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Edited by  
Alexander Loos



the global voice of  
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# International Bar Association

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The International Bar Association (IBA), established in 1947, is the world's leading organisation of international legal practitioners, bar associations and law societies. The IBA influences the development of international law reform and shapes the future of the legal profession throughout the world.

It has a membership of over 55,000 individual lawyers and 206 bar associations and law societies spanning all continents. It has considerable expertise in providing assistance to the global legal community as well as being a source of distinguished legal commentators for international news outlets.

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The IBA GEI will become the leading voice and authority on global HR issues by virtue of having a number of the world's leading labour and employment practitioners in its ranks, and the support and resource of the world's largest association of international lawyers.

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# The People's Republic of China

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## I INTRODUCTION

In China, companies are established pursuant to the Company Law of the People's Republic of China (hereinafter 'Company Law'), which was most recently amended by the Standing Committee of the National People's Congress on 28 December 2013. Companies are classified as limited liability companies (LLCs) (which are analogous to private companies under some common law jurisdictions) or stock limited companies (SLCs) (which are also similar to public companies under some common law jurisdictions). Companies can also, by reference to the place of incorporation of the shareholders, be divided into foreign-invested enterprises (where the shareholders include foreign legal persons) or domestic companies (where all shareholders are Chinese legal persons). Foreign-invested enterprises can be set up in the form of wholly foreign-owned enterprises (WFOEs), where all shareholders are foreign entities, Sino-foreign equity joint venture companies (EJVs), or Sino-foreign cooperation joint venture companies (CJVs). Historically, special rules have been enacted with respect to corporate structure and corporate governance in relation to foreign-invested companies. Nevertheless, the provisions in the Company Law concerning director liabilities are uniformly applicable to foreign-invested companies and domestic companies. In this chapter, we will focus our discussion on the general rules as the main theme and make reference to the special rules where it is appropriate.

### **[A] Three-Tiered Corporate Governance Body**

Under the Company Law, a company is required to have a three-tiered corporate governance body, namely: (1) the shareholders; (2) the board of directors or an executive director; and (3) a board of supervisors.

**[1] Shareholders**

The shareholders are the highest authority of a company and exercise their authority at shareholders' meetings. There are exceptions to this rule. EJVs and CJVs are not required to hold shareholders' meetings, in which case, the board of directors is the highest authority. The Company Law is silent on how often the shareholders of a company should meet to transact business in relation to LLCs. This is left to be set out in the articles of association of the company. SLCs are required to hold annual shareholders meetings.

**[2] Board of Directors or Executive Director**

The board of directors or the executive director is the highest business-decision-making body of a company. The Company Law grants certain statutory powers to the board of directors or executive director (the 'Statutory Powers') as enumerated below. The Statutory Powers consist of the powers:

- to convene shareholders' meetings and to report to the shareholders at such meetings;
- to implement the resolutions issued during shareholders' meetings;
- to determine the business and investment plan of the company;
- to formulate the annual financial budget and financial settlement plan;
- to formulate a dividends distribution plan and a plan for making up losses of the company;
- to formulate a plan in relation to the increase or reduction of registered capital and issuance of corporate bonds;
- to formulate plans for the merger, division or amendment of the corporate form of the company as well as the dissolution of the company;
- to determine the establishment of internal corporate departments;
- to determine the term of employment and removal of the general manager, vice general manager, and the person in charge of financial matters as well as their salaries; and
- to formulate management regulations of the company.

In theory, the Statutory Powers cannot be fettered or delegated to others, such as non-board members or third parties. Nonetheless, the resolutions of the board of directors can be overridden by a resolution of a shareholders' meeting, in which case, the matter will be returned to the board of directors for reconsideration.

The board of directors can be granted additional powers as set out in the terms of the articles of association of the company. There is no rule prohibiting any restriction of non-Statutory Powers.

