Major Issues in PRC Company Law
A comparative analysis with English Company Law
Business Organizations

Chinese Law:

• Business Partnership
  – General Partnership
  – Special General Partnership
  – Limited Partnership

• Business Legal Person
  – Company
  – State-owned Enterprise ("SOE")
  – Collective-owned Enterprise
Foreign Investment Enterprise

- Sino-foreign Equity Joint Ventures (EJV)
- Sino-foreign Contractual Joint Ventures (CJV)
- Wholly Foreign-owned Enterprises (WFOE)

EJV \ CJV → WFOE

- The other investors’ consent
- Approval authority: the one approved the establishment of the enterprise
- Authority for registration: the original registration authority
Corporate Management

- Appointment of directors

- Board of supervisors
  - Representatives of shareholders and 1/3 should be the representatives of employees
  - Convene interim shareholders meetings; check financial affairs; bring proposals to remove directors or senior management; initiate actions against directors or senior management

- Legal Representative
  - Chairman of the board of directors, an acting director or a manager
  - Responsibilities: sign the paper form stocks, issued bonds and other corporate contracts
  - Shareholders meeting, general meeting or board of director passes a resolution to remove the legal representative.
Duties and Liabilities of Company Directors

- Declare shareholdings & changes

- During their terms of office, not more than 25% of the shares they hold can be transferred within a year.
- Restriction from assignment of shares lasts until half a year after their leaving.
- Listed companies: 1-year locked-up period after the listing date; prohibition of short-term (6 months) trading
Duties of directors

• Duty to keep within its powers — not providing loans or guarantee to any other person with the company’s fund w/o approval
  — unauthorized disclosure of corporate secrets

• Duty not to obtain a personal profit — not signing a contract or trading with his company
  — not seeking business opportunities for himself
  — not operating any like business
  — not taking commissions of corporate transactions

• Duty to use director’s powers for a proper purpose — not assisting bidders in acquisition
  — not misappropriating funds

• Duty of care and skill — providing time and attention to fulfill obligations
  — answering inquiries, presence at the meeting
  — understanding responsibilities
Duties and Liabilities of Company Directors

• Approval for breaches of duty by shareholders’ meeting:
  – provision of loan or guarantee to any other person with the company’s fund
  – signing a contract or trading with the company
  – usurping company opportunities
  – operating for himself or any other person a like business

• CSRC punishment of breach of duties:
  – Directors of listed companies; directors of a listed company’s holding company; other liable persons deemed by the CSRC as having violated relative laws
  – Prohibited from engaging in any securities practice or holding any post of director, supervisor or senior manager in the original organization and any listed company within a prescribed term or for life.
  – Securities practice: brokerage; investment consulting; financial advising; underwriting; self-operation of securities; asset management.
The Company’s Articles of Association

• Amendment
  – CJV: unanimous agreement of the members in BOD or Joint Management Committee
    Major revision needs approval.
  – EJV: unanimous agreement from directors present in BOD; requires approval.
  – WFOE: requires approval from the approval authority which approved the establishment

• Validity
  – Valid upon approval
Enforcement of Corporate Rights

- **Statutory Derivative Actions**
  - Defendant(s): art. 150, 152
    - a director or senior manager who violates any law, administrative regulation, or the bylaw during the course of performing his duties and causes any loss to the company
    - a person whose conduct impairs the legitimate rights and interests of the company and causes any loss to the company
  - Plaintiff(s): shareholders who separately or aggregately holding 1% or more of the total shares of the company for 180 days or more
  - Practice: company is named as a second defendant or a third party in the lawsuit.
Enforcement of Corporate Rights

Statutory Derivative Actions

- 1st: request in writing to board of supervisors
- 2nd: If the supervisor involves in the violation of law, request in writing to board of directors
- 3rd: If board of directors refuses to act or fails to act within 30 days, shareholders can lodge a suit directly on their own behalf. (art. 152)

- If, in emergency, the failure to lodge an action immediately will cause unrecoverable damages to the interests of the company, the shareholders can lodge an action directly on their own behalf. (art. 152)
Enforcement of Corporate Rights

