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CHINA'S SUPREME COURT ISSUES RULES ON FOREIGN INVESTMENT DISPUTES

Introduction

On 5 August 2010, China's Supreme People's Court (**SPC**) promulgated the *Rules on Several Issues Concerning the Adjudication of Cases Involving Disputes of Foreign-Invested Enterprises (Rules)*, which took effect on 16 August 2010.

According to the SPC, disputes involving foreign-invested enterprises (**FIEs**) have accounted for about 20% of all civil and commercial cases involving a foreign entity or individual in the past 2 years. This number is expected to increase in the future. The Rules aim to provide detailed guidance to the lower courts on how to adjudicate such disputes.

Key Provisions

1. **Validity of Contracts**

The Rules reaffirm that contracts concluded for the establishment or modification of FIEs become effective upon their approval by the relevant authorities. However, without such approval, the contracts are not invalid per se. Rather, they are deemed "yet-to-be-effective", and any provisions they contain which require the parties to obtain approval are still enforceable.

"Supplementary agreements" involving an FIE will not be held invalid merely because they have not been approved, unless they involve significant or material changes to the original, approved contract. "Significant or material changes" are defined by the Rules to include changes to an FIE's registered capital, corporate nature, business scope, term of operation, amount or method of capital contributions, as well as mergers, divestitures and equity transfers.

In practice, investors often undertake the approval procedures for their original FIE contracts, but then fail to seek approval for the supplementary agreements they conclude thereafter. The Rules are thus helpful in asserting the validity of such agreements.

2. Equity Transfer Agreements (ETAs)

Transferee Remedies

The Rules provide specific remedies in cases where an FIE and/or a transferor of its equity has failed to complete the necessary approval and registration procedures.

If the approval process has been properly carried out, but the ETA was ultimately not granted approval, then the transferee can demand a refund of any consideration it has already paid under the ETA, and claim for damages. The court will award damages based on whether, and to what degree, the transferor was at fault.

These provisions are intended to address circumstances where the value of the equity being transferred increases after the execution of the ETA, thereby creating an incentive for the transferor to avoid its obligations.

Transferor Remedies

The Rules state that, if an ETA requires the transferee to pay the equity transfer price before the transferor applies for approval, and the transferee fails to do so, then the transferor is entitled to cancel the ETA and sue for damages.

Where an ETA is silent on the timing of the purchase price relative to the initiation of the approval process, and the transferor sues for payment, the Rules direct the court to suspend proceedings and order the transferor to apply for approval first. If the ETA is approved by the competent authorities, then the transferor's claim for payment must be upheld.

These provisions aim to prevent transferees from evading their ETA obligations in bad faith where there is a decrease in the value of the equity in question.

3. Equity Pledge Agreements (EPA)

The Rules confirm that there is a distinction between the effectiveness of an EPA and the effectiveness of the underlying equity pledge. An EPA will become effective upon its execution, absent any legal or contractual provision to the contrary. The Rules indicate that failure to register the underlying equity pledge with the authorities will not invalidate the EPA: the agreement will remain binding.

4. Nominee Shareholding Arrangements

Shareholder Status

The Rules stipulate that three conditions must be met before a court will uphold any claim by an actual investor to confirm its status as a shareholder in the FIE. Specifically:

- (a) the actual investor must have actually effected its investment in the FIE;
- (b) all the other shareholders except for the nominee shareholder must confirm its status as a shareholder; and
- (c) the actual investor's change of status to a direct shareholder must have been approved by the FIE's examination and approval authorities during the course of the litigation.

Effectiveness of Agreement

Even in the absence of its approval by the relevant authorities, a nominee shareholder agreement will be deemed as valid by the courts unless it violates the law.

Profit-Sharing

The actual investor is entitled to demand that the nominee shareholder remit to it any dividends received from the FIE – even if the nominee shareholder agreement is silent on this issue. Should the nominee ask for necessary remuneration, the court must assess its request in light of the facts of the case.

Commentary

The Rules provide welcome clarification on issues that have plagued many foreign investors when doing business in China. They also illustrate the SPC's policy of unifying the principles applied by local courts in complex foreign investment cases. As such, the Rules should enhance transparency and fairness in the judicial process, and thus provide greater predictability and consistency with regard to court verdicts in FIE-related disputes.

Nevertheless, the Rules do not cover how to adjudicate disputes involving mergers and acquisitions with foreign investors. Such disputes have been increasing in recent years and are expected to be covered in subsequent rules issued by the SPC. In addition, certain provisions of the Rules will need further clarification. For example, it is currently unclear how to calculate the "other reasonable losses" incurred by a transferee suing to cancel an ETA. Exactly how and to what extent the Rules will be enforced by the SPC also remains to be seen.

This newsflash was written by partner Joonho Tan (jhtan@TransAsiaLawyers.com), together with associates Daniel Su and Gabe Bloch.

Beijing

Suite 2218 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004, China
Tel: +86 10 6505 8188
Fax: +86 10 6505 8189

Shanghai

Unit 1101 Platinum
233 Tai Cang Road
Shanghai 200020, China
Tel: +86 21 6141 0998
Fax: +86 21 6141 0995

<http://TransAsiaLawyers.com>

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