



# CHINA'S SUPREME PEOPLE'S COURT ISSUES RULES ON FOREIGN INVESTMENT DISPUTES

On May 17, 2010, the Supreme People's Court of the People's Republic of China ("SPC") passed the "Provisions of the Supreme People's Court on Several Issues Concerning the Trial of Disputes Involving Foreign-Invested Enterprises" (the "FIE Dispute Rules"), which were issued and came into force on August 16, 2010.

The release of the FIE Dispute Rules was driven by two major factors. First, the laws and regulations governing foreign-invested enterprises ("FIE"), such as the Law on Chinese-Foreign Contractual Joint Ventures, the Law on Chinese-Foreign Equity Joint Ventures, and the Law on Wholly Foreign-Owned Enterprises, cannot adequately deal with many of the issues arising out of China's rapidly developing economy.

Second, with the huge increase of foreign investment in China, disputes involving foreign companies are also increasing. According to Jungong Sun, a spokesman from the SPC, the proportion of disputes concerning foreign-invested companies accounted

for 20 percent of the foreign-related civil and commercial cases in the last two years.

The FIE Dispute Rules, however, address only issues arising during the creation and change of FIEs. The Supreme People's Court is expected to issue additional rules on disputes related to termination of FIEs.

## INTRODUCTION TO THE FIE DISPUTE RULES

The FIE Dispute Rules have 24 articles: Articles 1 to 4 mainly deal with the effectiveness of contracts subject to approval by the FIE examination and approval authority (the "FIE Approval Authority"); Articles 5 to 13 deal with disputes arising out of the transfer of equity in an FIE; Articles 14 to 21 cover disputes arising out of nominal investment in an FIE; and the remaining of provisions deal with the application of the FIE Dispute Rules. This *Commentary* will concentrate on three specific issues addressed by the FIE Dispute Rules:

- The effectiveness of contracts subject to approval by the FIE Approval Authority.
- The resolution of FIE equity transfer disputes.
- The resolution of disputes concerning nominal investment in FIEs.

## THE EFFECTIVENESS OF CONTRACTS SUBJECT TO APPROVAL BY THE FIE APPROVAL AUTHORITY

The FIE Dispute Rules provide that contracts concluded during the course of an FIE's establishment, which in accordance with applicable laws and regulations become effective only upon approval by the FIE Approval Authority, will come into effect on that date. Article 1 provides that where approval has not been obtained, the court will hold that the contract has not yet become valid. If the parties to the contract request a determination that the contract is invalid, the court will not uphold this request.

Article 2 further provides that where the parties enter into a supplementary agreement concerning an FIE that does not amount to a significant or substantial change to the contract already approved by the FIE Approval Authority, the court will not hold the supplementary agreement invalid simply because it had not been approved by the FIE Approval Authority. The "significant or substantial changes" referred to above include changes to the registered capital of the company, the type of company, the term of the company's operation, the proportions of the capital contributions by the company's shareholders, changes to the method of capital contribution to the company, and the merger or division of the company or transfer of shares in the company.

If, during the course of the hearing of a dispute, the court discovers that a contract for the establishment of an FIE that has been approved by the FIE Approval Authority is in fact invalid in accordance with relevant laws and regulations, Article 3 requires the court to hold the contract invalid. If the contract is voidable in accordance with relevant laws and regulations, then the court will uphold any request from the parties for rescission of the contract.

Article 4 states that the court must hold that a party has performed its capital contribution obligation if the following occur:

- A party to the FIE uses a property whose change of ownership needs registration as its capital contribution or its condition of cooperation;
- The property is delivered to the FIE and is being used by the FIE; and
- The party under an obligation to conduct the change of ownership registration procedures completes the registration within the time limit prescribed by the court.

Further, the court will not support any claim by the FIE or its shareholders that such party does not hold rights as a shareholder due to its failure to perform its capital contribution obligations or provide the condition of cooperation with the other parties in the enterprise. If the FIE or its shareholders can show evidence that the FIE has suffered losses due to such party's delay in registering for change of ownership and bring a claim for compensation, the court will uphold the claim.

