Inheritance of Corporate Shares in a China Company (III)

Description

This is the third post regarding inheritance of corporate shares in a China company. Again it is about a special situation that may become more and more in reality with more and more Chinese riches migrating to foreign countries.

I. Facts of the Case

In 2002, a Chinese husband set up a trading company with a third party, and business went well. In 2006, the husband took his family including his wife and daughter to Germany and were all naturalized into German citizens. But the company had been running in its course without making any changes about the change of the husband's nationality. By an accident, the husband died in Germany in 2008, leaving his equity interests or shares in the China trading company behind. As in most cases in China, the trading company's articles of association didn't touch on the issue of the inheritance of equity interests in the case of death of any individual shareholder, so the default rule is that the legal heirs of the deceased shareholder shall have the right to take up the shareholdership in the trading company. Based on the intestate inheritance rules under China laws, the final heirs to the equity interests in the company are the wife and daughter (other heirs waiving their rights to the estate shares).

However there is a particular twist here. As mentioned, the wife and daughter are now both foreigners, and if they were allowed to inherit the shares in the company, they will turn this domestic company into a foreign-invested company. Back then, the foreign investment regime is still stringent in that it requires the approval of the foreign investment department of the government to approve the conversion of the domestic company into a foreign invested company.

So what will turn out in the end?

II. Court Rulings

The trial court of Shanghai Pudong New Area apparently was at a loss as to how to deal with such a tricky situations. On the one hand, the court noticed that the wife and daughter had not obtained the approval from the foreign investment department and thus denied their request for the trading company to register them as shareholders with the company registry, and on the other hand claimed that registration of shareholdership was not a condition for giving effect to shareholdership in the company, thus the non-registration should not affect the inheritance of the shares by the wife and daughter.

This is a bit of ridiculous. Without registration of shareholdership with the company registry, the wife and daughter can do nothing about their shares and cannot effectively participate in the management of the company, putting the heirs in an awkward situation.

Of course the wife and daughter were not happy with the results, and they appealed to the intermediary court in Shanghai.

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The appellate court took a total novel stance on the issue. It reasoned from the starting point of what is a foreign invested company. It concluded that a foreign invested company is dictated by the source of the capital, or in other words, if the registered capital of the trading company in question is from a foreign source (foreign countries or from HK, Macau or Taiwan regions), then the company is a foreign invested company; otherwise, it should remain a domestic company despite the fact that some of the shareholders are foreign nationals.

Based on that, the appellate court affirmed the shareholdership of the wife and daughter in the company and order the company to update its company registry accordingly.

Interesting enough.

With so many Chinese rich families migrating to foreign countries, it is foreseeable that many families may be caught in such a situation whereby the heirs of foreign nationals need to inherit their family estate in a domestic company in China. With this case ruled this way, it opens the door for such foreign heirs.

III. Implications of the Case

Well, given the way laid down by the appellate court in determining a foreign invested company, one may readily want to stretch the rule to think that foreign investors should now be allowed to set up a domestic company with RMB money that is earned from within China, so as to tap the business in industries that are otherwise restricted or prohibited to foreign investors.

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Unfortunately, the answer is a sure “no”.

Under current foreign investment regime, foreign investors are not allowed to set up a company with the money they earn from within China, but they are allowed to set up foreign invested company with RMB money legally obtained outside of China.

Another incidental issue of the court ruling is that the foreign heirs in a domestic company will have difficulty in taking out of China the money stemming from the corporate profits and dividends. Theoretically, the foreign heirs may be able to cash in on the equity interests in whole and the take the money out of China by way of the migration route as laid down by China foreign exchange authority concerning Chinese people taking their China assets out of China as result of being naturalized into a foreign national.

IV. Last but not Least Issue: applicable laws

You shall not miss this part of this blog. As always, a foreign-related legal matter shall be analyzed in accordance with proper applicable laws.

If the estate is located in China, then the inheritance formalities and legal procedures shall have to be done in China, but the applicable laws shall be first decided.

Here are the general rules in relation to inheritance of estates in China:

(1) in the case of intestate succession/inheritance, the applicable laws shall be the laws of the habitual

residence of the deceased at the time of death, but when it comes to inheritance of real estate (real property) in China, then the applicable laws shall be the inheritance laws of China where the real property is located; ***so where the estate is corporate shares, how it shall be inherited and distributed shall be governed not necessarily by Chinese laws***.

(2) in the case of testate succession/inheritance, the applicable laws can be of multiple choices. With regard to the mode or form of making the will, a will shall be considered as “formed” (or effective in form) if the will meet the formal requirements of any laws of habitual residence, nationality or of the place where the will is made. With regard to the validity of the will, the applicable laws could be the laws of the habitual residence (at the time of making the will or death) or the laws of the nationality of the deceased. With regard to the administration of the estates, the laws of the place where the estate sits shall apply.

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