China Law Update

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China's Supreme Court Drafts Guidelines For Adjudicating Disputes Involving Foreign Investment

On November 23, 2009, China's Supreme Court launched public consultation on draft Regulations on Issues in Adjudicating Cases Involving Foreign Invested Enterprise Disputes (Part 1) (the "Guidelines"). The Guidelines provide detailed rules regarding dispute resolution for foreign investors based on the court's experience in real cases.

Main Points

The Supplementary Agreements of Joint Venture Contracts
Under the Chinese law, contracts that establish or amend a foreign investment enterprise (FIE) will take effect only when approved by a competent government authority. In practice, investors often deliberately leave some terms out in the joint venture contract in order to simplify it to obtain faster approval. They then put detailed terms into the supplementary agreements. The Guidelines stipulate that as long as the joint venture contract is approved and the supplementary agreements do not make "material changes" to the approved contract, the court shall not rule such agreements ineffective. “Material changes” include changes in registered capital, company type, term and scope of the enterprise, amount of contributions by shareholders, methods of contribution, mergers and divisions, and share transfers.

Contribution by Shareholders
Under the Guidelines, the court will check whether contributions, other than those in cash, are actually made to the FIE. If the party has transferred those contributions such as buildings and equipment but has not yet changed the title at the registration authority, the court should order it to change the title. If the party fails to change the title or provide such contributions, the court should regard this as breach of contract, and require such party to make the contributions and to pay for damages if any.

Transfer of Shares
If the transferor does not go through the approval procedure after the share transfer agreement is executed, the transferee can request that the court join the FIE as a third party and order the transferor to obtain the approval. In addition, the transferor should return the amount of the purchase price and recover the damages incurred to the transferee if the failure to obtain approval is the transferor's fault.

In the case where the transfer of shares is completed and the buyer is acting as a shareholder in the FIE, if the seller sues for the unpaid purchase price, the court should order the seller to obtain the approval from the government. Only when the transfer of share is approved will the court order the buyer to pay the purchase price. This confirms what is happening in practice, and hinders the freedom of contract in transferring shares of FIEs.

Rights of Preemption
Article 8 of the Guidelines provides shareholders of a joint venture with the statutory right of preemption when one shareholder intends to sell its shares to a third party. Those shareholders can claim preemptive right within the prescribed period even after the share transfer agreement is approved by the government. As long as the shareholders can prove that their preemptive rights are being violated, the court can declare the share transfer agreement void. It should be noted that the seller and the buyer do not have such right.

Share Pledge Contract
A share pledge contract is a legal instrument by which a person gives shares he/she holds in the FIE as a hypothecation to his/her creditor. Unless otherwise required by the property law, registration is not a prerequisite for a share pledge contract to be valid. However, the shareholder and the FIE still need registration to confront a third party in good faith.

Investment Trust Agreement
In an investment trust agreement, one party agrees to make the contribution and enjoy the rights and benefits as a shareholder while the other party agrees to be the nominal shareholder. According to the Guidelines, the court shall recognize such trust agreement as being valid unless it violates the mandatory requirements of the laws and administrative regulations, and is against the public interest.

According to the Guidelines, the court should not support the actual investor's request for shareholder status in the FIE unless an approval of change of shareholder is obtained before the court debates in the first trial. The court should support the nominal shareholder when it requests that the actual investor should perform its obligations under the investment trust agreement, pay its commission, or pay the dividends if it is not covered in the investment trust agreement. If the actual investor requests that the FIE to pay dividends or respect other shareholder rights according to the investment trust agreement, the request will not be supported by the court. However, the court will support the actual investor's request to terminate the investment trust agreement and the request that the nominal shareholder pay damages if it fails to perform its obligation under the trust agreement.

The guidelines also give instructions of what to do after the investment trust agreement is declared void.

Other Issues

When two or more foreign investors form a wholly foreign-owned entity (WFOE), most of the time they choose the laws of their home countries as governing law in the joint venture contract in order to minimize the legal risks in China. Such choice of law will not be enforceable, according to the Guidelines.

The Guidelines extend their authority to investors from Taiwan, Hong Kong and Macau, and Chinese citizens residing outside of China.

The Guidelines have the retroactive effect to all cases that have not reached final verdict.

Conclusion

The Guidelines provide detailed rules regarding foreign investment disputes and are, to some extent, aggressive in the scope of application.

It is time to wait and see how the Guidelines will be modified by public opinion, but they will undoubtedly shape the behavior of investors of FIEs

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