ISSUE 3 | VOLUME 9 | JULY 2011

CHINA Legal Bulletin

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The China Legal Bulletin is produced by

Wang Jing & Co. Law Firm

Executive Summary

Company Law

The Third Judicial Interpretation on Company Law (the Interpretations), issued by the Supreme People's Court, aims to clarify a number of longstanding issues regarding company law. It addresses in detail the liabilities of corporate shareholders and senior management as well as the methodology and adequacy of capital contributions. According to the Interpretation, the name, whether it is an entity or a person, which is used to conclude a contract will bear the liabilities. With the Interpretation in place, certain rights will also be reasonably restricted for shareholders who fail to contribute their capital in full, such as the right to ask for a profit report. In this article, we discuss some of the major changes the Interpretation brings to the field and provide some advice on how to prepare for them.

Breach of Contract

When a party breaches a contract agreement it can lead to severe damages or losses to the non-defaulting party. The Contract Law of the PRC and the United Nations Convention on Contracts of International Sales of Goods provides both guidelines and limits to the compensation for any damages or losses incurred as well as the method for calculating the amount of compensation for damage. According to the two documents, the defaulting party will have to compensate the other party for all losses to existing property and interests receivable as long as the rules of foreseeability and mitigating losses are followed. We discuss the basics on how such damages, including liquidated damages, are assessed, limited, and pursued in our article.

Chongqing Reportedly Creating a Cloud Computing Development Area

On April 12th, 2011, Chongqing Economic and Information Technology Commission began construction of a 150,000 square kilometer cloud-computing development area. This area will be China's first step in the business of cloud computing technology. "The Great Firewall of China" has been an obstacle towards China's emergence and China is eager to boost its status in the development of this new technology.

The "International Offshore Cloud Computing Special Management District" in Chongqing will reportedly be directly connected to the Internet free of any government controls in order to attract more business from foreign corporations. However, it has been reported that this cloud development zone will be accessible only to foreigners and foreign companies.

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Introduction to the Third Judicial Interpretation on Company Law

Last amended in 2005, the Company Law has significantly enhanced the effectiveness of settling disputes in court. However, some issues have remained unsettled, and some legal systems have varying fundamental provisions and principles which have led to conflicts over the application of the law. To deal with such problems the Supreme People's Court issued the Interpretations. We discuss some of the major issues addressed by the Interpretations and give some advice on how to adapt to them below.

The Burden of Liability

Concerning the liability borne by promoters when concluding a contract in the course of establishing a corporation, the Interpretations provide an "apparent" standard. To be specific, if a promoter concludes a contract in his own name, he assumes the contractual liability, but if the promoter concludes the contract in the name of the entity that will become a corporation, that entity will bear the contractual liability after its incorporation. In order to protect the promoter's interests, we recommend that promoters conclude contracts not in their own name but in the name of the entity.

Capital Contributions

In practice, disputes related to capital contributions, by way of non-monetary properties, are not uncommon. One topic of dispute is the criteria for determining whether the subscribed capital is contributed in full. With regard to this issue, the Interpretations establish that equal attention should be paid to changes in ownership and actual transfer of properties. For example, if a capital contributor provides their portion in real estate, their contribution is only deemed complete when

- the real estate is actually handed over to the company for use, and
- the ownership transfer procedures are completed.

Unfortunately, the latter of these two criteria receives too little attention in actual practice. Currently, in their capital verification reports, accounting firms pay little attention to the handling of changes of ownership, and they do not examine or verify whether the title transfer procedures are completed. In the past, some corporations would only confirm capital contributions based on the capital verification report issued by an accounting firm. As a result, there have occasionally been cases where the title transfer formalities could not be completed due to defects in the contributed assets despite the fact that the real estate/assets had actually been handed over. We suggest that for future verification of capital contributions, the status of the title transfer should be carried out with care and in accordance with the Interpretations.

Adequacy of Capital

The Interpretations provide strict rules regarding the adequacy of the capital of a company. For example, the law that the promoter of a joint-stock, limited company bears joint and several liabilities for capital contributions from shareholders now also applies to limited-liability companies and extends to a number of other cases as well. Directors or senior executives who default on their portion of a capital increase or assist shareholders in secretly withdrawing funds and third parties who provide capital contributions to the corporation before shareholders withdraws or transfers capital now bear joint and several liabilities as well. Moreover, the Interpretations restrict the rights of the shareholders who fail to contribute capital in full or illegally withdraw the contributed capital. As a result, shareholders' rights such as the right to ask for a profit report, the preemptive right to subscribe for new shares, and the right to ask for a distribution of residual property, etc., have been restricted.

