

## Win-Win Corporate Governance in China

### Updated guidance on reducing the liability of PRC companies and limiting the liability & powers of their senior officers

Foreign investors into subsidiaries in the People's Republic of China (PRC), and senior personnel employed by such investors or subsidiaries, should be attentive to the types of liabilities that they risk, the importance of chops used for signatures, and the risk reduction that can be obtained through implementation of transparent corporate governance procedures.

How can a PRC company protect itself against unauthorized actions taken by its Legal Representative, and against a Legal Representative's refusal to resign or be removed? How can an innocent Legal Representative or other officer be protected from bearing liability for a PRC company's misconduct or debts? What prevents a chop from being used to issue an unauthorized "signature"?

### Precautions to protect all stakeholders - summary

The following summarized precautions can create substantial protections of investors, their PRC subsidiaries and individual appointees:

- Each PRC company's Legal Representative should be selected carefully and, before being appointed, should be required to sign undated termination-related documents, and to deliver them to the company's board of directors.
- Shareholders should define, in each PRC company's articles of association (AOA), clear limits on the authority of the company's Legal Representative and other officers, along with procedures for approving actions that exceed those limits, should observe and monitor observance of such procedures, and should notify them to potential contract counterparties.
- Each PRC company should establish and observe procedures to control key chops and record their usage.

### Company liability for Legal Representative's actions

When is a company liable for the unauthorized actions of the individual appointed as the company's Legal Representative? Since 1999, the PRC Contract Law has clarified this question somewhat by stating that "If the Legal Representative ... of a [company] creates a contract in excess of authority limits, such representative action is valid except where the counterparty knows or should know that it exceeded authority limits."

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But what “should” a counterparty know? In order to persuade a court or arbitration tribunal to release a company from liability for an unauthorized signature or other action by its Legal Representative, the company will generally need to demonstrate that it has made reasonable efforts to define, implement and give notice of its Legal Representative’s authority limits.

Defining these authority limits must be done by specifying them clearly in the company’s AOA. This often entails resisting pressure from the local government to use its published and preferred “standard” form of AOA. A normal compromise is to adopt the basic style and sequence of that form, while adding more detailed provisions, on the Legal Representative’s authority limits, and on other points that are important to the shareholders.

To implement these authority limits entails, as a first step, creating and preserving records of compliance with authorization procedures that are specified in the AOA. As a second step, all personnel must resist the tendency towards allowing ‘short cuts’ to become a customary practice. The customary practices of a company, in China like in many foreign jurisdictions, can cause a company to be liable even for actions of its personnel that are not formally authorized.

To ensure that all counterparties “should” be aware of the authority limits (even those counterparties who might be deceived by active efforts of the Legal Representative), it is not sufficient to merely comply with the legal requirement for the AOA and all amendments therein to be filed with the local Administration of Industry & Commerce (AIC). Such filings will not prevent counterparties from arguing (rightly) that the PRC has no tradition of requiring (or even of universally permitting) counterparties to check these AIC records (despite the fact that filings with the AIC are increasingly treated as a public record).

Additional precautions are necessary. One useful precaution is to post on the company’s website and other prominent places (including in the company’s standard form documents) a notice alerting potential counterparties to the existence of authority limits. Those limits, which may be set out in the company’s AOA, or in resolutions (normally updated annually) of the board of directors, may also be posted on the company’s website (as may the entire AOA). Alternatively, in order to maintain privacy, those limits may be made available upon request by potential counterparties (who should be prominently invited to request copies before entering into contracts with the company).

## Termination of Legal Representative

The outgoing Legal Representative can block his or her own termination and replacement, and can paralyze the activities of the company, in some localities, merely by failing to sign required documents (or by failing to surrender possession of company chops, which normally cannot be replaced without a signature from the Legal Representative). Such blockage typically occurs when a dispute motivates the individual to ‘hold the company hostage’, but can also result merely when the individual departs more quickly than the company is prepared for. In order to prevent such blockage and paralysis from occurring, or even from being threatened by the Legal Representative as a negotiating tactic, a useful precaution is to require the Legal Representative, before being appointed, to sign and deliver to the board of directors undated documents sufficient to complete local procedures for termination and replacement, along with the Legal Representative’s written irrevocable consent to later insertion of later effective dates.

## Chop policy & procedures

Particular risks arise from the fact that many of a China company’s “signatures”, on contracts or government documents, are provided through an ink imprint of a carved stone or molded rubber “chop”. Consequently, a person who has not received proper authorization, but who has physical possession of a relevant chop, may be able to cause a document to be “signed”, unless reliable precautions are in place. The most reliable way to prevent unauthorized usage of a chop is to restrict access and to record all usage. If the company keeps clear records of who holds possession of the chop, during what time period and for what purpose, then these records will reduce several key risks: of documents being chopped without authorization, of the company being held liable for unauthorized chopping, and of the Legal Representative bearing individually liability if his chop is used by another person. Another useful precaution is for a company to formally disclaim liability for all (or major) documents that are chopped without authorized signatures. This can be done through similar procedures to those discussed above (provisions in the AOA, postings on websites and standard form documents), but also entails persuading counterparties to depart from customary practice.

## Representative's liability – duties of loyalty & diligence

All personnel are somewhat at risk of individual liability for PRC company activities under their supervision, but the Legal Representative is at greater risk - for the full range of company activities. In practice, the Legal Representative, at least of foreign-invested enterprises (FIEs), has generally not been held personally liable without allegations of individual errors or omissions that would violate generally applicable duties of loyalty or diligence.

The duty of loyalty, imposed on directors and senior management personnel, is illustrated in the PRC Company Law by a list of prohibited individual conduct, which unfortunately includes an open-ended catch-all provision (as is customary in PRC laws and regulations). There is no such direct illustration of the duty of diligence, but a list of prohibited company conduct, set out in the PRC Bankruptcy Law (while focusing primarily on requiring fair treatment of creditors by the company) suggests that a relatively high level of diligence is required from the company's Legal Representative and other personnel, at least during a certain period before the company goes bankrupt.

Risks can be reduced at all times by clearly allocating particular powers and responsibilities to particular company officers (acting individually or jointly, depending on the importance of the matter and on the company's degree of confidence in each officer). Such allocations of authority will not only reduce the risks borne individually by the Legal Representative and other personnel, but will also benefit the company by preventing important matters from 'falling between the cracks' and by enabling the Legal Representative to be more focused and less defensive.