
China Business Series: Legal Representatives

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The "legal representative" of a Chinese company has wide-ranging powers. Multinationals should carefully select the legal representatives of their PRC subsidiaries and plan in advance for issues that occasionally arise. This advisory is one in a series prepared by Pillsbury's China Practice on questions frequently asked by our clients doing business in China.

Here, we summarize current PRC laws relating to the legal representatives of foreign invested companies, including the responsibilities and potential liabilities of a legal representative and some methods of minimizing risk. This memo also briefly discusses the general procedures for appointing or removing a legal representative. Unless otherwise specified or as otherwise indicated by the context, we will use the word "company" to refer to a foreign invested company in China, rather than its offshore parent company.

What is a "Legal Representative"? Qualifications And Authority

By law, every company in China must have a "legal representative." The concept may be unfamiliar to US companies, but is more significant than it may first appear. In China, the "legal representative" of a company has broad-ranging power to act in the name of the company. This is similar to the authority of a CEO, but the Chinese position is more explicitly addressed in the law. And, even if a Western investor might be comfortable with a CEO having broad-ranging authority, frequently such an investor will not realize that the bureaucratic-sounding position of "legal representative" is such a powerful position.

A company's legal representative has authority to act on behalf of the company in any matters within the business scope of the enterprise. Subject to the limitations imposed by the legal principle of apparent authority, actions taken by a legal representative are binding on a company as a matter of law. For example, a legal representative can enter into negotiations and sign commercial contracts on behalf of a company without any need to present evidence of his corporate authority.

The owners of a PRC company have some discretion in choosing the company's legal representative. Frequently, the Chairman of the Board (or, in cases where the company has a single "executive director" rather than a board of directors, the executive director) is the legal representative of the company, but the owners can also chose one of the other directors or the general manager of the company. There are no residence or citizenship requirements, but the legal representative must be a natural person and cannot be

a corporation, partnership, or other form of "legal person." In addition, the following persons **cannot** serve as legal representatives:

- 1) An individual with no civil capacity or with limited civil capacity – for example, a minor, a person who is mentally incapacitated, or a person who is legally incompetent;
- 2) An individual who has been convicted and sentenced for corruption, bribery, misappropriation of property, embezzlement of property or disruption of economic order, and less than five years have passed since the end of any term of imprisonment or payment of a fine;
- 3) An individual who has served as a director or general manager of a company which has declared bankruptcy or has been adjudged insolvent, and is personally liable for the bankruptcy, and less than three years have passed since the completion of the bankruptcy liquidation.
- 4) An individual who has served as the legal representative of a company whose business license was revoked or that has been ordered to close down for violation of law, and less than three years have passed since the revocation or close-down.¹
- 5) An individual who has a large amount of due and unpaid personal debt.

Appointment/Removal of a Legal Representative

To appoint or remove a legal representative, a company must undertake certain formalities with the appropriate approving authority,² the registration authority,³ or both.

In the case of a new company, an appointment letter and shareholders' resolution naming the first legal representative for the company will be submitted to the approving authority as part of the incorporation process. We generally recommend against naming the legal representative in a company's articles of incorporation. There is no requirement to do so, and it makes any subsequent change more difficult.

If a company has already been established and wants to replace its existing legal representative, it will have to register the change with the registration authority.⁴ This process can take 10-20 working days depending on where the company is located. After the registration authority completes its review, the company must submit the same amendment application to various other government entities, such as the Administration of Foreign Exchange, the local statistics bureau, and the local taxation bureau, because the licenses or certificates issued by those government entities to the company bear the name of the legal representative.

¹ PRC law is not clear whether this would include a foreigner who was the owner, Chairman or executive officer of an offshore company that had fallen out of good standing. As a practical matter, when applying for the registration of the legal representative of a company, the PRC approving authority and the registration authority would only check domestic public records.

