

**ABSTRACT**

The Foreign Investment Law will replace the Law of PRC on Sino-Foreign Equity Joint Ventures (“EJV Law”), and become the basic law to regulate EJVs in China. The corporate governance structure stipulated in the Company Law of PRC (“Company Law”) shall apply to all the foreign invested companies. In this regard, the incorporated EJVs will have to make corresponding changes in order to adapt to the Company Law, which could bring challenges to the equilibrium of the power between the foreign and Chinese investors pertaining to the decision-making scheme.

We summarize the adaptations to be dealt with by EJVs and propose the potential solutions to the decision-making scheme of EJVs.

***Impact of Foreign
Investment Law on
Company
Governance
Structure of Equity
Joint Venture
in China***



FOREIGN INVESTMENT LAW – IMPACT ON COMPANY GOVERNANCE STRUCTURE OF EQUITY JOINT VENTURE IN CHINA

Following our last issue of Newsletter introducing the newly promulgated Foreign Investment Law of PRC (the “Foreign Investment Law”), in this issue, we analyze in detail its impact on company governance structure of equity joint venture (“EJV”) in China.

The Foreign Investment Law will replace the Law of PRC on Sino-Foreign Equity Joint Ventures (“EJV Law”), the Law of PRC on Wholly Foreign-Owned Enterprises and the Law of PRC on Sino-Foreign Cooperative Joint Ventures, and become the basic law to regulate foreign investment in China.

The Foreign Investment Law stipulates explicitly that the corporate governance structure stipulated in the Company Law of PRC (“Company Law”) shall apply to all the foreign invested companies. In this regard, the incorporated EJVs will have to make corresponding changes in order to adapt to the Company Law, which could bring challenges to the equilibrium of the power between the foreign and Chinese investors pertaining to the decision-making scheme.

We summarize the adaptations to be dealt with by EJVs and propose the potential solutions to the decision-making scheme of the EJVs.

I - Decision-making scheme of the highest authority of EJV

The table below indicates the comparison of decision-making scheme of the highest authority between the EJV Law, under which the existing incorporated EJVs are structured, and the Company Law, which the existing incorporated EJVs are granted a five-year transmission period to adapt to.

	EJV Law	Company Law
Highest authority	Board of directors	Board of shareholders
Composition	At least 3 directors appointed by the shareholders respectively	All the shareholders

	EJV Law	Company Law
Voting rights	One vote for each director	Voting rights corresponding to the proportion of each shareholder’s capital contribution, or subject to the specific stipulations of the AOA
Decisions on the most significant issues	Statutory unanimous approval on the following issues of the company: (1) Amendment of the articles of association (“AOA”); (2) Suspension or dissolution; (3) Increase or decrease of the registered capital; and (4) Merger or division.	The following issues of the company require approvals of shareholders representing 2/3 or more of the voting rights compulsorily: (1) Amendment of AOA; (2) Increase or decrease of the registered capital; and (3) Merger, division, dissolution or transformation.

The application of the Company Law on EJVs could bring forward the influence to the minority shareholders representing less than 1/3 of the voting right of the company, who could lose veto right on the most significant issues of the company, while for the majority shareholders representing 2/3 or more of the voting rights, the Company Law provides them with more control on the most significant issues, pertaining to which less deadlocks would occur since not the approvals of all the shareholders representing all the voting rights are necessary for the decision-making.

II - Potential solutions for the minority shareholders

Nevertheless, minority shareholders of EJVs may use the liberty and autonomy granted by the Company Law to set up a mechanism in the AOA to reasonably protect their interests. Below are some solutions.

1. Change the rules of voting right

The Company Law allows the company’s AOA to stipulate the rules of voting right other than to be exercised in proportion to the shareholder’s respective shares. Therefore, if the minority shareholder holding less than 1/3 of the total shares could negotiate for 1/3 or more voting right, it could retain its veto right on the most significant issues of the company.



Besides, the AOA could require unanimous approval of the board of shareholders on the most significant issues of the company, in order to ensure the opinion of each shareholder could be respected in process of decision making. This decision mechanism is permitted by the Company Law by virtue of reaching the statutory minimum requirement of 2/3 of the total voting right.

Moreover, the minority shareholder of a limited liability company could negotiate for itself the veto right on several special issues that are most concerned to it, which means even the AOA only requires for 2/3 of the total voting right on these issues, and the actual voting right reaches 2/3, as long as the minority shareholder does not cast positive vote, the resolution on such issues should not be passed.

