

Corporate Governance in the People's Republic of China

Legal Basis

As yet, there are no special laws on corporate governance in the PRC. In practice, corporate governance issues play a much less important role than in Europe or the US. However, the PRC authorities intend to strengthen corporate governance, especially for companies listed on the stock exchange. In 2007, the China Securities Regulatory Commission issued several regulations against insider trading.

For foreign investment enterprises ("FIEs"), the rights and duties of their company organs and the relationship

between the company organs and the shareholders are regulated in the following laws:

- PRC Law on Sino-Foreign Joint Equity Enterprises;
- PRC Law on Sino-Foreign Cooperative Enterprises;
- PRC Law on Sole Foreign Investment Enterprises;
- Implementation Rules for the above-mentioned laws; and
- PRC Company Law.

The amended version of the PRC Company Law took effect on January 1, 2006.

Basic Principles

Most FIEs are established as limited liability companies under PRC law. The advantage here is that shareholders are liable only for their contribution to the registered capital of the company. The information provided below refers to limited liability companies.

Generally speaking, the highest organ of a limited liability company is the shareholders' meeting. As a rule, these companies also have a Board of Directors. According to Article 51 of the PRC Company Law, limited liability companies with a relatively small number of shareholders

or that are relatively small in scale may have an Executive Director instead of a Board of Directors. In addition, companies have a Supervisory Board and a General Manager.

In joint ventures the structure is different. The highest organ in joint ventures is the Board of Directors. In addition, joint ventures must also have a Supervisory Board and a General Manager.

Legal Representative

The Chairman of the Board of Directors is usually registered as the legal representative of the company with the Administration for Industry and Commerce. Since the revision of the PRC Company Law in 2006, a manager of the company may alternatively be registered as the legal representative of the company. Unlike under German law, in PRC law the General Manager is not the legal

representative unless he is registered as such. All persons other than the registered legal representative may only represent the company on the basis of a power of attorney issued by the legal representative. A specific PRC characteristic is that the company seal has the same validity as the signature of the legal representative.

Functions and Powers of the Board of Directors

The members of the Board of Directors are appointed by the shareholders, with the maximum term of office being three years. According to the PRC Company Law, a Board of Directors must have between 3 and 13 members.

According to the PRC Regulations on Administration of Registration of Companies, the appointment and dismissal of directors must be registered with the competent Administration for Industry and Commerce. This means that a simple letter of release and appointment is not sufficient for changing the members of the Board of Directors. The change only becomes effective upon registration with the competent Administration for Industry and Commerce.

According to the legal requirements, the Board of Directors shall hold a meeting at least once a year. In joint ventures, the quorum for resolutions is two thirds of all directors.

In joint ventures, the following items require unanimously by all directors present at a board meeting: Amendment of the Articles of Association, termination of the joint venture, changes to the registered capital, share transfers and merging or splitting the company. In Wholly Foreign Owned Enterprises, resolutions on the above-mentioned items must be made by a two-thirds majority.

According to the PRC Company Law, the Board of Directors shall decide on the following matters:

- Amendment of the Articles of Association;
- Termination of the company;
- Changes to the registered capital;
- Share transfers;
- Merger of the enterprise with other units;
- Resolution on the company's business and investment plans;
- Resolution on annual budget plans and annual financial statements;
- Resolution on profit distribution;
- Preparation of plans to increase or reduce the registered capital;
- Preparation of plans for mergers, demergers, changes of corporate form or dissolution of the company;
- Resolutions on management organs of the company;
- Appointment and dismissal of the General Manager;
- Formulation of the general management system of the company.

In practice, the Articles of Association of many companies include a much more detailed list. For companies which have the shareholders' meeting as their highest organ, most of the above-mentioned matters will be decided by the shareholders' meeting and the Board of Directors is only responsible for preparing the above resolutions.

Functions and Powers of the General Manager

The General Manager is responsible for the day-to-day business of the company and is appointed by the Board of Directors. The General Manager may simultaneously be a member of the Board of Directors. According to the PRC Company Law, even if the General Manager is not a member of the Board of Directors he shall have the right to attend board meetings, but without voting rights.