² Depending on the amount of the registered capital and the total investment of the company, the approving authorities may be the Ministry of Commerce, or its local branches, the Commission of Foreign Trade and Economic Cooperation, or COFTEC."

³ Depending on the amount of the registered capital and the total investment of the company, the registration authorities may be the State Administration of Industry and Commerce (SAIC), or its local branches (AIC).

⁴ Unless the name of the existing legal representative has been indicated in the articles of association of the company (in which case replacing the existing legal representative will require also an application that needs to be filed with the approving authority to amend the articles of association), there is no need to go through the approval process with the approving authority. We, therefore, suggest that the company avoid naming the legal representative in any incorporation documents.

The process of amending a company registration to reflect a change in legal representative is normally straightforward, but there are some practical issues to be aware of:

- 1) The assistance and cooperation of the existing legal representative is desirable. The registration authority in some cities may request a resignation letter from the existing legal representative before registering the replacement. In some cases, the company can avoid presenting a resignation letter by providing other supporting documents, such as a board resolution from the offshore parent company, but it could cost additional time to get the board resolution properly executed and translated, if it is not already in Chinese.
- 2) The company should think ahead about transitional matters, such as who will be responsible during the period between removal of the existing legal representative and formal recognition by the registration authority of the new legal representative (who until then cannot legally act as the legal representative of the company). We normally recommend that our clients have the existing legal representative execute a power of attorney authorizing another person (or the new legal representative) to act as the legal representative of the company during the transitional period. The power of attorney should be carefully drafted to cover all daily operational issues.
- 3) The replacement of an uncooperative or hostile legal representative requires the company to take protective measures such as notification of major business partners, confiscation of company seals and chops that are in the custody the existing legal representatives, and, in some cases, change of bank signatures and authorization codes of online banking systems. In an extreme case, an uncooperative legal representative can cause significant interruptions in a company's operations. If this situation is anticipated, careful steps should be taken well in advance to forestall the exiting legal representative's ability to cause problems during the transition period, such as pre-executing resignation documents and the power of attorney mentioned immediately above.

Potential Liabilities of a Legal Representative

When a legal representative acts in compliance with law and the internal rules of the company, he or she will not be personally responsible for any actions taken in his/her capacity as a legal representative. However, if a legal representative violates the law, even if pursuant to due authorization by the company or its board, the individual is potentially subject to personal liability for both civil and criminal penalties. Since most corporate actions are taken by the legal representative, the effect is to make the legal representative at least potentially liable for violations of law by the company itself.

Below is a summary of some typical scenarios under which a legal representative might be exposed to administrative, civil, or criminal liabilities or punishment.

I. Breach of Fiduciary Duties

Articles 148 and 149 of the PRC Company Law set out the fiduciary duties of directors and management officers, which include the duty of loyalty and the duty of care. There are no clear stipulations under PRC law about the scope and content of these fiduciary duties, but PRC law does list several specific activities that will be considered a breach of fiduciary duty:

- a. Accepting bribes or other illegal income;
- b. Misappropriating the company's assets;

- c. Embezzling the company's funds;
- d. Depositing the company's funds into a personal bank account;
- e. Lending the company's funds to another person, or using the company's assets to provide security for another person, without authorization from the shareholders or the board;
- f. Entering into contracts or transactions with the company without the approval of the shareholders, or in violation of the articles of association of the company;
- g. Diverting the company's business opportunities for personal benefit or for another person's benefit, without the approval of the shareholders;
- h. Engaging in any business directly or participating in another person's business that is competitive to the business of the company;
- i. Misappropriating any commission on any transaction to which the company is a party;
- j. Disclosing confidential information of the company without proper authorization; and
- k. Engaging in other activities that are inconsistent with his or her duty of loyalty to the company.

Breach of fiduciary duties entitles the company to confiscate any illegal income deriving from the breach.

