China Divorce: divide corporate equities indirectly held by one spouse

Description

A client asked an interesting question regarding her attempt to divide her husband's equity interests in a China limited liability company. Here is the story: the Chinese lady client got married with a foreigner husband ten years ago and now they are in the process of divorcing. The husband has invested indirectly through a BVI company, in a foreign-invested joint venture company in Shanghai which has been running its business successfully over the years. In other words, the husband directly owns the BVI company which in turn owns a percentage of the shares in the China joint venture company in Shanghai. The husband serves as a member on the board of directors.

Assuming that the equity interests owned by the husband in the Shanghai company through the shell BVI entity has doubled in value, can this wife claim to divide the increment part of the equity interests over the period of their marriage, in a China divorcing proceeding?

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I. Is the Incremental Amount Community Property?

Under China Marriage Law, one spouse is entitled to half of the community of the other spouse cumulated during their marital life. So, to entitle the wife's claim for half of the increment of the corporate equity interests, we need to firstly decide on whether or not this part of asset is considered as community property.

Generally speaking unless otherwise agreed between the couple, a spouse's pre-marriage assets will always remain his or her personal property throughout the marriage. On the other hand, China marriage laws makes it clear that the benefits generated from the pre-marriage personal properties shall be considered community property unless such benefits are the natural fruits (*??*) of the said personal property or otherwise of natural increment in value (*????*) of such personal properties.

Therefore, it is important to define what are natural fruits or natural increment in value. There are no further clear instructions handed down from China Supreme Court in this regard. In practice, whether there is active labor invested in the generation of the value increment demarcates the natural from the non-natural increase in value. In other words, if either of the spouses works in the company contributing to the business development and growth of the company, then this value increment will be considered as community property, subject to division by the other spouse upon divorce.

However, it could be very difficult in some cases to decide on whether certain kind of corporate management participation by the equity holding spouse or how much of it would qualify to change the otherwise personal property into community property in respect of the value increase in the equity interests. For example, it is obvious that the service by the equity holding spouse as the general manager of the company taking charge of the daily operation of the company would be easily sufficient to qualify the value increment as community property, but if the equity holding spouse is just a passive investor participating in the shareholder meeting once or twice a year or two years, will this kind of participation be enough to transform the personal property into community property? It is a question.

You can take a read of another post on this blog here: China Family Law: spouse interests in real properties and corporate equities

II. Will China Courts Divide the Community Property

Assuming the divorce proceeding is instituted at Chinese courts, will China courts divide the community properties of the value increment of the equity interest indirectly held by one spouse?

Please note the contents in Part I above are the discussion of the general rules in relation to value increase of equity interests held by one spouse prior to marriage in which case the spouse directly holds the equities in the China company. However in the inquiry case, we are seeing the equity interests held by the spouse indirectly through a pass-through entity in BVI:

spouse —-solely or jointly with others—-> BVI——solely—> China Company.

With the legal person doctrine in operation, the BVI company, not the spouse, is the legal owner of the shares of the China company, so this concept may bar the China courts from recognizing the spouse as having any personal property in the China company at all. Instead, China courts will be well ready to recognize the spouse's personal property/asset in the BVI company as he or she directly holds in his or her name the shares in the BVI company.

However it is also an easily understandable point that the spouse ultimately owns the assets in the China company even if the BVI is not just a shell pass-through entity. The value of his ultimate shareholding in the China company can be easily worked out and so is the value increment over the time of their marriage life. After all, the shareholder is the ultimate owner of any given corporation or limited liability company based on the agency doctrine defining the relationship between shareholders and companies. You can read this post for more: Legal personality of Corporation and limited liability

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The fact that the value increment is based on and sourced from China asset will entitle China courts to exercise jurisdiction over the properties in question, provided that China courts will also recognize such assets as the spouse's personal property disregarding the BVI entity in between.

It is my personal opinion that it is very likely (though not guaranteed) that China courts will be willing to deal with the value increment arising from the ultimate shareholding in the China company in a way that the share structure of the China company won't be changed or affected, but the China court could be well ready to take into account the value increment of the shares altogether with other community properties in China when it makes the division for the divorcing couple.

The the rest of the job is to find evidences in the foreign country (BVI in the inquiry case) to prove the spouse holding shares in the BVI. Such offshore evidence discovery can be difficult indeed, but that is the nut the claiming spouse shall have to crack.

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