# Corporate Governance Watch

# China

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Corporate governance failures are among the most frequently cited legal risks of investing in the People's Republic of China (PRC). Both majority and minority shareholders have been stymied in the exercise of their fundamental rights as shareholders or suffered from the losses incurred by companies they invested in as a result of fraud or connected transactions that were not conducted at arms' length.

PRC legislators and regulators attempt to better protect minority shareholders. A major step in this direction is the new Company Law, which came into effect on 1 January 2006, as it introduces new requirements and remedies.

Yet, corporate governance issues will remain. In addition to unavoidable risks – individual's fraudulent conduct, shareholder disputes, divergence of interests among management, shareholders and other stakeholders – Chinese companies lack a culture of corporate governance. Despite many years of public sector reform, state-controlled enterprises still tend to see themselves as part of the bureaucracy to which they report and defer to the State over the company's economic interest. The interests of public shareholders in listed companies are often treated as irrelevant, once the listing has occurred. Private entrepreneurs treat outside shareholders as interfering in their management of the business and, in many cases, the company's growth towards an initial public offering.

## Corporate governance under the Company Law

How can investors enhance their legal rights so as to prepare for, and if possible pre-empt, the corporate governance problems they are likely to encounter? This article provides guidance and suggestions for minority shareholders to protect their rights under the Company Law.

The Company Law sets forth the basic rules for limited liability companies (LLCs) and companies limited by shares (CLSs). The traditional types of foreign invested enterprises in the PRC (Chinese-foreign equity joint ventures, Chinese-foreign cooperative joint ventures with legal person status and wholly foreign-owned enterprises) are LLCs, and the corporate governance provisions of the Company Law apply to them, except to the extent specific legislation for these foreign invested enterprises prevails. Other entities, such as Chinese-foreign cooperative joint ventures and foreign invested venture capital investment enterprises without legal person status, do not fall under the Company Law, and their governance is to a larger degree regulated by contract only.

## Representation and rights on the company's governance bodies

Under the Company Law, decisions are made by the shareholders' meeting, the board of directors or the General Manager. In addition, each company must elect a supervisory board (or, in a small LLC, at least one supervisor) which, however, has only a supervisory, and not a decision-making, function.

### *Shareholders' meeting*

The shareholders' meeting is the highest ranking of these bodies, where voting rights are held in proportion to the shareholding in a CLS or the equity interests in a LLC's registered capital, unless otherwise stipulated in the articles of association. Shareholders' resolutions are the primary vehicle for shareholders to exercise their decision-making rights and for minority shareholders to control the actions of the controlling shareholders and the management. Under the Company Law, amendments to the articles of association, increases and reductions of the registered capital, merger,

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division, dissolution or continuation of the company or change of company form must be approved by holders of two thirds of the equity interests or shares. Decisions on other matters can be made according to rules set forth in the articles of association, which may provide for a simple majority of the voting rights whose holders are present at the meeting. The decisions to be adopted by the shareholders' meeting include business strategy and investment plans, the election and remuneration of directors or supervisors, annual budgets, profit distribution and issuance of debt securities. The grant of security to secure debts of shareholders or of persons who – through indirect shareholding or other arrangement-exercise de facto control over the company must also be approved by a shareholders' resolution, and the interested shareholders may not participate in the vote.

In practice, many closely held Chinese companies rarely hold shareholders' meeting, unless they are required to submit a shareholders' resolution to a government authority (eg to register an amendment to the articles of association). Breaking this habit sometimes requires a persistent effort by outside investors and may reveal conflicts or concealment between management and previously passive shareholders.

The procedural rules for convening shareholders' meetings under the Company Law are not sufficient to ensure that the shareholders' meeting can effectively exercise its role in protecting shareholders' interests. Under the law, the board of directors convenes shareholders' meetings, and if the directors fail to do so, the supervisory board has the right to call the meeting. Holders of at least 10 percent of the company's shares or equity interests may themselves convene the meeting if the supervisory board does not call the meeting. No time frames are stipulated in the law. Thus, shareholders are obligated to wait for an undetermined period for the board of directors or the supervisory board (which minority shareholders do not control) to call a shareholders' meeting, before the minority shareholders can exercise this right themselves. When negotiating articles of association of LLCs and CLSs, minority shareholders should request a simpler and faster procedure with clear time limits.

### *Board of directors*

The board of directors is capable for determining operational plans and plans for individual investments, the company's internal management organisation, the employment and remuneration of senior executives and other matters set forth in the articles of association or delegated by the shareholders' meeting.

The board of directors of a LLC may have three to 13 members. Under the Company Law, shareholders of 'small scale' LLCs may appoint a single managing director instead of a board. A CLS must have between five and 19 directors. The law leaves it entirely to the articles of association to determine the mode of election of directors and does not require that shareholders have a right to be represented on the board pro rata to their shareholding. Such nomination rights must be specifically provided in the articles of association.