According to the PRC Company Law, the General Manager has the following responsibilities:

- Daily operations and production activities of the company, and arranging implementation of the resolutions of the Board of Directors;

- Implementing the company's annual business plans and investment plans;
- Drafting plans on the establishment of the internal management organs of the company;
- Drafting the basic management structure of the company;
- Formulating rules and regulations for the company;
- Appointing or dismissing management personnel other than those to be appointed or dismissed by the Board of Directors.

In practice, it is advisable to define the exact powers and functions of the General Manager in the Articles of Association.

Functions and Powers of the Supervisory Board

Normally, a company shall have a Supervisory Board consisting of three persons. However, one of the members of the Supervisory Board must be an employee representative. To avoid this, companies that operate on a small scale or which have a small number of shareholders can choose to have one or two Supervisors instead of a Supervisory Board. The Supervisors are appointed by the shareholders.

According to the PRC Company Law, the Supervisory Board has the following responsibilities:

- Examining the financial affairs of the company;
- Supervising the actions of the directors and senior managers;
- Calling and presiding over shareholders' meetings when the Board of Directors does not exercise the function of calling and presiding over shareholders' meetings as laid down in the PRC Company Law;

- Submitting proposals to the shareholders' meeting;
- Instituting legal proceedings for compensation in a People's Court against directors or senior managers who violate any law, administrative regulation or the Articles of Association in the course of performing their duties.

In addition, the Supervisors may take part in meetings of the Board of Directors as non-voting attendees, and may raise questions or make suggestions regarding the matters to be decided by the Board of Directors.

According to the PRC Company Law, directors and senior managers including the General Manager may not simultaneously serve as Supervisor.

Duties and Liabilities of Company Organs

Articles 148 to 150 of the PRC Company Law define a number of responsibilities of the Board of Directors, the Supervisory Board and the senior management of a limited liability company.

- According to Article 148, the directors, supervisors and senior managers of a company shall comply with the law, administrative regulations and the company's Articles of Association and have an obligation of loyalty and diligence towards the company. They may not use their functions and powers to accept bribes or other illegal income, nor may they seize property belonging to the company.
- Article 149 (1) of the PRC Company Law prohibits directors and senior managers of a company from misappropriating the company's funds. Article 149 (2) expressly forbids to deposit the company's assets or to use the company's property to provide guarantees to shareholders or a third party.
- Article 149 (5) of the PRC Company Law includes a statutory non-competition obligation. Directors and senior managers of a company are not allowed to take advantage of their positions to exploit for themselves or third parties commercial opportunities that should belong to the company, or to operate on their own behalf or for third parties in the same type of business as that of the company without the consent of the shareholders' meeting.
- Article 149 (4) prohibits the directors and senior managers of a company from entering into contracts or conducting transactions with the company or with themselves unless otherwise provided in the company's Articles of Association or with the consent of the shareholders.
- Article 149 (7) of the PRC Company Law includes a statutory confidentiality obligation.
- If directors, supervisors or senior managers of a company violate the administrative regulations or the Articles of Association of the company in performance of their functions and cause losses to the company, they are liable for compensation according to Article 150, PRC Company Law.

In addition to liability according to the PRC Company Law, the directors, supervisors and senior management of a company may also be subject to criminal liability according to the PRC Criminal Law of June 1, 1997.

Such criminal liability can occur for example in the following cases:

- The company presents false financial accounts or financial accounts to its shareholders or the public which conceal material facts and thereby seriously harm the interests of its shareholders or the public;
- The company, during its liquidation process, conceals property or makes false entries in its balance sheet or asset list, or distributes company assets before repaying debts and thereby seriously harms the interests of creditors or third parties;
- The company offers bribes in a considerable amount;
- Tax evasion by the company if the underpaid amount exceeds 10% of the amount owed or exceeds RMB 10,000;
- The company fails to settle payable taxes, or transfers or conceals property in order to prevent tax organs from recovering owed taxes amounting to more than RMB 10,000;
- Submission of forged export declarations or using other fraudulent means to receive significant state export tax refunds;
- Forging of value added tax invoices or other invoices to offset against or evade taxes;
- Forging and sale of value added tax invoices;
- Smuggling of goods, if the amount of the evaded customs duty exceeds RMB 50,000;
- Forging of bank or other business documents.

