Nominee Shareholder Agreement under Current Chinese Laws

Description

A nominee shareholder agreement (the "**Agreement**") used herein refers to the agreement or contract concluded between two persons (individual or body corporate) whereby A wants to invest in a certain company but for various reason he is hidden from public disclosure and instead, his investment is made and registered in the name of B who appears on public records or registration system as the official shareholder of the said company, and the Agreement sets out the terms and conditions of cooperation between A and B.

There seems no appropriate term in English for this arrangement. Some call it "dormant investment" or some "anonymous investment" or even "undisclosed investment".

Such an investment arrangement is quite popular in practice, and A and B can both Chinese or A is the foreign investor and B is a Chinese individual or company. As you can see, A is the party that actually makes the investment by contributing real money that is injected into the company, and B is the nominee shareholder who appears or holds himself out to be the shareholder of the company but he is bound by the Nominee Shareholder Agreement or Dormant Investment Agreement, whatever name you call it.

In the following text of this post, Party A is referred to as "actual capital contributor" and the Party B the "nominee shareholder".

I. Why Use a Nominee Shareholder

There are many reasons why such dormant or anonymous investment is adopted in practice.

1. A is not allowed at law to hold shares in a profitable business entity such as government officials;
2. for private reasons, A is afraid of being disapproved by the other shareholders;
3. if A is officially registered, the total number of shareholders in the company will exceed the bar prescribed by China Company Law;
4. A is restricted from making investment in such a company by his or her other obligations, for example, he is subject to non-competition obligation to his current employer or partners;
5. in the case of foreign investment in China, A may be hidden simply for the reason of avoiding onerous foreign investment approval formalities, or more often, A as a foreign investor is not allowed to invest in the industry or economic sector in which the company is engaged, or A wishes to invest and take up a percentage of shareholding greater than that allowed by the foreign investment restrictive rules. For example, in some restricted industries, foreign investment shall not be more than a certain percentage.

II. Validity and Effect of such Nominee Shareholder Agreement

So before or upon entering into the Agreement, the actual capital contributor may be wondering whether such a nominee shareholder agreement in valid in China and how much it can be protected under the Agreement.

There are two layers of issues to be considered: (1) validity or effectiveness of the Agreement itself, and (2) the effect of Agreement or in other words, what the actual capital contributor can achieve by concluding such an Agreement, for example, can he or she really enjoy any shareholder rights?

(1) validity of the nominee shareholder agreement

Basically China Supreme Court has issued two judicial interpretations addressing the validity of such arrangement in domestic investment and foreign direct investment in China.

Article 24 of *Provisions of China Supreme Court on Certain Issues of Application of China Company Law,* taking effect as of February 16, 2011, provides:

> Where the actual capital contributor and nominee shareholder in respect of a limited liability company have dispute over the validity of the contract concluded by them under which it is agreed that the actual capital contributor invests money and enjoys the rights and interests thereof and the nominee shareholder serves as such, such contract shall be considered as valid to the extent that it does not fall within the circumstances prescribed by Article 52 of China Contract Law.

Article 15 of *Provisions of China Supreme Court on Certain Issues of Foreign Investment Dispute Cases*, taking effective as of August 16, 2010, provides:

> A contract under which one party actually contributes capital and the other party serves as nominee shareholder in a foreign invested enterprise shall be considered as valid to the extent that it does not fall within the invalidating circumstances prescribed by the laws and administrative regulations.

The two interpretations virtually take the same stance as to the validity of such nominee shareholder agreement regardless of whether a foreign investor is involved or not. So the next question is what are those invalidating circumstances. As both interpretations have failed to identify any specific invalidating circumstances, it is then a matter of general contract law, namely, Article 52 of China Contract Law.

However in the case of such nominee investment in a foreign invested enterprise, there is a particular question to address: is the Agreement valid if the foreign invested company is engaged in business in restricted or prohibited industries or an industry in the Negative List as published by China central government?