The rules of attendance at board meetings are particularly important to ensure that directors especially those who reside outside the PRC, are effectively able to be present or represented at meetings. The Company Law does not allow directors to grant proxies for board meetings to person who are not themselves directors. Thus, if a shareholder is represented by a single board member, who is absent from a board meeting, the shareholder is effectively not represented at such meeting. To prevent this situation, foreign minority shareholders need to make sure that the articles of association stipulate adequate notice periods for meetings and allow participation by telephone or video conference.

### *Supervisory board*

Until the new Company Law came into effect, it was not mandatory to establish a supervisory board in LLCs, and in CLSs, the supervisory board was only competent to report corporate governance violations to the shareholders' meeting. When negotiating an investment in a PRC company, minority shareholders often did not insist on obtaining representation on the supervisory board.

Under the new Company Law, a supervisory board (or at least a single supervisor) is required also for LLCs, and its powers have been increased. (Note that inclusion of a supervisory board is, however, currently not required for a wholly foreign owned enterprise.) The supervisory board may now call a shareholders' meeting if the board of directors fails to do so at the request of shareholders, take legal action against directors and senior executives in the name of the company and submit a resolution for the dismissal of directors and senior executives to the shareholders' meeting. The supervisory board may also engage outside accountants at the company's expense to investigate irregularities. Thus, the supervisory board may in the future play an active role in shareholder disputes and disputes

between management and shareholders. Minority shareholders should seek to be represented on the supervisory board and have appropriate procedures for calling at attending meetings included in the articles of association.

### Information rights

There is a significant difference between the rights of shareholders of LLCs and CLSs to obtain information about the operations and accounts of the company.

Shareholders of a CLS only have the right to inspect the company's articles of association, register of shareholders and debentures, minutes of shareholders', directors' and supervisors' meetings and financial statements at the company's premises. The directors and officers of a CLS are not required to respond to enquiries by shareholders for other information, unless these are raised at a shareholders' meeting within the limit of the attributions of the meeting.

Investors in a LLC may in addition review the company's accounting records upon request and are thus granted a continuing right to access in-depth financial information, which is not available to shareholders of a CLS. However, even in a LLC shareholders do not have a statutory right to access to and information from directors and executives outside of shareholders' meetings.

In negotiating articles of association of PRC companies, it is therefore important for minority shareholders to request additional information rights. Such negotiations are, however, often difficult, because many PRC companies, in particular State-owned enterprises, cultivate the secrecy of business operations and are reluctant to grant more access than the law requires.

### Shareholders' remedies

The revised Company Law provides shareholders with many new remedies against decisions that are detrimental to the minority shareholders or the company itself. Shareholders are liable towards other shareholders for damages resulting from an abuse of their voting rights. Shareholders are jointly and severally liable with the company if their abuse the status of the company as a separate legal person or its limited liability to evade debts and cause severe damage to the company's creditors. Controlling shareholders, persons who de facto control the company, directors, supervisors and senior executives must indemnify the company for losses arising from the use of connected transactions.

These new rules are worded in general terms, concepts of fiduciary duty and conditions for piercing the corporate veil are only partially expressed, and the intentional elements and causal relationship for successful damage claims remain to be determined by the courts. Also, it is not clear from the Company Law itself whether avoidance is an available remedy against actions that violate shareholder rights. The law only provides in general terms that actions in violation of the Company Law or the articles of association are void, but does not specify whether an aggrieved shareholder can request nullification in addition to damages if one of the abuses referred to above has occurred.

Shareholders may also act against directors, supervisors or senior executives. In addition, if any of these officers commit certain fraudulent acts or breach their duty of loyalty towards the company, or if third parties violate the company's rights, shareholders may institute a derivate lawsuit (in their own name but for the benefit of the company) against them after unsuccessfully requesting the company's board of directors or supervisory board to take action.

An ultimate remedy is available to shareholders of LLCs: if a company has not distributed profits for five successive years although it was profitable throughout the period, undergoes a merger, division or sale of substantial assets or extends its corporate term, a shareholder who dissented on the relevant resolution may request the company to repurchase its equity interest at a reasonable price.

### Conclusion

The new Company Law constitutes a major step in the reform of corporate governance in China. In particular, specific shareholder remedies did not exist before and were politically highly contentious. However, short of their expanded litigation options, the law protects minority shareholders only to a limited extent, and investors will have to be aware of these shortcomings when negotiating charter documents such as articles of association of LLCs and CLS and promoters' agreements of CLS. These considerations should commence as early as the choice of company form: this article has shown the statutory difference of shareholder rights in LLCs and CLS, and investors should consider this difference when determining the best vehicle for their PRC investment. **AC**

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