

Breakthrough in taking control of Chinese subsidiaries

Foreign investors and insolvency practitioners have long encountered legal and other challenges brought by existing management or PRC regulatory bodies when they seek to recover assets in PRC. These legal challenges are often focussed on their power and authority to change the legal representative of the Wholly Foreign Owned Entity (“WFOE”) or Joint Venture (“JV”) incorporated in PRC and thus secure control of its affairs and assets.

Securing of the office of the legal representative is often an important milestone in any PRC-based recovery project or assignment. A legal representative is the principal of a PRC incorporated entity who has the authority to, inter alia, (i) act on its behalf in dealing with any assets, (ii) cause it to enter into binding obligations, and (iii) take possession of its property, seals, books and records.

Changing the legal representative requires, inter alia, an application to the Administration for Industry and Commerce (“AIC”) (a corporate regulator) to amend the Memorandum and Articles of Association (“M&A”) of the company (where the current legal representative and/or the authorised person of the shareholder are usually listed in the said M&A), to register the change of the legal representative and to make post-registration amendments to certain administrative documents.

When applying for the registration of the change in the legal representative, the company should present the following documents to the AIC: (1) the resignation of the original legal representative; (2) the appointment of the new legal representative; and (3) an application to register the change signed by the original legal representative. In other words, the change in legal representative needs the cooperation of the original or incumbent legal representative, which, in a contentious or distressed situation, is rarely forthcoming.

Legal proceedings are then necessary to obtain an order from the PRC court to compel the AIC to register the change.

This almost always causes delay (months, not weeks) – it also means that the incumbent legal representative remains in control of the company and its assets with all the risks which that entails.

Thankfully, a recent judgment of the Supreme People’s Court in Beijing (“SPC”), the highest court in PRC, seems to have delivered a solution. On 11 June 2014, there was a public hearing of a shareholder’s capital contribution dispute between Sino-Environment Technology Group Limited (In Liquidation) (“Sino-Env”) and its subsidiary. Cosimo Borrelli, Jason Kardachi and Hamish Christie of Borrelli Walsh are the Liquidators of Sino-Env and upon their application, the SPC made a final judgment confirming that:

1. a shareholders’ resolution passed by foreign insolvency practitioners in relation to its subsidiaries in PRC is effective in PRC;
2. the existing management of the PRC subsidiaries is bound by these resolutions passed by the shareholder with immediate effect; and

3. registration of the change of legal representative with the AIC is only required when dealing with external affairs of the company.

This decision is important as it confirms that upon the passing of a shareholders' resolution to remove the existing legal representative, the existing legal representative no longer has the authority to represent the company or conduct the affairs of the company. The change is binding upon the company internally, despite not being registered with the AIC.

The immediate impact of this is that the outgoing legal representative does not have the ability or standing to oppose or obstruct the incoming legal representative (including by opposing legal proceedings to confirm the appointment).

Conclusion

The judgment of the SPC is final and confirms a foreign investor's and/or insolvency practitioner's powers and authority and their power to change the legal representative of a WFOE or JV.

The SPC emphasised the importance of this judgment by inviting over 100 foreign diplomats, local media and members of the legal community and conducting the hearing publicly. This is the first time that the SPC has invited foreign diplomats to attend such a hearing. In November 2014, this case was also selected as one of 20 major civil and commercial cases of historical significance in the past 65 years since the establishment of the SPC.

Since the SPC judgment, Borrelli Walsh has been successful in obtaining a number of favourable judgments and decisions in PRC proceedings concerning the effectiveness of the shareholder's right to change the legal representative and defending the proceedings commenced by the outgoing legal representative. We are also embarking on a journey of bringing the SPC judgment to the attention of many AICs around PRC. Registering changes of legal representative on the basis of shareholder's resolutions remains a challenge. This is not a surprise given the magnitude of the change delivered by the SPC judgment, but the developments to date are encouraging.

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