Such rules concerning foreign investment categories in China are implementing rules of the administrative regulation promulgated by China State Cabinet breach of which can result in the

invalidation or nullification of a contract. It is our opinion that the nominee shareholder agreement as a way to circumventing the foreign investment rules is most likely to be invalidated by court.

But one familiar with foreign investment in China may easily find a defense for validating such anonymous investment arrangements: the widely existing VIE structured investments by foreign investors in China restricted telecom and internet industries. In essence, a VIE is contract based investment but over many years, China governments have acquiescently allowed such foreign investments to grow rapidly in some industries where foreign investments are restricted. So why now invalidate such a nominee shareholder agreement?

(2) Effect of Nominee Shareholder Agreement

Assuming the Agreement is valid, as the actual capital contributor, what does it mean to you? Are you safe from risks or does it enable you to act as a shareholder when you want to?

Often even some lawyers may inadvertently use the term “actual shareholder” in lieu of “actual capital contributor”, which is very misleading. In other words, the actual capital contributor, hidden from the company, other shareholders and the public, has nothing to do with being the actual shareholder of the company, and cannot assert any right or exercise any power as against the company. As a party to a commercial contract, he or she has no more rights and interests those those stipulated in or stemming from the terms and conditions of the Agreement.

That said, the actual capital contributor shall only rely on the Agreement/contract to protect his or her interests in the dormant investment. We even see China court enforce liquidated damages in the amount of millions of RMB as stipulated in the related nominee shareholder agreement. So serious anonymous shareholder shall make sure the Agreement is well written in his favor.

Actual capital contributor has some grave risks inherent and accidental to such business arrangement. In particular, he or she may lose all his investment if the nominee shareholder misbehaves. As a matter of China Company Law, any third party can rely on the company registration in deciding on who is the shareholder of the company or who is the owner of the shares in the company. Such third party reliance is protected by law in the commercial world. So if the nominee shareholder is deeply indebted or bankrupt, his or her creditor can go after the shares in the company for meeting the debts owed to such creditors. This risk has been manifested in a court case ruled by China Supreme Court.

To minimize or fend off such risk, it is advisable that the actual capital contributor shall register a pledge in his favor over the shares held by the nominee shareholder to ensure the nominee shareholder won’t be able to dispose of the shares without his knowledge or prevent the creditors of nominee shareholders from enforcing against the shares.

Reference post for more: click here.

III. New Development in Nominee Shareholder Arrangment in Foreign Investments

China has resolutely opened up more in welcoming foreign direct investment into China, adopting the so called Negative List for Foreign Investment that set out the industries and economic sectors inwhich foreign investments are restricted or prohibited. The Negative List has becoming shorter andshorter over time.

In the meantime, the formalities for setting up a foreign invested company have been relaxed and eased, transforming the original approval regime into filing system whereby foreign investment authorities won't substantively scrutinize or look much into the documentations submitted therefor, but rather a pretty much procedural job.

This has some significant legal impact on foreign actual capital contributors who have been investing in restricted industries by way of dormant or anonymous investment, making it easier for them to surface and become true and duly registered shareholder.

Let us go back to Article 14 of *Provisions of China Supreme Court on Certain Issues of Foreign Investment Dispute Cases:*

> Where according to their agreement, one party is the actual capital contributor and the other party the nominee shareholder in regard of a foreign invested enterprise, and the actual capital contributor requests to affirm his shareholdership in the foreign invested enterprise or amend the registration of shareholders in the enterprise, the court shall not support such claim, unless the following conditions are met concurrently:
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> (a) the actual capital contributor has actually made the contribution;
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> (b) other shareholders (except for the nominee shareholder) in the enterprise recognize his shareholdership in the enterprise; and
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> (c) the approval from foreign investment authority is obtained for turning the actual capital contributor into shareholder during the court proceedings.

The key point lies with condition (c) quoted above which is basically no longer applicable if the foreign invested enterprise engages itself in an industry that is off the Negative List.

So foreign investors that are the actual capital contributors to any nominee shareholder agreements may now consider exposing themselves and be a real shareholder.

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