

Advancing with the times

New provisions from the Supreme People's Court demonstrate the government's cognisance of the increasing complexity in settling disputes involving foreign-invested enterprises.

On August 5 2010, the Supreme People's Court (SPC) of the People's Republic of China (PRC) issued the *Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises (I)* (关于审理外商投资企业纠纷案件若干问题的规定(一)) (the Provisions) which, following the circulation of a draft version in November 2009, took effect on August 16 2010. According to the SPC, it is preparing a new set of rules on disputes involving the liquidation and dissolution of foreign-invested enterprises (FIEs). However, a detailed schedule on the promulgation of these new rules has not been disclosed yet.

It is fairly clear that the Provisions allow more flexibility of sophisticated foreign investment arrangements and should impede defaulters from making use of administrative complexity to avoid liability. The main issues addressed in the Provisions include: 1) the effectiveness of FIE contracts (Articles 1-3); 2) the liability of shareholders for delayed capital contribution (Article 4); 3) the effectiveness of equity transfer in an FIE (Articles 5-12); 4) the validity of equity pledge agreements (Article 13); and 5) the effectiveness of nominee shareholder arrangements (Articles 14-21).

1. Effectiveness of FIE contracts

FIE Contracts without administrative approval

Under Chinese law, contracts that establish an FIE or subsequent amendment of the FIE (collectively, the "FIE contracts") shall only take effect upon approval by a competent government authority, usually the Ministry of Commerce or its local counterparts. It was widely believed that an FIE contract without administrative approval is void from the very beginning and such contract is therefore not binding on the parties. The Provisions make a substantial change toward this view.

According to the Provisions, an FIE contract without

>> For full translation See p. XX

administrative approval is not void and the effectiveness of such contract is pending on the later action of the parties. The Provisions give the parties one more opportunity to determine whether or not to bring the contract into effect.

In practice it is necessary to closely examine the clause regarding obligation of application for approval of the contract and the remedies for breach of such obligation.

Effectiveness of side agreements

As mentioned above, any contract that affects the establishment or change of an FIE only becomes effective upon approval, therefore any side agreement is deemed unenforceable under the FIE regulations. Pursuant to the Provisions, however, if a side agreement does not constitute any "material or substantial changes" to the approved FIE contract, the court shall not rule that such side agreement has not come into force for lack of approval. "Material or substantial changes" include changes in registered capital, company type, business scope, term of operation, amount of capital subscription by shareholders, methods of capital contribution, mergers, divisions, equity transfer, etc.

In practice, investors often deliberately leave some terms out of the FIE contract to obtain easier or faster approval. The additional terms are put into a side letter or agreement without governmental approval. The Provisions recognise the effectiveness of such arrangements to the extent that there are no material or substantial changes to the FIE contract. The list of "material or substantial changes" is not meant to be an exhaustive list and it is unclear how the SPC will interpret each item in the list. However, it can be seen that the listed items are closely related to the capital structure of an FIE. Some common side arrangements such as shareholding adjustment schemes and a convertible loan commitment may be deemed "substantial" as these are capital-related items. Other side arrangements, such as non-compete commitments and disposition of operational powers are less likely to be classified as "material or substantial" changes before the SPC adds new items into the list.

Effectiveness of approved FIE contracts

The Provisions additionally provide that the court shall rule that an approved FIE contract is void under certain statutory circumstances, and shall rescind a contract, upon application of relevant parties, if such contract is voidable pursuant to statutory provisions.

According to the *PRC Contract Law* (中华人民共和国合同法) (the Contract Law), a contract shall be null and void under any of the following circumstances:

- the contract is concluded under fraud or coercion and thus damages the interests of the State;
- the parties conduct malicious collusion to damage the interests of the State, a collective or a third party;



No stopping side agreements: if there are no "material or substantial changes", they are now effective without government approval

- the parties adopt a legitimate form to conceal an illegitimate purpose;
- the contract damages the public interests; or
- the contract violates compulsory provisions of laws and administrative regulations.