**[3] Board of Supervisors**

The board of supervisors is the supervisory body responsible for monitoring the conduct of the directors and other senior managerial personnel. The board of supervisors has the following powers under the Company Law:

- to examine the financial accounts of the company;
- to monitor the official performance of the directors and senior managers and to make proposals for the dismissal of directors or senior managers who acted in breach of laws or regulations, the articles of association of the company, or any resolution of the shareholders' meetings;
- to request the directors and senior managers to take corrective action in the event that the conduct of the directors or senior managers is in conflict with the interests of the company;
- to propose extraordinary shareholders' meetings and to convene and preside over the shareholders' meetings in the event that the board of directors fails to perform its duties to convene and preside over such shareholders' meetings;
- to propose an agenda to the shareholders' meetings; and
- to take legal action against the directors and senior managers in accordance with the Company Law.

The Company Law also allows the articles of association to provide for additional powers to be granted to the board of supervisors.

**[B] Board Structure and Concurrent Offices**

The board of directors of an LLC must consist of three to thirteen directors unless the executive director structure is adopted in lieu of a board of directors. The board of directors of an SLC must consist of five to nineteen directors. EJVs and CJVs typically have boards of directors consisting of no less than three directors.

**[1] Board Structure**

The board of directors must have a chairman, who is elected by the shareholders or the board members in accordance with the Company Law and the articles of association. Chinese laws do not make distinction between executive directors and non-executive directors. Listed companies must have at least one-third of the board consisting of independent directors. Chinese financial regulators also require certain financial institutions to have independent directors as well.

**[2] Concurrent Office**

Except for independent directors of listed companies, directors are allowed to serve concurrently in executive offices. In most circumstances the chairman of the board of

directors will be concurrently the legal representative of the company. The legal representative has statutory authority to represent and bind the company in transactions with third parties. However, directors and senior managerial officers of the company cannot concurrently serve as supervisors in the same company.

#### **[C] Delegation**

As noted above, the board of directors may not fetter or delegate its Statutory Powers to a third party. In recent years, China has witnessed the development of a convoluted indirect investment structure known by the acronym C-C-F (for Chinese-Chinese-Foreign). This structure aims to circumvent complicated or moribund approval procedures for the establishment of a foreign investment enterprise in highly restricted business sectors, such as telecoms, media and film-making. While these structures often seek to provide a foreign investor with 'belts and suspenders' protection by having the directors of a domestic company issue proxies to foreign investor's representatives to exercise their authority for the benefit of the foreign investor, the lawfulness of such delegation is questionable at best.

#### **[D] Elections**

Directors are appointed by the shareholders by a simple majority unless the articles of association provide otherwise. For EJVs and CJVs, the shareholders will agree on the number of directors appointed by each shareholder in the joint venture contract and the directors will be appointed by a shareholder without going through the election process.

#### **[E] Removal of Directors**

Directors can be removed by the shareholders by a simple resolution unless the articles of association provide otherwise. It should be noted that an outgoing director removed from the office will continue to be entitled and obliged to exercise his or her statutory authorities until the upcoming director is elected and assumes the office.

It should be noted that under the Chinese company registration rules, a director should be filed with the competent bureau of industry and commerce as registration authority. Even though legally such filing should not be used as a conclusive evidence of the authority of the director, it would technically have a significant complication if a board resolution is signed by a director who is not yet filed with the registration authority for certain amendment of the corporate registration matters, such as a change of shareholder or articles of association. Unless the director filing is updated, it may seriously impact the processing for amending the registration even though such director may be duly appointed by the appropriate shareholder.

**[F] Qualification of Directors**

Under the Company Law, the following circumstances will disqualify a candidate (hereinafter 'Disqualified Person') from serving as a director of a company:

- the person does not have legal capacity;
- the person was criminally penalized for economic offences in the past five years;
- the person was a director or the person in charge of an enterprise which was declared bankrupt in the past three years and that person was responsible for such bankruptcy;
- the person was the legal representative of an enterprise, with respect to which the competent authority revoked its business license or issued a closure order against that company in the past three years; or
- the person is in significant indebtedness that has become overdue.

The appointment of a Disqualified Person to serve as the director is void. A director who has become a Disqualified Person during the term of his or her appointment must be removed from the office.