II. Illegal Activities in Capacities of Directors or Senior Managers

Article 150 of the PRC Company Law provides that if any director, supervisor or senior manager, in the course of performing his or her duties, violates any law, administrative regulation or the articles of association of the company, he or she should compensate the company for any resulting losses caused. This imposes a requirement on the directors or the senior managers to make an independent judgment on the legality of their actions (as opposed to simply following the instructions from, for example, the board of directors, because it does not matter whether the actions have been properly authorized, as long as the actions are in violation of the laws and regulations and cause losses to the company, the directors or senior managers (or the legal representative acting as a director or a senior manager) will be held responsible.

III. Illegal Activities of the Company

The legal representative of a Chinese company can be civilly liable for illegal conduct by the company itself. Article 49 of the PRC General Principles of Civil Law lists the following activities of a company that might expose its legal representative to administrative sanctions or fines or both.

- a. Conducting illegal operations beyond the business scope approved and registered by the government authorities;
- b. Concealing material facts from registration or taxation authorities;
- c. Secretly withdrawing funds or hiding property to evade repayment of debts;
- d. Disposing assets without proper authorization after a company is dissolved, terminated or bankrupt;

- e. Failing to register or make a public announcement promptly upon any changes to the company, and causing significant losses to interested persons; or
- f. Engaging in other illegal activities and damaging the State or public interests.

In these cases, the legal representative can be subject to administrative sanctions or fines or both, and criminal punishment if the elements of a criminal offense are met.

Generally, a legal representative will not be held criminally liable for criminal acts committed in the name of the company. However, for some criminal offenses, the PRC Criminal Law has extended the punishment to both the company and "persons who are directly in charge or directly responsible for the crime." Although the PRC Criminal Law does not provide a clear definition of "directly in charge" or "directly responsible for the crime," it is commonly understood that the terms include the legal representative of a company. Typical criminal offenses that expose the legal representative of a company to criminal punishment include manufacturing and sale of counterfeit products, tax evasion, and copyright infringement.

IV. Compulsory Measures Against Legal Representatives

If the company is involved in an ongoing bankruptcy proceeding, an unsettled tax dispute, or an unsettled civil proceeding, some procedural rules may also impose restrictions on the ability of a legal representative to leave the country.

Ways to Minimize the Risks

Depending on a company's business needs, we normally suggest one or more of the following measures to minimize the risks faced by legal representatives, directors and managers in China. There are certainly other methods that can be employed, and we are happy to discuss alternative approaches in specific cases.

I. Indemnification Agreements

An Indemnification Agreement is an agreement by the company to indemnify and hold harmless the legal representative (or directors and other senior managers) from certain claims or losses suffered by the legal representative by reason of, arising out of or relating to his actions or failures to act as the legal representative, member of the board of directors or manager of the company. Depending on the needs of the company, the indemnification agreement can include restrictions on the types of damages, total amount of damages, and the situations that will enable the legal representative to enjoy indemnification from the company.

An Indemnification Agreement can be a part of the employment agreement with the legal representative or an independent contract.

II. Liability Insurance

Directors' and officers' liability insurance (D&O insurance) is increasingly available for directors and officers of Chinese companies. Typically, D&O insurance is provided to directors and senior managers of a public company to cover losses or damages arising from certain types of alleged wrongful conduct.

III. Well-Drafted Articles of Association and Internal Rules

Well-drafted articles of association and comprehensive internal rules are necessary for the healthy development of a company. They clearly delineate the duties and liabilities of senior management officers, directors, and the legal representative, in addition to providing a clear reference for the resolution of potential disputes. Indemnification agreements as well as the internal rules of the company should address issues such as when the legal representative needs to obtain proper authorization from the board before taking actions, or what types of actions taken by the legal representative will be considered to be his or her personal actions instead of the company's.

China does not have a "business judgment rule" similar to the concept which is widely recognized in the U.S. Nevertheless, a company can adopt such a concept in its charter and internal rules. Incorporating a "business judgment rule" in corporate documents can also work with any indemnification agreements to provide thorough yet not unreasonable protection for a legal representative.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

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