Legal issues regarding dormant investment by foreign investors in China

Description

Just came across an article on the Internet, entitled “Protection for the Rights & Interests of Dormant Shareholders” discussing the protection of legal interests of dormant shareholders. While this article cast some lights on the issue, but some of its points do not apply to foreign investors being a “dormant shareholder”. For example, it claimed that

> “Therefore, as long as the contract is established on the basis of agreement and goodwill of both sides, the legal effect of such contract should be confirmed.”

Apparently, it is true of dormant shareholder agreement with Chinese nationals involved only. But when it comes to the contract between foreigner dormant shareholder with their Chinese dummy/nominee shareholders, the legal effect may not be well confirmed at all.

I have written a brief summary a year ago introducing a judicial interpretation handed down by China Supreme Court in respect of dormant investment by foreign investors, one of the most important points in that interpretation.

Here it is:

In FDI practice, we see a number of cases where foreign investors make investment in China via a nominal shareholder for various reasons such as circumventing industry restriction rules, foreign exchange rules, government formalities and so on. Very often, such arrangement is intended to last for years. The long period breeds disputes between the parties, giving rise to an array of litigious cases. The China Supreme Court has issued in August of this year (2010) a judicial interpretation, titled *Provisions on Several Issues of Trial of Foreign Investment Disputes* (the “**Provisions**“). In these 24-article Provisions, seven articles are devoted to address the issues in relation to dormant investment via nominee shareholders.

The overall idea of the Provisions is that foreign investment through a nominal shareholder is doable but the rights and obligations of the parties (dormant shareholder, nominal shareholder and the invested company) shall be clearly and smartly designed and defined in the related contract. A contract is a must in such an arrangement esp in term of protecting the foreign investors.

I hereby select and put forward a few points in the Provisions that may intrigue you.

1. Validity of the contract

Previously courts tend to invalidate the contract under which a foreign investor uses a Chinese person as nominal shareholder in registering a company on the ground that such contracts violate the foreign investment regulations which require that foreign investment shall be approved by foreign investment department. Now in Article 15 of the Provisions, it is provided that such a contact shall be held valid if it does not have the invalidating conditions as provided by laws and administrative regulations. The “ invalidating conditions” shall mean those set out in China Contract Law, such as contracts resulted from fraud and coercion that damages state interests, contracts used as disguise covering illegal

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pursuits, and contracts that violate social public interests and compulsory provisions of law and administrative regulations. Great pity that it has not been made clear what such “invalidating conditions” are, or at least shortlist a few. Given this ambiguity, it is believed that contracts under which foreigners making dormant investment in some restricted or prohibited industries may be held void, as such restriction and prohibition policies are generally regarded as concerned with state interest or public policy.

As the contract is valid, parties thereto can enforce the contract in courts now.

2. What if the nominee shareholder breaches contract?

In case that the nominal shareholder refuses to perform the contract, resulting in failure of attaining the purpose of the contract by the dormant investor, the dormant investors may ask the court to terminate the contract and claim damages from the nominal shareholder based on the contract. Please note that the remedy available to the real investors under the laws is to pursue the breach liability of the breaching nominal shareholder, which often means monetary compensation. Given that it is always difficult to compute losses in such situations, it is important to stipulate in the contract a liquidated damages clause providing for the way of computing losses in case of breach of contract by either party.

When relationship gets sore, it often leads to end of the investment. Dormant investors often have to back out of the investment seeing a good investment gulped by others.

3. What if the contract is invalid?

In case that the contract is held invalid by court, the dormant investor may have the right to recoup his or her invested money but the benefits accruing thereon do not belong to the dormant investor only. In such a circumstance, the part of the equity value in excess of the original invested money shall be distributed between the parties according to the conditions of the investment and the involvement of either party in the management of the invested company. If the nominal shareholder does not want to hold the investment any longer, the court may order the sale of the equity through auction in order to return the original invested money to the real investors and any excess thereof shall be distributed as described in preceding sentence.

4. Can I ask to become the direct shareholder of the company?

As a general principle, dormant investors cannot ask courts to affirm and recognize his or her shareholdership in the invested company or to change the shareholders of the invested company, unless the following conditions are all satisfied: (1) the real investor has already made the investment; (2) other shareholders in the company other than the nominal shareholder accept the shareholdership of the dormant investor in the company; and (3) the court or the party has obtained the approval of foreign investment department for changing the dormant investor to be the shareholder during the process of litigation.

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It is obvious that it will not be easy for dormant investors to become a direct shareholder of the company. Another hurdle for the change is the foreign exchange issue. In many cases, under such nominee shareholder arrangement, the invested money is RMB instead of foreign currencies. But, foreigners are prohibited at large from making investment in China in Chinese currency. It remains tobe seen how this issue will be tackled in practice.

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