**II LIABILITY ISSUES**

**[A] Directors' Duties**

Under Chinese law, a director owes a duty of fidelity such is similar to the concept of fiduciary duty in some common law jurisdictions (hereinafter 'Fiduciary Duty') and a duty of care to the company.

**[1] Fiduciary Duty**

A director owes a Fiduciary Duty to the company. More specifically, a director is prohibited from engaging in the following activities under the Company Law:

- appropriation of corporate funds;
- depositing the company's funds in an account in the name of an individual;
- making loans or providing security to third parties by using the company's property without the consent of the shareholders or the board of directors or in violation of the articles of association;
- self-trading with the company without the consent of the shareholders or the board of directors or in violation of the articles of association;
- competing with the company for business without the consent of the shareholders or the board of directors;
- accepting secret commissions in the course of business transactions between the company and third parties; and

- disclosing confidential information of the company without proper authorization.

Gains made in breach of the aforementioned Fiduciary Duties are recoverable by the company.

### **[2] General Duties**

A director owes a duty of care to the company under the Company Law and the General Provisions of the Chinese Civil Code, which will be supplemented by the Torts Liability Law of the People's Republic of China, taking effect from 1 July 2010. A director must exercise due care in the course of exercising his or her Statutory Powers as well as other powers provided in the articles of association. The director also has a duty to comply with the requirements stipulated in the relevant laws, regulations, and the articles of association of the company. For instance, the directors of a listed company are required to sign a written confirmation on the periodic financial report of the company and must ensure that the information disclosed is true, accurate and complete.

### **[3] Legal Representative**

In many East Asian countries, company laws recognize the role of a legal representative as a key person who has extensive authority and responsibility for the company. In China the legal representative has a statutory power to represent and bind the company. In addition, the legal representative can be held responsible for the harmful acts or omissions of the company even where there is an absence of knowledge on the part of the legal representative. Legal representatives have been held personally responsible for the acts of the company in cases such as environmental damage or non-compliance with health and safety standards.

In the cases of foreign-invested enterprises, the chairman of the board of directors or the executive director is the legal representative by dint of statute. Because of the significance of the position, the legal representative is also normally the chairman of the board of a purely domestic company, or sometimes a general manager or a factory head for state-owned enterprises. He or she has the authority to represent the company to enter into commercial transactions, to conduct litigation in the name of the company, and to transact business with the government authorities in relation to administrative matters.

The company may restrict the authority of the legal representative in the articles of association or shareholders' agreement. In the event that the legal representative acts outside his or her scope of authority, the company will be entitled to claim damages suffered as a result of the *ultra vires* of the legal representative. However, such restriction will not be binding on any relevant third party unless such third party is acting in bad faith in the sense that it has actual or attributed knowledge on the restricted authority of the legal representative. Although documents such as the articles of association are registrable instruments under the Company Law, they are only in



theory available to the public, as certain registration authorities refuse to provide access to the public of such documents. For this reason, the inclusion of a restriction on the authority of the legal representative in the articles of association of a company will not per se attribute such knowledge to the third party automatically.

#### **[4] *Apparent Authority***

The concept of apparent authority is to some extent recognized under Chinese laws. It is useful to note at the outset that the concept of apparent authority is not applicable to the legal representative of the company, as the legal representative has a statutory authority to represent the company to enter transactions with third parties. The concept of apparent authority is devised to facilitate transactions entered into by senior personnel, such as directors, other than the legal representative. Their authority to bind the company is derived through a process of delegation by the legal representative. The classic case, in which a company is held liable for *ultra vires* acts of a director under the concept of apparent authority under Chinese laws, is that the actual authority of such director was previously represented to the third party, which, not being subsequently informed of the revocation of the actual authority, enters into transactions with the company in reasonable reliance upon the previous representation of the actual authority. The other classic case is that the company acquiesced in such director entering into transaction with third party in excess of his or her authority.

