

## Limiting the Liability of China Companies; Limiting Their Officers' Liability & Powers

Foreign-invested and other PRC companies and their senior personnel should be attentive to the types of liabilities that they risk, the importance of chops used for signatures, and the value of transparently implementing corporate governance procedures, and considering appropriate insurance coverage.

How can a PRC company be protected from unauthorized actions – or hostile actions – taken by its Legal Representative or other officers? 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 stolen chop from being used to forge an unauthorized signature?

### Company liability for Legal Representative's actions

When is a company liable for the unauthorized actions of the person appointed as its 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."

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, observe and give notice of its Legal Representative's authority limits.

Defining the authority limits must be done by specifying them clearly in the company's articles of association. This often entails resisting pressure from the local government to use its published and preferred "standard" form of articles. 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.

Observing the authority limits entails creating and preserving records of compliance with authorization procedures that are specified in the articles, while resisting the tendency towards allowing 'short cuts' to become a customary practice. This is important because, like in many foreign jurisdictions, the customary practices of a company can cause a company to be liable for formally unauthorized actions of its personnel.

Ensuring that all counterparties "should" be aware of the authority limits (even those counterparties who might be actively deceived by the Legal Representative) entails additional precautions. Although the articles and all their amendments are required to be filed with the local Administration of Industry & Commerce (AIC), and although filings with the AIC are increasingly treated as a public record, 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. One useful approach is to post on the company's

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website the authority limits and/or the company's entire articles of association, and to post in other prominent places (including in the company's standard form documents) a notice stating that potential counterparties should view the limits. Another approach is to post in all these places a notice stating that, the scope and limits of all individuals' authority to bind the company will be determined by resolutions (updated annually) of the board of directors, and that copies of such resolutions will be made available to potential counterparties, who are invited to request and review them.

## Chop policy & procedures

Particular risks arise from the fact that many "signatures" in China are provided through an ink imprint of a "chop" (and banks typically require the Legal Representative's chop for fund withdrawals). Consequently, any person who has physical possession of the relevant chop can cause a document to be "signed". A company may attempt to persuade its bank to accept the Legal Representative's signature (perhaps together with a second officer's signature), and more generally can adopt a policy requiring all its contracts and other documents to be executed only by signatures (of the Legal Representative and/or an authorized representative), but implementing such a policy entails persuading a variety of counterparties to depart from customary practice. Even if chop usage can be reduced in this manner, each company must have a general "company chop".

The most reliable way to prevent unauthorized usage of it 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 not only the likelihood of documents being chopped without authorization, but also the risk of the company being held liable for such chopping, along with the risk of the Legal Representative being individually liable if his chop is used by another person.

## 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). No such direct illustration exists 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, also suggests that a relatively high level of diligence is required from the company's Legal Representative and other personnel, at least during the 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 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.

## Termination of Legal Representative

Termination and replacement of the Legal Representative can be blocked, and the activities of the company can be paralyzed, in some localities if the outgoing Legal Representative does not sign required documents. This typically occurs when there is a dispute, 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 termination-related documents, along with the Legal Representative's written consent to the company later filling in any dates that it deems appropriate.

## Protecting all stakeholders

The following precautions can protect investors, their PRC subsidiaries and individual appointees (thereby helping to attract and retain experienced managers in the PRC's tight employment market):

- Each PRC company's Legal Representative should be selected carefully and should be required to sign and deliver to the company undated termination-related documents before being appointed.
- Shareholders should define, in each PRC subsidiary's articles of association, 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 give notice to potential contract counterparties through the company's website, form documents and/or other channels.
- Each PRC company should establish and observe procedures to control key chops and record their usage.

## Insurance availability and reliability

The above precautions also increase a company's ability to obtain liability insurance from a reputable insurer at an acceptable price. Many individuals invited to fill key positions will demand that the company provide individual liability insurance. Insurance for both companies and their "directors and officers" (including the Legal Representative), is available from an increasing variety of insurers. Insurance coverage obtained by a China subsidiary directly (rather than as an extension of a foreign parent company's global coverage) on liability for activities in China can only be issued by a carrier licensed to operate in China. Such carriers include domestically owned companies as well as subsidiaries of foreign groups. The reliability of insurance from domestically licensed insurers is supported by a national fund, capitalization, solvency and prudential standards, government supervision, and limits on the ability of insurers to terminate insurance contracts.

## Parent's experience

Foreign companies that are experienced in corporate governance and risk management are well positioned to assist their PRC subsidiaries' implementation of the above precautions. As with many aspects of investments and operations in the PRC, the know-how that foreign investors bring from their home markets can often be adapted to PRC circumstances and turned to competitive advantage.