement. In other words, shareholders are obliged to make these items the actual organizational rules of the company by including them in the articles of association.

In view of the nature and function of the articles of association, the record of the articles of association shall prevail in cases involving the interests of a third party, while the special agreement shall prevail in cases not involving the interests of a third party. For example, a shareholder agreement may specify that the effectiveness of an agreement on a particular matter takes precedence over the effectiveness of the articles of association, such as whether new shareholders shall be bound by both the articles of association and the shareholder agreement. Since the articles of association is not only the contract between shareholders but also the organizational basis of the company, with the transfer of shares, its effectiveness will be directly conveyed to the new shareholders, that is, new shareholders are bound by the articles of association upon acquiring the shares. Nevertheless, the effectiveness of an agreement between shareholders only exists between the parties involved in the agreement while the rights and obligations in it do not have any direct effect on the new shareholders with the transfer of shares. In the case that there is no other agreement between the new shareholder and the original shareholder, the new shareholder shall not be affected by the original shareholder agreement after acquiring the shares. Although in law and practice, shareholders will make relevant norms for equity transfer, restrict the transfer of shares by shareholders in various methods or take the new shareholders' recognition of the shareholder agreement as the premise of transfer, etc., new shareholders may still not be bound by the shareholder agreement in case of enforcement, inheritance, etc..

Finally, on condition that the shareholder agreement is formulated by all shareholders, does not involve the interests of a third party, and does not make a special agreement on the priority of the effectiveness of the agreement on a certain item over the effectiveness of the articles of association, the time sequence of the two formulated will be taken as the judgment standard and the principle of last formulated effectiveness priority will be adopted. The record in the articles of association shall prevail in the case that there is neither special agreement nor the time sequence can be determined.

CONCLUSION

As a key tool for the governance of limited liability companies in China, the shareholder agreement has been approved by the *Company Law* of a great number of countries by virtue of its positive significance in building the private order of the governance of limited liability companies and protecting the legitimate rights and interests of shareholders in the company. However, there is still a lack of clear and systematic norms in the legal system of China. In conclusion, notwithstanding

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that the shareholder agreement and the company's articles of association may involve some of the contents of the corporate organization, the articles of association stipulated in the British and American *Company Law* are classified into the compendium of the articles of association and the specification of the articles of association, where the compendium of the articles of association should be conducted registration publicity while the specification of the articles of association is not required to be registered. The dichotomy of articles of association has greatly improved the flexibility of governance of British and American companies. In contrast, the widespread application of shareholder agreement greatly facilitates the improvement of this drawback of the articles of association. Certain rules shall be followed in case of conflicts between the shareholder agreement and the articles of association of the company. It is not advisable to indiscriminately adopt only the articles of association or shareholder agreement. The actual exertion of the governance function of the shareholder agreement depends on the exploration of the true will of shareholders and the guarantee of their autonomy rights while ensuring the strict implementation of the mandatory provisions of the law and the rights and interests of the company and the third party as far as possible.

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