Nevertheless, the scope of operation of apparent authority is subject to further development under Chinese laws as compared with some common law or other, more advanced civil law jurisdictions. This lack of jurisprudential progress is mainly a consequence of the traditional over-emphasis on the statutory authority of the legal representative. For instance, in many jurisdictions, the principle of apparent authority can be invoked based on the fact that the agent is appointed to certain specific offices, such as managing directors, chief operation officers, and sometimes sale or purchase managers. The issue of whether apparent authority can be invoked by the fact that one is appointed to a particular office remain unsettled under Chinese laws.

### **[B] Who Can Sue?**

#### **[1] *Duties Owed to the Company***

The directors owe a Fiduciary Duty and a duty of care to the company. The company can sue the directors who have breached these duties. The board of supervisors is also entitled to sue the directors in the name of the company.

#### **[2] *Duties Owed to Shareholders***

The directors owe a duty of care to shareholders. The directors who acted in breach of laws, regulations, or the articles of association of a company, thus causing losses to a shareholder, can be sued by such shareholder.

**[3] Duties Owed to Creditors**

Directors of SLCs are obliged by statute to establish a liquidation committee in the event of dissolution of the company as well as fulfil other obligations in relation to the preservation of assets of the companies. Failure to discharge these duties will make the directors jointly and severally liable to creditors to the extent of the losses so caused. These obligations are not applicable to directors of LLCs, with respect to which, such obligations are imposed upon shareholders.

**[C] Who Can Be Sued?**

The directors registered on the official registrar of the relevant company can be sued. The concept of shadow director or de facto director is not recognized under Chinese laws.

**[D] Derivative Actions by Shareholders**

Where directors acting in breach of their duties cause losses to the company, a shareholder of an LLC or a shareholder having 1% share for a continuous period of 180 days in an SLC is entitled to request the supervisors to institute legal actions against the directors in the name of the company. In certain situations, the shareholder is entitled to take legal actions in the name of the company directly, namely, where (1) there is no supervisor in the company; (2) the supervisors omit to take legal action within thirty days; (3) the supervisors decline to take legal actions; or (4) the action of the directors poses an eminent loss to the company.

**[E] Unfair Prejudice**

Chinese laws have not developed remedies to protect minority shareholders from unfair prejudice such as those available in many common law jurisdictions. However, the Company Law does afford the minority shareholders some protection against certain prejudicial conduct by the majority shareholders carried out in the name of the company.

**[1] Compulsory Buy Back**

A shareholder of an LLC is entitled to request the company to purchase back its equity interest provided that it has voted against the following proposals:

- the company has not distributed dividends for a continuous period of five years, during which period the company has made profits each year;
- the company will merge, be divided or transfer major assets;

- the shareholders have passed a resolution to extend the operational term of the company.

The company must reach an agreement with the petitioning shareholder in relation to the purchase price within sixty days after the relevant shareholders' resolution is passed. Otherwise, the shareholder is entitled to petition to the court within ninety days after the passage of the relevant shareholders' resolution.

**[2] Compulsory Winding Up**

In the following circumstances, a shareholder with 10% voting rights is entitled to petition to the court to have the company wound up:

- the company is unable to convene a shareholder meeting for a continuous period of two years, which has caused the company serious operational difficulty;
- the shareholders are unable to pass resolutions for a continuous period of two years, which has caused the company serious operational difficulty;
- the board of directors is in a deadlock which cannot be resolved by a shareholders' meeting and this has caused the company serious operational difficulties; or
- the company is in other serious operational difficulties and the continued existence of the company will cause serious damage to the interests of the shareholder.

**[F] Representative Actions**

Where the company or the directors are sued by a number of shareholders or creditors, actions can be consolidated at the discretion of the court into one legal action and the shareholders or creditors will be treated as joint plaintiffs. If there are more than ten plaintiffs, the plaintiffs are allowed to elect two to five representatives to conduct the legal proceedings.

**[G] Liquidation Context**

In the event of liquidation, the directors of LSCs as well as EJV and CJV are required to establish a liquidation committee within the statutory period. Failure to establish the liquidation committee which causes losses to the assets of the company will make the directors jointly and severally liable to the creditors to the extent of such losses.