Actual Capital Contributors and Nominal Shareholders

The Interpretations explicitly stipulate that nominal shareholders shall not rely on the corporation's registry information to act against an actual capital contributor. However, the shares that a third party, acting in good faith, acquires from a nominal shareholder in accordance with the registered information of the corporation are legal and valid. This principle also applies to circumstances where the actual shareholder is inconsistent with the registered shareholder due to a failure in completing the registration formalities for the share to transfer in a timely manner after the transaction. If the failure stems from the negligence of the director, senior executive, or actual controller of the corporation, the negligent party bears all liabilities for compensation.

Conclusion

The Third Judicial Interpretation on Company Law pertains mainly to the regulation of the liabilities of company shareholders and senior management, and the clearly-defined personal liabilities of the senior management are particularly noteworthy. We believe the institution of the Interpretations better codifies the responsibilities of corporate shareholders as well as senior management and recommend all shareholders and businesses be aware of them.

By: Zhao Shuzhou / Hu Jian

Compensation for Damages for Breach of Contract

Compensation for damage caused by a breach of contract refers to the liability a party faces for failing to perform the contract, either in full or in part, based on the terms of the contract itself or according to PRC law. Currently, the PRC Contract Law, the relevant judicial interpretation and the United Nations Convention on Contracts of International Sales of Goods that China was party to (hereinafter referred to as "Convention") provide the following for damages for breach of contract:

I. Scope of Compensation for Damage

According to Article 113 of the PRC Contract Law, when a party fails to perform its contractual obligations or its performance fails to conform to the agreement and causes losses to the other party, the amount of compensation for losses shall be equal to those losses and include the interests receivable after performance. Article 74 of the Convention also conforms to this definition.

Losses to Existing Property

Losses to existing property, or "active losses," are the damages suffered by the injured party due to the defaulting party's breach of contract. These include direct and indirect losses such as expenses made towards performance of the contract and reasonable expenses made to limit the extent of damages. The injured party seeks compensation restoring it to the position it was in before the contract.

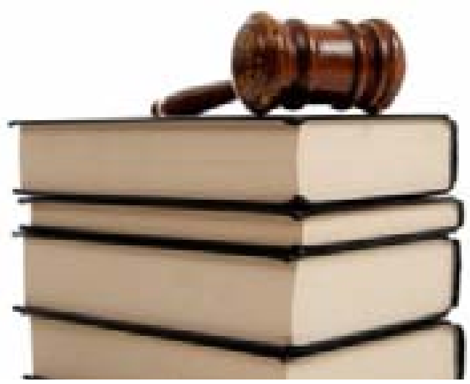
Losses to Interests Receivable

Interests receivable are different from existing interests in that they are not in the possession of the contracting parties prior to performance. This form of interest is a property right that the contracting party expects to obtain after the contract is fully performed. Interests receivable are pure profits, and thus fees paid for obtaining these interests are excluded.

Interests Receivable Bear the Following Three Features:

- **Futurity**: the interest is not in the contracting parties' real possession
- **Expectability**: the interest is expected by the contracting parties upon the execution of the contract, and is expected to be obtained through performance of the contract
- **Actuality**: the profit has conditions of realization and will be acquired by the contracting party after performance. The injured party can claim for compensation for losses to the interest receivable, which would put the injured party in the position that it would have achieved if the contract were performed.

II. Rules Limiting Compensation for Damages



Rule of Foreseeability

According to Article 113 of the PRC Contract Law, the amount of compensation for losses shall not exceed the probable losses caused by the breach of contract that were foreseeable or should have been foreseeable when the contract was originally formed. According to this rule, the injured party is entitled to compensation only when the damage caused by breach of contract is foreseeable by the defaulting party at the time of contract formation. If the damage is not foreseeable, then the defaulting party does not have to compensate. This reasonable foresight test ensures that the contracting parties can adequately measure future risk, and calculate possible expenses and interest. If the future risk is too great, then the contracting parties can choose to forego business dealings. But parties are not burdened by fears of endless liability. The principle of reasonable foresight limits the scope of compensation for damages, thus promoting autonomous and equitable transactions.

