



Turkish Industry & Business Association

2009/005

CHINA BUSINESS INSIGHT

September, 2009

`` Individual and Corporate Risks & Precautions for
Foreign Invested Enterprises in China ``

Organization of a Limited Liability Company (LLC)
Legal Representative's Power and Company Liability
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Monthly Bulletin, prepared by TÜSİAD Beijing Office

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When establishing an entity in China, investors must select a Legal Representative and a Supervisor to operate and manage the entity according to the People's Republic of China's (PRC) company law. It is important to pay careful attention to the selection of people in these positions and to make sure precautionary measures are taken from the very beginning of the operation to protect the company. It is then also important for the people in these positions to understand their legal liability within the company and to place internal control systems for smooth operational purposes.

Organization of a LLC

As a business owner, you will be faced with many important decisions, including what business structure to use in your company formation. According to the PRC's Company Law, the Investor (company or individual) is the designated shareholder. The investor shall then appoint a Board of Directors, whereby there should be a minimum of three persons and a maximum of 50 people. A supervisor must also be selected by the Investor. The supervisor's role is to "supervise" all activities being conducted by the Board of Directors.

Until recently, only a company's chairman (or its executive director if it did not have a board of directors) was normally permitted to be the company's Legal Representative. But the Legal Representative can now be a person not appointed as a member of the Board of Directors. This person will be responsible for the activities of the Limited Company and is considered the "legal face" allowing him to sign all related government forms and any documents that are required by the government offices. This person can also have automatic authorization on bank accounts and can create any type of Powers of Attorney.

A first-time foreign investor choosing a Legal Representative for its new PRC company typically must choose either an existing employee, probably lacking experience in the PRC, or a new PRC recruit, inevitably lacking familiarity with the investor's culture,

policies, decision-making procedures and home-country compliance obligations. These alternatives, and related risks and precautions deserve much more careful attention than they usually receive. **It is recommended** that FIEs in China should pay more attention to the appointment of these positions than in their home countries in order to reduce risks for the company as well as for the individuals involved.

Legal Representative's Powers and Company Liability

When is a company liable for the unauthorized actions of a "rogue" Legal Representative? The PRC Contract Law has clarified this question somewhat by stating that "If the Legal Representative of a company creates a contract in excess of authority limits, such representative's action is valid except where the counterparty knows or should know that it exceeded authority limits."

The difficulty lies in how should the counterparty know? If authority limits are specified in a company's articles of association, which are required to be filed with the local Administration of Industry and Commerce, the company may argue that they are a public record that should be known by its counterparties. But counterparties can rightly argue that the PRC has no tradition of requiring (or of universally permitting) unrelated persons to



check this public record. **The customary precaution** is for counterparties to review the company's business license, and to rely on the Legal Representative name shown on it. If another person signs a contract as an authorized representative of the company, then a letter of authorization or power of attorney issued by the Legal Representative will be reviewed.

In order to persuade a court or arbitration tribunal to release a company from liability for an unauthorized contract or other action by its Legal Representative, the company will generally need to demonstrate that it has made reasonable efforts to define, implement, record and give notice of its Legal Representative's authority limits. **One approach** likely to be useful is to specify authority limits in the articles of association and post them on the company's website, while encouraging and facilitating viewing of the website by potential counterparties.

Public disclosure of the Legal Representative's authority limits can be minimized by specifying in the articles of association merely that the scope of the Legal Representative's authority will be determined by resolutions of the board of directors. These resolutions would not need to be disclosed except to potential counterparties and other persons who 'need to know.

Chop/Stamp Control

While signatures are used to validate documents or bind a contractual relationship in the West, the chop is **the primary tool** in China. There are several chops available to each entity.

➤ Company Chop

A legally registered company is required by law to have at least one Company Chop, which is **the most important** for the organization. This chop can legally bind the company and is required on documents such as contracts, internal and external

memorandums, documents filed with the government or bank account applications.

➤ Legal Representative Chop

Another significant chop is the Legal Representative chop, a **carved version** of the Representative's name which represents the signature. The Legal Representative Chop together with the Company Chop is required for numerous official documents, such as the applications for business licenses and tax certificates.

➤ Finance Chop

The Finance Chop is usually kept by the company's finance officer in order to conduct the daily transactions. It is required for banking transactions such as cash withdrawals, wire transfers or changes to account information. The Company's bank will keep a specimen stamp of the chop to verify the documents presented to the bank.

➤ Contract Chop

The Contract Chop can only be used to execute contracts. It is possible that a company has several contracts chops allocated to certain types of contracts.