- Protection of Minority Shareholders
  - cumulative voting system: a minority shareholder can multiply his voting rights by the number of candidates and vote them all for one candidate. (art. 106)
  - lodge a lawsuit if any director or senior manager damages the shareholders’ interests by violating any law (art. 153)
  - revoke resolutions if the procedure for calling meetings or voting violates any law or bylaw (art. 22)
Enforcement of Corporate Rights

- Protection of Minority Shareholders

  - request the company to buy back shares at a reasonable price under the following situations (art. 95)

  - the company has made profits for 5 years and has failed to distribute any dividends for 5 years, or
  - the company is going to merge with others, to be split up, or transfer the major properties, or
  - when the business term expires, the shareholders’ meeting makes the company exist continuously by adopting a resolution to modify the bylaw
Enforcement of Corporate Rights

• Protection of Minority Shareholders
  – The shareholder is liable for compensation if he causes loss to the other shareholders due to an abuse of shareholder’s rights. (art. 20)
  – No guarantee shall be provided to a shareholder or actual controller unless a resolution is passed by the shareholder’s meeting or shareholders’ assembly without the interested shareholder’s participation in voting. (art. 16)
Enforcement of Corporate Rights

- Protection of Minority Shareholders
  - The shareholders holding 10% of the voting rights can
    - initiate an interim meeting. (art. 40)
    - initiate shareholder’s meetings if the board of directors and board of supervisors fail to do so (art. 41)
    - dissolve the company if it suffers unsolvable difficulties in operation and management and will have heavy losses (art. 183)
  - review the minutes of shareholders’ meetings, board meetings, supervisors’ meetings and financial reports; review accounting books (art. 34)
Share Capital and Issue

- **Issuance of Share**
  - Same class → same rights, same benefit
  - Issue at the same time → same conditions, same issue price
  - Issue price must not be less than the par value

- **Public offering**
  - Issue to unspecified persons; or
  - Issue to more than 200 specified persons cumulatively

- **IPO (art.13 Securities Law)**
  - A complete and well-operated organization
  - Capable to make profits continuously + a sound financial status
  - No false record in its financial statements over the last 3 years and having no other serious violation of laws
Listing of Shares

• Requirements
  – The stocks shall have been publicly issued upon the approval of the securities regulatory authority under the State Council;
  – Registered capital ≥ RMB 30 million → publicly issued shares ≥ 25% of total shares;
  – Registered capital ≥ RMB 0.4 billion → publicly issued shares ≥ 10% of the total shares.
  – The company shall not have any major irregularities over the preceding three years.
  – There is no false record in its financial statements.
Insider Trading - Definition

- **U.S. Law**
  - buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.
  - also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

- **P.R.C. Law**
  - Any insider who has access to insider information or has unlawfully obtained any insider information on securities trading may not purchase or sell the securities of the relevant company, or divulge such information, or advise any other person to purchase or sell such securities. (art.76 Securities Law)
Insider Trading – Rat Trading

- Rat trading occurs when a broker receives an order from a client to buy a share at a certain price. If the broker believes the share will drop, he may be tempted to wait and buy the stock at a lower price through his own account. He then sells the stock to the client at the client's original price and pockets the difference.

- A fund manager controls "rat accounts" for relatives or friends.

- CSRC Guidelines (drafted)
  - Immediate relatives of fund employees must obtain fund-company permission before investing in stocks.
  - These relatives would not be allowed to open trading accounts except at certain, designated securities companies.

- Criminal Law (2009)
  Any staff members of fund management companies, securities companies, commercial banks or other financial institutions who make use of the insider information obtained through the convenience of their job to conduct trading related to the information so obtained, or suggest other people to conduct such trading are violating the rules.
• **Market Manipulation** (art. 77 Securities Law)
  
  – anyone, independently or in collusion with others, manipulates the trading price or quantity of securities by centralizing their advantages in funds, their shareholding advantages or taking their information advantage to trade jointly or continuously;
  
  – anyone collaborates with any other person to trade securities pursuant to the time, price and method as agreed upon in advance, thereby affecting the price or quantity of the securities traded;
  
  – trades securities between the accounts under his own control, thereby affecting the price or quantity of the securities traded;
Joint Ventures

