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Client Alert: New Judicial Interpretations of the PRC Company Law and Its Focus

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The Supreme People's Court of the People's Republic of China (the "**Supreme People's Court**") issued Provisions of the Supreme People's Court Regarding Certain Issues Concerning the Application of the Company Law of the People's Republic of China (III) (the "**Interpretation**") on February 16, 2011, which took effect on the same day.

The Company Law of the People's Republic of China was promulgated on December 29, 1993, and has been amended three times since its promulgation; the current version was issued on October 27, 2005, and became effective as of January 1, 2006 (the "**Company Law**").

The Interpretation is the third judicial interpretation of the Company Law; following the first and second interpretations issued by the Supreme People's Court in April 2006 and May 2008, respectively, the purposes of which were mainly to clarify the issues involved in the application of the Company Law, in particular, dissolution and liquidation matters.

The Interpretation, according to the Supreme People's Court, is intended to provide clarification and guidance on a few major issues, including, among others, assumption of liability incurred at the pre-incorporation stage, defective contributions and corresponding liabilities, limitations on the rights of shareholders who have made defective contributions, and the trust arrangements between beneficial investors and nominal shareholders.

ASSUMPTION OF LIABILITY INCURRED AT THE PRE-INCORPORATION STAGE

It is very common that promoters, on behalf of the company to be incorporated, may enter into contracts with third parties at the pre-incorporation stage. In general, for such contracts, if the contracts are for the benefit of the company to be incorporated, the company (if incorporated later) should assume the liability, and if the contracts are for the benefit of the promoters, the promoters should then assume the liability.

However, due to the difficulty in identifying who benefits from such contracts in practice, which can sometimes cause disputes, the Interpretation has adopted a new approach which provides that promoters or the company that is named as a party to the contract should assume the liability, except that: (a) the company then incorporated may assume the liability if it agrees to do so by ratifying such contract or by becoming a party to such contract itself; or (b) it is evidenced that the contract to which the company to be incorporated is a party is in fact for the benefit of the promoters rather than the company and the counterparty to the contract knows such fact, in which case the promoters should assume the liability of the contract instead.

DEFECTIVE CONTRIBUTIONS AND CORRESPONDING LIABILITIES

Defective contributions have always been a problem, causing not only damage to the company but to the creditors of the company as well. To address the matter, the Interpretation seeks to ensure that shareholders will perform their equity contribution obligations by:

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- Expanding the scope of the persons responsible for defective contributions
 - The promoters and the shareholders of a company shall bear joint and several liability for defective contributions. This provision was only available to joint stock limited companies under the Company Law until the Interpretation finally expanded the application to limited liability companies, which fills the loophole.
 - The directors or members of senior management who fail to fulfill their obligations and thereby cause the failure of a company to collect its full capital contribution shall be liable to the extent of their obligations owed. This stipulation appears to be a step forward intended to ensure that the directors and senior managers diligently perform their duties to collect the contribution; however, how their obligations and the nonfulfillment of the same can be established remains unclear and needs to be further tested in practice.
 - Where a third party advances funds for a promoter to assist him or her in establishing a company and both parties agree that the capital contributed by the promoter shall be withdrawn after capital verification or establishment of the company in order to repay such third party, such third party shall be jointly and severally liable to the extent that the promoter cannot offset the difference after withdrawing the contributed capital according to the aforementioned agreement. It is not unusual for company registration agents to advance funds to their clients during the incorporation process and then withdraw the capital as soon as the companies are incorporated, to which the authorities can only impose penalties upon the promoters rather than such agents. By introducing this provision, it is anticipated that such “advancing” activities will be eliminated to some extent, the effect of which, however, remains to be seen.
- Clarifying the scope of the persons who may sue,
 - Under the Company Law, it is not clearly identified who may sue for the performance of shareholders’ contribution obligations. According to the Interpretation, the company itself, other shareholders of the company and the creditors of the company shall have the right to sue to request that shareholders fulfill their obligations to make contributions and to claim for damages for nonperformance thereof.
- Denying defense on the ground of statute of limitations
 - Where a shareholder fails to fulfill or fails to fully fulfill his or her obligation for capital contribution or withdraws the contributed capital, he or she shall be denied the defense on the ground of the statute of limitations when the company, any other shareholder or any of the company’s creditors claims that such shareholder shall fully fulfill his or her contribution obligations. It should be noted that when it is the company’s creditor who is making such claim, the creditor has to first make sure its debt is still within the statute of limitations.

LIMITATIONS ON THE RIGHTS OF SHAREHOLDERS WHO HAVE MADE DEFECTIVE CONTRIBUTIONS

The Interpretation provides that where a shareholder fails to fulfill or fails to fully fulfill his or her obligation for capital contribution or withdraws the contributed capital, the company may, according to the articles of association or a resolution of the shareholders, impose restrictions on the rights of such shareholder, including the right of profit distribution, the preemptive right and the right to distribution of residual properties.

TRUST ARRANGMENTS BETWEEN BENEFICIAL INVESTORS AND NOMINAL SHAREHOLDERS

Further, in the case of a limited liability company, a shareholder who fails to perform his or her contribution obligation may be disqualified as a shareholder by a shareholders’ resolution. However, it should be noted that this approach is more severe, and would apply only in instances when a shareholder does not make any capital contribution or later withdraws all of his or her capital contribution.

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- Where there is any dispute between a beneficial investor and a nominal shareholder over the shareholder's rights and interests, the beneficial investor's claim should be supported, as he or she has actually fulfilled the obligation for capital contribution. However, without obtaining the consent of more than half of the other shareholders of the company, the nominal shareholder's name shall remain as the shareholder of the company.
- Where the nominal shareholder disposes of, transfers or pledges the shares of the company under his or her name to a bona fide third party, the beneficial investor's claim that such disposal, transfer or pledge is invalid shall not be supported.

In addition to the above, the Interpretation also includes more detailed provisions in relation to, among others, the evaluation of nonmonetary assets and the effectiveness of capital contributions using assets that one does not own.

KEY TAKEAWAYS

It is clear that the Interpretation focuses on issues such as pre-incorporation liability, capital contributions, and balance among shareholders' (investors') rights, which are practice oriented and are marginally addressed by the Company Law. The Interpretation reflects the perspectives of China's judicial system governing these issues and the corresponding position taken, though the effect is yet to be seen.

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