Before the release of the FIE Dispute Rules, the courts often ruled contracts invalid if they had not been examined and approved by the FIE Approval Authority. Now, the courts are not permitted to rule such contracts invalid, but rather, that they are more correctly to be held as "not yet valid." This is an important distinction. On the other hand, the Chinese Contract Law does not address the treatment of contracts that are "not yet valid." There may be confusion as to the effect of other provisions of such contracts that are not related to the registration obligation. Of course, if one of the parties can show that the party responsible for registering the contract has delayed in doing so, and the other party has suffered losses as a result of this delay, then the court is entitled to uphold a claim for compensation from the aggrieved party.

## THE RESOLUTION OF FIE EQUITY TRANSFER DISPUTES

The following provisions of the FIE Dispute Rules attempt to cover the types of situation that might occur while an

FIE contract is being examined and approved by the FIE Approval Authority. During this period, the value of the shares may change and, in some cases, the transferor might prefer to sell the shares when the value of the shares is high, rather than go through the process of approval. The FIE Dispute Rules provide guidance in such circumstances.

Article 5 of the FIE Dispute Rules provides that a transferee can request the termination of the contract and compensation for actual losses incurred due to the failure to submit the contract for approval if the transferor and the FIE:

- Fail to perform their obligations to submit the contract for approval by the FIE Approval Authorities after a contract for the transfer of equity in an FIE has been formed, and
- Continue to fail to perform their obligations within a reasonable period after being requested to do so.

In this case, the court will uphold the transferee's request.

The court will also uphold a request by the transferee for specific performance by the transferor and the FIE (Article 6), or alternatively it will allow the transferee to submit the contract for approval if the transferor and the FIE fail to carry out their obligation to submit the contract for approval within a period prescribed by the court (Article 6). Despite these provisions, in practice it is difficult to enforce specific performance in China. Even if the transferee itself submits the contract for approval, it needs the transferor's cooperation to provide the necessary documents. In addition, it is unclear whether the FIE authorities will allow the transferee to apply for the approval. It may depend on the FIE authority's local practice. For these reasons, Article 6 provides additional punishment in terms of compensation to the transferee if the transferor and FIE refuse to carry out their obligations after the court orders them to do so.

Article 6 further provides that if the transferor and the FIE refuse to carry out their obligation to submit the contract for approval within the period prescribed by the court, and the transferee initiates separate proceedings requesting termination of the contract and compensation for its losses, the court will support the transferee's request. The losses to be compensated may include those arising from differences in

the value of the shares, shareholder earnings, and other reasonable losses. In comparison, the loss provided in Article 5 is limited to "actual loss."

In the event that the parties fail to obtain the approval of the FIE Approval Authority, the court will support an application by the transferee requesting that the transferor return the consideration already paid. Where the transferee requests that the transferor compensate it for losses incurred as a result of the failure to obtain approval, the court will determine whether the transferor should be liable to compensate the transferee, and the amount of the compensation, based on the existence and degree of the transferor's negligence in requesting the approval (Article 7).

Article 8, on the other hand, provides that if the transferor is obliged only to conduct the approval procedures upon receipt of the consideration, and the transferee has not paid the consideration and fails to do so within a reasonable period after having been requested to do so by the transferor, the court will uphold a request by the transferor for the termination of the contract and for compensation for the actual losses incurred as a result of the delay.

Another situation addressed in the FIE Dispute Rules is where, after the formation of a contract for the transfer of equity in an FIE, the transferee has not paid the consideration for the transfer of the shares, and the transferor and the FIE have also not carried out their obligation to submit the contract for approval by the FIE Approval Authorities. In this case, if the transferor files a case requesting that the transferee pay the consideration for the transfer, the court will adjourn the case and order that the transferor conduct the approval procedures within a prescribed time limit. If the share transfer contract is then approved by the FIE Approval Authority, the court should uphold the transferor's request for payment of the consideration for the transfer (Article 9).