2. Lower the decision-making power to the board of directors

The Company Law stipulates a three-level company governance structure, i.e. board of shareholders – board of directors – managers. The board of directors, though is not the highest authority, still plays an important role in the company's governance structure. Especially, the Company Law allows the company's AOA to stipulate the function and power of the board of shareholders and the board of directors to the extent permitted by the law.

In this regard, when adapting the governance structure of the company to the requirements of the Company Law, it is considerable to narrow the function of the board of shareholders and expand the power of the board of directors, in order to as far as possible remain the control of board of directors, avoid material change to the governance structure of the company, and facilitate the consensus to be reached by the shareholders as soon as possible.

Nevertheless, the function and power of the board of shareholders explicitly stipulated by the Company Law should not be "lowered down" to the board of directors, which includes the following:

- a) determine the company's operational guidelines and investment plans;
- b) elect and replace non-employee representative directors and supervisors and determine matters relating to their remunerations;
- c) deliberate on and approve reports of the board of directors;
- d) deliberate on and approve reports of the board of supervisors or of the supervisor(s);
- e) deliberate on and approve annual budgets and final accounts of the company;

- f) deliberate on and approve the company's profit distribution plans and loss recovery plans;
- g) make resolutions on any increase or decrease of the company's registered capital;
- h) make resolutions on the issuance of corporate bonds;
- i) make resolutions on any combination, division, dissolution, liquidation or transformation of the company; and
- j) revise the articles of association of the company.

3. Underline the right of board of directors to make proposals to the board of shareholders

According to the Company Law, the board of directors performs the function of formulation of plans to be submitted to the board of shareholders for deliberation, which includes:

- formulate the company's annual budgets and final accounts;
- formulate the company's profit distribution plans and loss recovery plans;
- formulate the company's plans on the increase or decrease of its registered capital and on the issuance of corporate bonds;
- formulate the company's plans on the combination, division, dissolution or transformation of the company;
- any other function or power specified in the AOA.

The company's AOA could refer to the above provisions of the Company Law and develop a mechanism of the prepositive proposal right of the board of directors. That is to say, in terms of substantial matters of the company, it could be stipulated in the AOA that they must be formulated and discussed by the board of directors before being submitted to the board of shareholders for deliberation, otherwise any resolution of the board of shareholders relating to these matters should be void. The actual power and influence of the board of directors could be enhanced by this means.

4. Seats in the board of directors

In accordance with our analysis in Section II.2 and II.3 herein, the power of the board of directors could be substantial to the company, which gives reason to the minority shareholders to fight for the seats in the board of directors.

Under the Company Law, the directors are selected by the board of shareholders, other than directly appointed by the shareholders respectively. The minority shareholder could lose its seats in the board of directors due to its limited voting right on selection of directors. In order to secure the seats in the board of directors to the utmost for minority shareholder, it is worth trying to agree in the AOA the nomination right of the shareholders and the number of directors to be nominated by each shareholder.

NEWSLETTER

THE FOREIGN INVESTMENT LAW OF PRC

Comments

The application of the governance structure provided by the Company Law to the EJV will bring a lot of challenges to the minority shareholders for the purpose of secure the control on the company. It could be foreseeable that the design of the function and power of the board of shareholders and the board of directors in the company's AOA will become the key of contention between the minority shareholders and majority shareholders.

Contacts



Robert GUILLAUMOND

Email : robert.guillaumont@adamas-lawfirm.com



Denis SANTY

Email : denis.santy@adamas-lawfirm.com



Alban RENAUD

Email : alban.renaud@adamas.com.cn



Huini LI

Email : li.huini@adamas.com.cn

Offices of ADAMAS

We warmly welcome you to contact with our offices in **Beijing** and **Shanghai**:

Suite 2108, Zhongyu Plaza
A6 North Gongti Road
Chaoyang District
Beijing, 100027
Tel: +86 10 8523 6858
Fax: +86 10 8523 6878

Suite 3301, United Plaza
1468 West Nanjing Road
Jing'an District
Shanghai, 200040
Tel: +86 21 6289 6676
Fax: +86 21 6289 6672

Moreover, ADAMAS collaborates closely with law firms in Guangzhou, Chengdu, Wuhan and Hong Kong.