- **Types**
  - EJV: limited liability company
  - CJV: limited liability company or partnership
  - Chinese side must be Chinese companies, enterprises or other economic organizations

- **Documentation**
  - MOU is not compulsory
  - joint venture contract prevails MOU
  - JV contract prevails articles of association (CJV)

- **Scope of business**
  - Foreign Investment Industrial Guidance Catalogue

- **Investment capital**
  - In EJV or CJV (limited liability company), the capital contribution by the foreign party shall not be less than 25% of the total capital.
Corporate Finance – Issuance of Stocks

Step 1: Restructuring

JV Limited Liability Co. → JV Joint stock Limited Liability Co.

- Requirement
  - make profits continuously in the latest 3 years

- Procedures
  - Original investors sign agreements and articles of association for the establishment of a joint stock Ltd. Co.
  - submit the documents to responsible departments in the place where JV is located for initial approval, which will then move to MOFTEC for final approval.
  - After approval, the promoters can undergo transformation formalities with responsible departments for registering the companies.
Foreign-invested Stock Company IPO

- Step 2: listing

Requirements

- passed the joint annual inspections of foreign-invested enterprises for the last 3 years;
- the scope of business complies with the Interim Provisions on Guiding the Orientation of Foreign Investment and the Catalogue of Industries for Guiding Foreign Investment;
- the proportion of shares held by foreign investors shall not be less than 10% in the total shares after the initial public offer;
- if the foreign-invested stock company shall be controlled by the Chinese parties or there are special regulations governing the holding of shares by the Chinese parties, the Chinese parties shall continue to keep their controlling position or continue to hold the proportion of shares.
Foreign Enterprise Mergers & Acquisitions

- Mergers between foreign enterprises
  - EJV, CJV with legal person status, WFOE, and foreign-funded joint-stock Ltd. Co.
    - a company absorbs another and remains in existence while the absorbed is dissolved. $A + B \rightarrow A$
    - two or more companies merge into one new company and the original ones are dissolved. $A + B \rightarrow C$
  - Applicable law: Regulations on Merging and Splitting of Foreign-funded Enterprises

- Mergers between foreign & domestic companies
  - Regulations on Merging and Splitting of Foreign-funded Enterprises is also applicable.
  - No mergers with domestic enterprises unless the foreign investors have already paid the capital, provided the conditions for cooperation to the foreign enterprises.
  - Foreign shareholdings $\geq 25\%$ after the merger
  - guarantee full employment of their original staff & have proper arrangement
Liabilities

- **Mergers**
  - btw foreign and domestic companies: guarantee full employment of original staff
  - after merging the existing company shall succeed all creditors' rights and debts of the companies dissolved.

- **Equity Acquisition**
  - The acquirer inherits the creditor’s rights and debt of the merged or acquired company.
  - The acquirer, target company, the creditors and other persons concerned may reach an agreement on the inheritance of the creditor’s rights and debt which is subject to the approval of MOFCOM or its provincial counterparts.

- **Asset Acquisition**
  - the domestic enterprise that sell the assets will bear the original creditor’s rights and debt.
Due Diligence

- Group structure and summary of the development and history of the company
- Incorporation documents
  - e.g. business permits and licences
- Capital structure
- Properties
  - real property, titles to land and buildings or lease
  - other fixed assets
- Intellectual properties & intangible assets
- Company’s business
- Material contracts and business documents
- Tax
- Employees of the company
- Environmental matters
- Litigation \ Arbitration
- Others
  - e.g. loans, security arrangement
Foreign Enterprise Mergers & Acquisitions

• Share swap option

  Requirement
  – The equity is assignable, free from any dispute over ownership, pledge or any other property encumbrance.
  – The equity is listed on an overseas exchange.
  – The stock price is stable in the current year.

• Anti-monopoly Review

  Notification criteria
  – total global revenues > RMB10 billion, and 2 business operators’ China revenues > RMB400 million respectively; and
  – total China revenues of all business operators > RMB2 billion, and the China revenues of at least 2 business operators > RMB400 million respectively

Approval authorities: MOFCOM, SAIC