➤ Customs Chop

The Customs Chop is used to execute all customs activities for import and export trade.

Consequently, any person in possession of the Legal Representative Chop or Company Chop may exercise the Legal Representative's power to bind the company. In order to prevent unauthorized use, each Company should **restrict access to all chops** and delegate authorized use of a specific chop to a custodian whose role is relevant to the use of the chop. The chops should be physically safeguarded by the authorized custodians with clear policies in case of their absence. There should be a record of any use of each chop including the **time, date, signature and purpose of use**. Additionally, a company should have written policies regarding the circumstance and purpose of use for each chop as well as the



custodian's responsibility for the chop. Chops should never be used or passed onto anyone without proper approval.

A common oversight made by FIEs is that they leave responsibility of the chops to local employees, and in some cases, after only over a year of operation, find out that contracts with third parties were chopped which had not been approved by the Board of Directors or even the Headquarters. At the moment of firing they will then discover that the local employees and acting General Manager had used the company chop to re-negotiate his employment contract, giving them a greater compensation in the case of early termination.

This is a worst-case scenario example, but if proper policies in regards to the chops are in place, companies should not be too worried about the use of them and the potential misuse. In reality, the risk of misusing a chop is similar to the risk of faking a signature. There are [severe penalties for chop-related fraud](#) and anyone who fraudulently obtains property or goods could be subject to a three year prison sentence and fine.

The law is so strict, that even if a company misplaces a chop and makes a new one without informing the Public Security Bureau, the company as well as the chop maker could potentially be charged with forgery.

Recently in Shenzhen a new regulation has been issued stating that should a company in Shenzhen lose the company chop, the Legal Representative is required to be present and file the application in person. This person is required to come to China prior to notifying the loss to the authorities. In Beijing and Shanghai the company has to report the loss to the Public Securities Bureau and make a public announcement in the newspaper. The Legal Rep does not have to be present in China. After the announcement the company has to make a new set of chops.

Termination of a Representative

Problems can arise when a company wants to lay off its Legal Representative. The Legal Representative normally controls the Legal Representative Chop and the Company Chop which means that he or she would then be responsible to approve his own termination documents.

[It is recommended](#) for the companies to take precautionary measures to prevent any difficulties in this regard. The most reliable precaution is to have the Legal Representative [sign undated termination-related documents](#) before being appointed.

Supervisory Board

The new position of company "Supervisory Board" is also relevant to the potential liabilities of the Legal Representative. The Supervisory Board's role is to exercise supervision over "the execution of company duties by the directors and senior management personnel". If notices are delivered to the Supervisory Board when the Legal Representative plans or takes an important action, there should be less risk of the Legal Representative being held individually liable for those actions. The Supervisory Board, like the company's directors, is not required to reside in, or even to visit, the PRC. An individual that does not reside in or visit the PRC is likely to be less troubled by a threat of individual liability under PRC law, and would be a less attractive target for such a threat.

The Best Defence

There are several precautions that can be implemented to protect investors, their investment in China as well as the individual appointees, such as the following:

- A Legal Representative of an FIE should be selected carefully. Additionally, the appointed person should sign and chop undated termination-related documents before being appointed.



- The Legal Representative and other directors and managers can be provided with individual liability insurance, as the individuals invited to fill these positions may demand that investors give them a broad indemnity.
- The shareholder(s) should define clear limits on the authority of the company's Legal Representative and other officers along with procedures for approving actions that exceed those limits, observe and monitor these procedures, and should consider using the company's website and other channels to give notice to potential counterparties of the limits on these individuals.
- When establishing the entity in China, the parent company should not rely on the published and standard form of articles which is preferred by the local governments. The best compromise is to adopt the basic style and sequence of that form and add detailed provisions on the authority of the Legal Representative as well as other senior officers within the entity and any other points that are important to the shareholders.
- Additionally the company should have a chop control mechanism in place to record all usage and restrict access to the chops. If there is a clear policy as well as strict record keeping of possession and usage of the chop, the risk of misuse is reduced dramatically.
- If a chop is used for emergency purposes while the usual keeper is out of town, it is recommendable to leave it with your accountant or law firm.

Conclusion

In the normal course of business, risks can be reduced by clearly allocating particular powers and responsibilities to a number of company managers. Along with chop control and other internal controls (e.g., contract signing limits), this allocation of authority will not only reduce the risk to the Legal Representative and other personnel, but will also benefit the company by preventing important matters from 'falling between the cracks' and by enabling the Legal Representative to be more focused and less defensive.



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