Furthermore, the directors of LSCs will be held jointly and severally liable to the creditors if they have breached their duties, causing losses to the property of the company, and as a result the liquidation of the company cannot be carried out.

As discussed earlier on, with regard to LLCs, the obligations to establish the liquidation committee and to protect the property of the company rest on the shareholders rather than the directors.

#### **[H] Costs and Fees in Liability Litigations**

In China, legal costs consist of court fees and attorney costs. The general rule is that the losing party pays for the court fees of the winning party. In contrast, each party is responsible for its own attorney costs regardless of the outcome of the legal action.

### **III INDEMNIFICATION**

Chinese laws do not prohibit a provision under which the directors are indemnified by the company against liabilities incurred during the course of performing their duties. Therefore, it is in theory permissible under Chinese laws, though it is not common in practice.

### **IV PROTECTION AGAINST WRONGS OF DIRECTORS**

#### **[A] Ratification**

The notion of ratification in relation to a breach of duties by the directors has yet to be fully developed under Chinese jurisprudence. A number of the Fiduciary Duties, such as prohibition against self-trading and competition of business opportunity, are drafted in terms of a relative prohibition. In other words, these activities can be carried out provided the consent from the shareholders is obtained. Since the law does not strictly require that such consent must be given by the shareholders prior to these activities, it is arguable that at least these activities are ratifiable under Chinese laws.

#### **[B] Directors' and Officers' Liability Insurance**

The Company Law is silent on directors' and officers' liability insurance. Therefore, as a general statement, a company is permitted to purchase insurance for the directors. Indeed, a circular issued by the China Security Regulatory Commission explicitly allows listed companies to purchase liability insurance for their independent directors. In practice, the use of directors' and officers' liability insurance has not become very widespread in China. There are only a number of listed companies which have reportedly taken out liability insurance policies for their directors.

### **V CORPORATE GOVERNANCE**

The Company Law was amended significantly for the purpose of improving the corporate governance in 2006 (2006 Company Law Amendments). These amendments

reduced the power of the chairman of the board of directors, emphasized the role of the board of supervisors, and clarified the duties of the directors. They also provided protections to minority shareholders.

However, there are areas for further improvement in relation to corporate governance under the Company Law. It is often argued that some of those provisions in the Company Law are drafted in a manner which is too abstract and which has rendered their enforcement difficult. Sometimes, these have given the court considerable discretion in the application of the relevant provisions in the Company Law, which has created some uncertainties in the enforcement and observation of good corporate governance practice.

As China continues with its rapid economic development, the National People's Congress and the State Council will address these areas for improvement. In addition, the Supreme People's Court has often taken the step of issuing interpretations of laws for application by first-instance and intermediate people's courts to resolve unclear topics. Given the size of the national economy and the complexity of China's bureaucracy, such improvements are not likely to come about rapidly.

There is also a trend to uniform the special corporate governance rules for the foreign-invested companies with the general rules provided in the Company Law. For example, there is no clear stipulation on a WFOE's highest authority in law. Before the 2006 Company Law Amendments, the government approval and registration authorities in China were of the view that WFOEs should follow the rules for EJVs and CJVs and thus the Articles of Association of a WFOE are required to provide that its board of director is the highest authority. After the 2006 Company Law Amendments, however, as a demonstration of the trend to uniform the rules governing the foreign investment companies and the general rules in the Company Law, the shareholders' meeting is required to be set out as the highest authority of WFOE in its Articles of Association. Such trend is being demonstrated by more and more legislation initiatives – such as the issuance of the draft Foreign Investment Law by the Ministry of Commerce on 19 January 2015 (Draft Foreign Investment Law) with the purpose of reforming the whole foreign investment administration regime. According to the Draft Foreign Investment Law, there should be no exceptional rules for the corporate governance of foreign investment companies three years after it becomes effective. The law is still in the draft form but is expected to be promulgated within two or three years after more rounds of deliberations.