According to the Contract Law, a contract shall be voidable under any of the following circumstances:

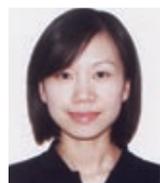
- the contract is concluded as a result of significant misunderstanding;
- the contract is obviously unfair at the time it is concluded; or
- the contract is concluded by one party against the other party's true intentions through the use of fraud, coercion, or exploitation of the other party's unfavourable position, the injured party shall have the right to request to rescind the contract.

The Provisions indicate that FIEs shall abide by both FIEs' administrative regulations and general contract law provisions in China. Governmental approval of an FIE contract will not cure the defects of the same contract under the Contract Law.

2. Liability of shareholders for delayed capital contribution

If a shareholder contributed his subscribed equity in an FIE by property but failed to complete the title transfer registration procedures, the court shall recognise such shareholder's equity interests in the FIE if the FIE has commenced using the property and that shareholder can subsequently complete the title transfer procedures within a reasonable period designated by the court. However, the party contributing the property will be liable to the FIE for the losses incurred by the FIE as a result of any delay in conducting the title transfer procedures.

As implicated by the Provisions, if the shareholder never delivers the property to the FIE or fails to complete the title transfer registration, it will be deemed as having failed to complete the capital



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contribution obligation and its equity interests in the FIE as a shareholder should not be recognised.

It should also be noted that many administrative regulations set up punishments if the shareholder of an FIE has failed to pay his share of registered capital on time. Examples of these could be revoking the FIE's certificate of approval and business licence or being refused to remit profits from the FIE to all offshore shareholders. The SPC has also indicated in an unofficial situation that the Ministry of Commerce showed its reluctance to accept the direct application of equity transfer by the transferee solely based on a court order. Therefore, it is yet to be shown in practice whether the delayed shareholder may complete the capital contribution process

within an extended period according to a court's order where the FIE's certificate of approval or business licence has been revoked by the approval authority.

3. Effectiveness of equity transfer in an FIE

Failure to apply for approval of the equity transfer in an FIE

An investor may exit from an FIE by transferring its equity interests in the FIE to others. The obligation to obtain approval for such equity transfer falls on the selling shareholder and the FIE. In the circumstances that the transferor and the FIE fail to apply for or obtain the required approval, the Provisions provide several remedies for the transferee.

If, upon the formation of an equity transfer contract, the transferor and the FIE itself fail to carry out their obligations to submit the equity transfer contract for approval, and have still not done so within a reasonable period after having been urged to do so by the transferee, the court shall uphold a claim by the transferee:

- to terminate the equity transfer agreement and to return the paid consideration to the buyer, and to compensate the buyer for his actual losses caused thereto; or
- to order the transferor and the FIE to apply for approval jointly within a specific period of time.

If the transferor and the FIE still fail to fulfil their obligations within the extended period, the court shall support either of the following claims upon the buyer's request:

- the transferee may carry out the application procedures by itself; or
- order to terminate the equity transfer contract and the transferor to pay for the damages including the price differences of the equity interest, shareholder earnings and other reasonable losses caused to the transferee.

The Provisions further provide that, if approval is not obtained after either party (including the transferee) proceeds to submit the approval applications, the transferee may seek the return of the consideration paid for the transfer. If the transferee also seeks an order for compensation for losses, the court shall determine such a claim on the basis of the existence and degree of fault on the part of the transferor.

In practice, it is important to include the FIE as a party to the equity transfer agreement in China since the FIE shall be the principal entity to submit the approval applications.

Payment of transfer consideration by the transferee before or after approval

If the equity transfer agreement expressly states that the agreement shall only be submitted for approval upon the payment of consideration, the court will support the transferor's claim for payment of consideration first. If the equity transfer agreement does not state that payment of consideration is a condition for submission of approval, the transferor shall obtain the approval before requesting for payment of consideration from the transferee.

