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The PRC Supreme People's Court Issued Draft Regulations on Disputes Concerning Foreign-invested Enterprises

● Inside the News

On November 23, 2009, the Supreme People's Court published on its official website the *Regulations of the Supreme People's Court on Some Issues in Adjudication of Disputes concerning Foreign-invested Enterprises (Draft for Comment)* (the "**Draft**") to solicit public comments. The deadline for comments to the Draft is December 8, 2009.

The Draft mainly addresses such issues as the validity of contracts affecting the establishment or amendment of foreign invested enterprises ("**FIEs**"), failure to contribute or provide cooperative conditions, disputes arising from equity transfer of a FIE, share pledge, entrusted investment, dormant investment, the applicable law governing WFOE contracts, etc. Once officially passed and coming into force, it will have significant implications to the practice of FIEs in China. Highlights of this Draft are expanded on below.

Validity of contracts affecting FIEs

According to the Draft, contracts affecting the establishment or amendment of FIEs only take effect when approved. However, the court may hold valid a supplemental agreement entered into by parties to an approved FIE contract, provided that such supplemental agreement does not constitute a material or substantial change to the approved one, even if the parties fails to submit the supplemental one to the examination and approval authorities for approval. Besides, already approved contracts that are in violation of certain articles of *the PRC Contract Law* may still be held invalid or revocable.

"Material or substantial changes" include changes in registered capital, company type, business

scope, operating term, capital subscribed by shareholders, means of contribution, merger, division, equity transfer and changes of address among different jurisdictions.

Failure to contribute or provide cooperative conditions

If a party to a Sino-foreign cooperative or equity joint venture contract is to provide cooperative conditions or contribute by using lands or buildings, but fails to register such change of title with competent government authorities, this shall constitute a breach contract, and the court may order the breaching party to complete the tile registration or assume default liability such as compensation.

Disposal of unapproved share transfer agreements

According to the Draft, where a share transfer agreement of a FIE is not approved by the examination and approval authority, the court shall order the transferor and the FIE to conduct the approval procedures jointly within a specified period. If the party who has the obligation to conduct the approval procedures refuses or delays to do so, the transferee has the right to request return of payment or compensation. If the approval procedures cannot be completed due to reasons attributable to the transferor, the transferee is entitled to terminate the contract and request return of payment or compensation.

In case that the transferee has already exercised shareholder's rights but hasn't paid any transfer price prior to the approval of the share transfer agreement, only after the transferor completes the approval procedures and an approval is obtained, will the request of the transferor for payment of the transfer price be upheld by the court. This provision seems to deviate from the principle of freedom of contract, in that even if the transferee has the obligation to pay under the share transfer agreement, the payment will not be supported by the court if the agreement is not approved.

First refusal rights

The Draft sets forth that a share transfer agreement entered into by a shareholder of a FIE with a party who are not shareholders of the FIE, might be revoked by the court upon the other shareholders' request, even if the share transfer has been approved by the examination and approval authority, if the other shareholders have not been given a chance to exercise their rights of first refusal when the transfer occurs.

Share pledge

The Draft restates the relevant provisions of *the PRC Property Law (2007)* and sets forth that a share pledge agreement among shareholders of a FIE and their creditors shall come into force upon its formation, without regard to whether it has been registered or not; whereas, the establishment of the share pledge rights is subject to registration.

Entrusted investment

According to the Draft, an entrusted agreement pursuant to which one party actually invests and enjoys the equity interests, while the other party acts as the nominal shareholder of the FIE, is valid, provided that the agreement does not evade or violate the mandatory clauses of laws and administrative regulations, and does not impair social public interests.

If the de facto investor requests the court to confirm its shareholder identity in the FIE, or request an alternation of the shareholders of the FIE, or if he sues the FIE itself for dividends or other shareholders' rights, the court should not support his claims. However, if he requests the court to cause the nominal shareholder to perform the relevant obligations under the entrusted agreement or to deliver to him the proceeds it has obtained from the FIE, the court shall support him. In addition, if the nominal shareholder fails to perform the entrusted agreement, causing the purpose of the de facto investor under the agreement impossible to be realized, the de facto investor may sue to terminate the agreement, request a refund of the capital invested and compensation, which shall be upheld by the court.

Dormant investment

In the event that an investor invests in other person's name, and requests the court to cause the investee FIE to file with the examination and approval authority for an alternation of its shareholders, the court shall uphold this claim, provided that the de facto investor has actually taken part in the operation and management of the FIE, or it is clearly known to the other shareholders that he is the actual investor. If the nominal shareholder who has not invested actually sues the FIE for exercising its shareholder's rights, the court should not support such claim.

Governing law

The Draft explicitly provides that any disputes arising from contract(s) regarding the establishment of a WFOE by two or more foreign investors shall be governed by Chinese law. Any provisions choosing a foreign law as the governing law shall be null and void.

The above is a brief introduction to the relevant provisions of the Draft, which is subject to further amendments and modifications by the Supreme People's Court going forward. We will monitor any updates in this regard and keep you posted of the same.

Should you have any questions regarding the above, please feel free to contact us.

Important Announcement

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