Similarly, Article 10 provides an example in which, after the formation of a contract for the transfer of equity in an FIE, the transferee has already started participating in the actual business operations and management of the FIE and received shareholder earnings from the FIE, but the contract

has not been approved by the FIE Approval Authority. In that case, the transferor can request that the transferee withdraw from the management and business operations of the FIE and pay the transferor any earnings obtained from the transferee's participation in the management and business operations (deducting related costs and expenses), and the court will uphold the transferor's request.

Further, according to Article 11, where one of the shareholders in an FIE transfers all or part of its shares in the FIE to a third party who is not an existing shareholder in the FIE, it must obtain the unanimous consent of the other shareholders. Where the other shareholders request the termination of the share transfer contract because of the transferring shareholder's failure to obtain their consent to the transfer, the court is empowered to uphold the request, except in one of the following circumstances:

- There is evidence demonstrating that the other shareholders have approved the transfer;
- The transferring shareholder has issued a written notice of the share transfer, and the other shareholders have failed to respond within 30 days from their receipt of the written notice; or
- The other shareholders do not consent to the transfer, but also do not purchase the shares from the transferring shareholder.

Where one of the shareholders of an FIE transfers all or part of its shareholding to a third party other than an existing shareholder, and the other shareholders request that the share transfer contract be terminated on account of it having infringed their right of first refusal, the court will uphold the other shareholders' request. The only exception would be if such shareholders have failed to assert their right of first refusal within one year from the day that they knew or ought to have known that the share transfer contract had been signed. Similarly, where the transferor or the transferee of the above-mentioned share transfer contract requests a determination that the share transfer contract is invalid because it infringed upon the right of first refusal of the other shareholders, the court will uphold such request (Article 12).

Finally, an equity pledge contract executed between the shareholders and creditors of an FIE becomes effective upon its conclusion, except as otherwise provided by laws and administrative rules and regulations, or as otherwise agreed in the contract. Failure to register the pledge will not affect the validity of the contract. Article 13 of the FIE Dispute Rules provides that the court will not uphold a party's claim that an equity pledge contract be held invalid or ineffective merely on the ground that the contract has not been approved by the FIE Approval Authority. If the registration of an equity pledge contract is carried out in accordance with the relevant provisions of the Property Law, the pledge will be deemed to have been created from the time of registration. Article 13 in effect invalidated Rule 12 of the Rules on Foreign Invested Entities' Equity Transfer, issued by the State Administration for Industry & Commerce and the previous Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce), which provided that an equity pledge contract is invalid unless it has been registered. The Supreme People's Court's reasoning is that an equity pledge contract itself does not change the ownership of shares. To effect the change of ownership, the party still needs to register with the authorities.

## **THE RESOLUTION OF DISPUTES CONCERNING NOMINAL INVESTMENTS IN FIES**

It is often the case that the shareholders of an FIE reach an agreement whereby one party makes the actual investment in the FIE, and the other party simply serves as a nominal shareholder in it. The FIE Dispute Rules make it clear that the court will uphold such agreements, provided that they are not invalid pursuant to other laws and administrative regulations (Article 15).

Article 14 of the FIE Dispute Rules provides that the court will not grant a request by the actual investor for confirmation of its identity as a shareholder in the FIE or for an amendment of the shareholders of the FIE, unless:

- The actual investor has already invested in the FIE;
- Shareholders other than the nominal shareholder recognize the actual investor's identity as a shareholder; and

- During the period of the court proceedings, the court or the parties receive the consent of the FIE Approval Authority for the actual investor to become a shareholder in the FIE.