Even if, upon the formation of the equity transfer agreement,

the transferee has started participating in the business operations and management of the FIE and receiving earnings as a result, the court will still not recognise such transferee's equity interests in the FIE prior to governmental approval of the equity transfer agreement.

Right of first refusal of the non-transferring shareholders

Shareholders of an FIE shall have the statutory right of first refusal to purchase the equity interests in the FIE to be sold to a third party other than the current shareholders. Even if the transfer has been approved and completed, the non-transferring shareholders may request to rescind the equity sale if they are not provided with the opportunity to exercise their right of first refusal unless any of the following exceptions exists:

- there is evidence showing that the other shareholders have consented to the equity transfer;
- the other shareholders fail to respond within 30 days after receipt of written notice from the transferring shareholder; or
- the other shareholders do not consent to the transfer but refuse to purchase the transferred equity interests.



Contract Law (see above in section I). The nominee shareholder shall be liable to the actual investor for breach of contract to the extent it did not carry out its obligations under the nominee shareholding agreement, and the actual investor may request the nominee shareholder to pay the shareholding profits in the FIE according to the nominee shareholding agreement. However, the FIE will not directly recognise the actual investor's equity rights in the FIE unless all of the following conditions are met:

- the actual investor has actually made an investment in the FIE;
- the other shareholders other than the nominee shareholder has recognised the actual investor as a shareholder; and

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- the court or the actual investor has obtained governmental approval to change the actual investor as a shareholder during the course of the litigation.

The dissenting shareholders shall raise such claim to rescind the equity transfer within one year from the date when the dissenting shareholders become aware or should have become aware of the formation of the equity transfer agreement.

It should be noted that neither the transferor nor the transferee is entitled to the right to rescind the completed equity transfer. Only the non-transferring shareholders may raise such a claim.

4. Validity of equity pledge agreements

The Provisions specify that where an equity pledge has been entered into by an FIE, the agreement will become effective immediately without approval, unless otherwise stated in laws and regulations. Any failure to register the pledge will not affect the validity of the agreement, although the equity pledge itself will only be effectively created upon proper registration. This is consistent with the *PRC Property Law* (中华人民共和国物权法).

It should be noted that duly registration of the pledge will give priority to such registered pledge in case that the underlying equity interests are, or have been, transferred or pledged to others. Therefore, it is important to specify the pledgor and FIE's obligation to register the pledge in the equity pledge agreement, and to complete the registration timely.

5. Effectiveness of nominee shareholding agreements

The Provisions confirm the nominee shareholding agreements which are similar to the trust arrangements under the English laws. Pursuant to the Provisions, an agreement between two parties, whereby an actual investor makes an investment and nominates another party as the registered shareholder in an FIE, is valid and enforceable even without governmental approval as long as such agreement is not voidable under the general principles of the

The Provisions also provide detailed rules on dividing proceeds of the investment if the nominee shareholding agreement is declared null and void. Generally speaking, where the value of the equity is higher than the original investment of the actual investor in the FIE, the investment amount shall be returned to the actual investor and the additional value will be shared between the parties depending on the investor's investment and the shareholder's level of participation in the business and management of the FIE. If the value of the equity is lower than the original investment, the nominee shareholder shall repay the current value of the equity to the actual investor and may be required to pay damages to the actual investor depending on the existence and degree of his default on the void of the agreement.

Arguably the above provisions should not apply to the nominee shareholding arrangements typically used by foreign investors in order to avoid foreign investment restrictions in restricted or prohibited industries, whereby foreign investors nominate one or more PRC citizens as the nominee shareholders in a domestic company. The Provisions shall only apply to FIE-related disputes, and the typical nominee shareholding arrangements in a purely domestic-invested company are not directly governed by the Provisions.

It is widely believed that the Provisions will greatly impact the foreign investment arrangements and related contracts drafting in general. On the other hand, it remains to be seen whether their application will be limited by the widespread use of arbitration clauses in FIE contracts. Arbitrators may well want to follow these rules, but they are not obliged to do so.

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