In all of the above cases, criminal liability of the directors, supervisors or managers requires that the criminal act was committed within the area of responsibility of the relevant person and that the relevant person was at fault and acted at least with gross negligence. In practice, criminal prosecution of company organs of FIEs is still rather rare.

For further information and assistance, please contact

Dr Ulrike Glueck

Managing Partner, Head of Corporate

E ulrike.glueck@cmslegal.cn

Dr Falk Lichtenstein

Senior Associate

E falk.lichtenstein@cmslegal.cn

CMS, China

2801 Plaza 66, Tower 2

1266 Nanjing Road West

Shanghai 200040, China

T +86 21 6289 6363

F +86 21 6289 0731

NOTE

NOTE

CMS, China has been active in China on behalf of its clients for almost 30 years and has had an office there since the mid-90s. Our offices in Mainland China are staffed by lawyers from China, France, Germany, the Netherlands and the United Kingdom, who provide an extensive range of legal advice and services to clients doing business with China. CMS, China is a member of CMS Legal Services EEIG, a European Economic Interest Grouping that coordinates an organisation of independent member firms. CMS Legal Services EEIG provides no client services. Such services are solely provided by the member firms in their respective jurisdictions. In certain circumstances, CMS is used as a brand or business name of some or all of the member firms. CMS Legal Services EEIG and its member firms are legally distinct and separate entities. They do not have, and nothing contained herein shall be construed to place these entities in, the relationship of parents, subsidiaries, agents, partners or joint ventures. No member firm has any authority (actual, apparent, implied or otherwise) to bind CMS Legal Services EEIG or any other member firm in any manner whatsoever.

CMS member firms are: CMS Adonnino Ascoli & Cavasola Scamoni (Italy); CMS Albiñana & Suárez de Lezo, S.L.P. (Spain); CMS Bureau Francis Lefebvre (France); CMS Cameron McKenna LLP (UK); CMS DeBacker (Belgium); CMS Derks Star Busmann (The Netherlands); CMS von Erlach Henrici Ltd (Switzerland); CMS Hasche Sigle (Germany), CMS Reich-Rohrwig Hainz Rechtsanwälte GmbH (Austria) and CMS Rui Pena & Arnaut.

CMS offices and associated offices: Amsterdam, Berlin, Brussels, London, Madrid, Paris, Rome, Vienna, Zurich, Aberdeen, Algiers, Antwerp, Beijing, Belgrade, Bratislava Bristol, Bucharest, Budapest, Buenos Aires, Casablanca, Cologne, Dresden, Duesseldorf, Edinburgh, Frankfurt, Hamburg, Kyiv, Leipzig, Ljubljana, Luxemburg, Lyon, Marbella, Milan, Montevideo, Moscow, Munich, Prague, Rio de Janeiro, Sarajevo, Seville, Shanghai, Sofia, Strasbourg, Stuttgart, Tirana, Utrecht, Warsaw and Zagreb.

“CMS, China” should be understood to mean the representative offices in Mainland China of CMS Bureau Francis Lefebvre, CMS Cameron McKenna LLP and CMS Hasche Sigle, working together.

CMS, China

CMS Hasche Sigle Shanghai Representative Office
2801 Tower 2, Plaza 66 | 1266 Nanjing Road West | Shanghai 200040, China
T +86 21 6289 6363 | F +86 21 6289 9696

CMS, China

CMS Cameron McKenna LLP
Beijing Representative Office (UK)
Room 1901, Building A, Sanlitun Soho Centre | Chaoyang District | Beijing 100027, China
T +86 10 85270259 | F +86 10 85900831

www.cmslegal.cn