Article 15 states that the court will not allow one of the parties to claim that the contract is invalid or has yet to become valid because it has not been approved by the FIE Approval Authority. Further, where the parties have not reached any agreement regarding the distribution of benefits, the court will allow the actual investor to request that the nominal shareholder pay it the earnings received by the nominal shareholder from the FIE. On the other hand, Article 15 empowers the court (after careful consideration of the circumstances) to allow the nominal shareholder to request that the actual investor pay necessary remuneration to the nominal shareholder.

Article 16 gives the court authority to uphold the actual investor's claim for termination of the contract in the event that the nominal shareholder in the FIE fails to perform the contract. However, Article 17 provides that if the actual investor makes a direct claim against the FIE for the distribution of profits or its exercise of other rights as a shareholder on the basis of its agreement with the nominal shareholder, the court will not support the actual investor's claim.

Articles 18 and 19 of the FIE Dispute Rules deal with the tricky question of valuation. Article 18 provides that if the contract between the actual investor and the nominal shareholder is held to be invalid, and the value of the shares held by the nominal shareholder is higher than the actual amount of investment, the court will allow the actual investor to request that the nominal shareholder return its investment and also allocate the benefits it received from its participation in the management and business operations of the FIE. Article 19, on the other hand, states that if the contract between the actual investor and the nominal shareholder is held to be invalid, and the value of the shares held by the nominal shareholder is lower than the actual amount of investment, the court will allow the actual investor to request that the nominal shareholder return to it an amount equal to the current value of the shares.

Alternatively, where the nominal shareholder in the FIE clearly indicates that it wishes to give up its shares or refuses to continue to hold them, the court may order that the actual investor's investment be returned to it through the proceeds of an auction or forced sale of the nominal shareholder's shares in the FIE. Based on the investment of the actual investor and on the nominal shareholder's involvement in the operation and management of the FIE, the court will undertake a reasonable distribution of the equity earnings between the parties in accordance with the principles in Articles 18 and 19 of the FIE Dispute Rules. Where the actual investor requests that the nominal shareholder compensate it for its losses, the court will determine whether the nominal shareholder is liable for compensation and the amount of any compensation based on the existence and extent of any negligence on the part of the nominal shareholder.

In Article 20, the court is given the power to requisition or return any property obtained by the parties where the contract between the actual investor and the nominal shareholder in the FIE is deemed invalid on the grounds of malicious conspiracy, or on the grounds of harming the state or the interests of any collective or individual. In practice, many nominal investor arrangements were set up to escape the limitations on the types of industry in which a foreign-invested enterprise can conduct business. Article 20 raises a potential issue: Will violations of China's industrial policy be deemed as harming the state interest and therefore invalidate the contract between the nominal investor and the actual investor? This question remains to be answered by the courts.

Fraud is covered in Article 21, which addresses what occurs if the FIE or one or more of its shareholders engages in fraudulent behavior (such as providing false materials to apply to the FIE Approval Authority to change the shareholders specified in the FIE's approval certificate) that causes the other shareholders in the FIE to lose their status as shareholders or their original shareholding percentage. In that case, the court will uphold a claim by the other shareholders confirming their status as shareholders or confirming their original shareholding percentage or compensation, unless a third party has already obtained the shares without fault on its part.

In summary, the principle underlying the nominal investment rules is to decide disputes between the actual investor and the nominal investor according to the contract they have entered into. One cannot automatically assume, however, that Chinese law applies to such a contract. Instead, because such contract is not covered by the Law on Chinese-Foreign Equity Joint Ventures, the Law on Chinese-Foreign Contractual Joint Ventures, and the Law on Foreign Capital Enterprises, the court applies the general choice of law principles in deciding which jurisdiction's laws will apply.

## CONCLUSION

Overall, the FIE Dispute Rules are a welcome clarification of the law as it affects FIE disputes in China. In many ways, the SPC is taking a very practical and pragmatic approach to FIE investment disputes, which is consistent with approaches adopted in many foreign jurisdictions.

It should be noted that the FIE Dispute Rules also apply to companies established by investors from Taiwan, Hong Kong, and Macau, as well as Chinese citizens with permanent residence outside of China.

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