Three points should be noted in applying the rule of reasonable foresight:

- It limits damages to actual losses and losses of interests receivable.
- It does not apply to the stipulated compensation for damages.
- Whether the loss was or should have been foreseeable is judged according to the facts and conditions when the was contract formed.

Rule of Mitigating Losses

The rule of mitigating losses means that after one party breaches the contract, the other party should take reasonable measures to prevent further losses. Otherwise, the injured party may not claim losses that occurred after the breach. This rule is reflected in Article 119 of the PRC Contract Law and Article 77 of the Convention.

This rule is based on the principle of good faith. Failure to perform this obligation constitutes a breach of good faith. All of this reflected in the principle of fault liability. Here, the party that fails to take reasonable measures to prevent further losses after breach of contract is at fault, and the wrongdoer should thus be liable for the consequences caused by his fault.

In summary, the rule of mitigating losses has three features: First, it recognizes that the breach of contract by one party causes losses. This means the injured party is not at fault for the loss, so the breach of contract by two parties is not constituted. Second, the injured party is sometimes in a position to prevent further losses stemming from the breach of contract. The injured party's actions in preventing further losses should be considered under the principle of good faith. The measures taken by the injured party must be economically reasonable and timely. And third, the rule of mitigating losses takes into account whether further losses actually occurred.

III. Calculation of Amount of Compensation for Damage

Calculation of Losses to Actual Property

Calculation of losses to actual property is a relatively simple concept. Generally, the amount of compensation is calculated based on the losses and fees that the injured party suffers. For example, in a sale of goods contract, after one party is found to be in breach, the other party adopts an alternative transaction (the buyer buys alternative goods or the seller resells the goods). The injured party can then claim for compensation based on the difference between the contract price and the trading price of the alternative goods The injured party can also choose to instead, when there is an established market price for the goods, claim for compensation based on the difference between the contract price and market price of the goods when the goods were received or when the contract was determined valid.

Calculation of Interests Receivable

Generally, compensation for lost interests receivable is calculated by comparison. The amount should reflect that of a typical transaction under the same circumstances. The accuracy of this calculation will depend on how similar the surrounding circumstances of the transaction are to a typical transaction of its kind. For instance, in a claim for lost wages, you could consider the amount of income earned by the injured party prior to the breach of contract as compared to what he actually earned (nothing).

IV. Agreement on Liquidated Damages

When Applied Jointly with Compensation for Damage

Article 114 of the PRC Contract Law provides that contracting parties can agree to a predetermined damages award, or liquidated damages, to be paid in the event that one of the parties breaches the contract. In practice, contracting parties always reach an agreement on liquidated damages.

In contract liability, liquidated damages have the dual purpose of compensation and penalty. This contrasts with compensatory damages, which are only intended to compensate the injured party. Thus, compensation for damage is always closely related to actual damage, while the amount of liquidated damages is not necessarily associated with actual damage. Even when the breach of contract does not cause any actual damage, liquidated damages must still be paid. If the compensatory portion of the liquidated damages is insufficient to cover the losses suffered by the injured party, then the party in breach should pay the difference to achieve full compensation. Liquidated damages and compensation for damage can thus be used jointly. However, if both types of damages are used, the amount of liability cannot exceed the actual loss to the injured party. This has been codified in the Notice of the Supreme People's Court on Correctly Applying the Interpretation II of Several Issues concerning the PRC Contract Law. Thus, a liquidated damage clause is often included to limit damages rather than to increase them.

Limit on the Amount of Liquidated Damages

Parties to a contract can freely determine the amount of liquidated damages to be paid when one party violates the contract. Furthermore, Chinese law does not impose limits on the amount of stipulated liquidated damages. However, according to Article 114.2 of the PRC Contract Law, when the amount of stipulated liquidated damages is less than the losses incurred, the injured party can seek an increased damage award by applying to the People's Court or an arbitration agency. Likewise, if the amount of liquidated damages is unduly greater than actual losses incurred, then the party in breach can apply to the People's Court or an arbitration agency for a reduction. Judicial Interpretation II specifies that liquidated damages should not be thirty percent greater than the actual losses incurred by the non-breaching party.

In adjusting liquidated damage awards, the court bases its decision on actual losses, the parties' course of performance, fault of the parties, and expected profit. The court always considers these factors in light of the principles of fairness and good faith.

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