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A Brief Analysis of the Types of Conflicts of Interest under Chinese Law

By David Pan | Stella Huang

Properly handling cases concerning conflicts of interest ("COI") is an important part of an enterprise's compliance system. To help enterprises effectively deal with COI cases, Llinks' compliance service team will publish a series of articles regarding the types, constituent elements and investigations of COI based on practice experience. ***This article Analysis of Types of Conflicts of Interest under Chinese Law is the first one of the series.***

Conflicts of interest ("COI") may arise when the interest of an organization contradicts with the interest of its members. Activities involving COI may breed corruption, impede the healthy and orderly development of organizations, and may even lead to violations of laws and regulations. As part of the internal control systems, it is very important to prevent and deal with COI between organizations and their members. This article is intended to sort out the provisions on conflicts of interest under Chinese law and to briefly analyze different types of COI under Chinese law.

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1. Concept of COI

Some departmental rules[1] and local regulations define COI between administrative organizations and public officials as the potential contradiction and conflicts that may arise between personal interest of government officials and public interest represented or safeguarded by their official status.

The *Guidelines on Conflicts of Interest in Enterprises*[2] published by the International Chamber of Commerce define COI between enterprises and individuals as the following: COI may arise when the private interest of an individual or of his/her close relatives, friends or business contacts diverge from those of the organisation to which the individual belongs. COI are a particular form of corruption where an individual grants himself/herself an improper advantage by exercising his/her decision-making power to his/her advantage (or to that of a person close to him/her). Typical COI include hiring relatives or favouring relatives as suppliers of goods or services.

By reference to the above provisions and the general practices in corporate compliance management, we categorize COI between a company and its members (including general partners, directors, senior executives, employees, etc.) as the potential contradiction and conflicts that may arise between the members' personal interest and the company's interest represented or safeguarded by their membership, which may influence the members' loyalty to the company, or cause the members to harm the company's interest in pursuit of their personal interest. When a member is involved in COI, his or her activities may probably prejudice the commercial interest or proprietary rights and interest of the company, have an adverse impact on the company's good reputation or influence the member's performance of his or her responsibilities and obligations towards the company.

2. Provisions on COI under Chinese law

There are two kinds of COI: statutory and contractual ones. After preliminary research and summarization, we have found around one hundred legal documents involving COI at or above the level of regulations. Contractual COI are established by both or multiple parties' agreement.

(1) Statutory COI

Statutory COI exist mostly in the following areas:

(a) Requirements of government agencies and judicial organs for their professionals and hired external professionals, such as provisions regarding judges' qualification in the *Judges Law*;

(b) Requirements for intermediaries and their staff, such as COI regulated in the *Lawyers Law*;

(c) Requirements for particular personnel in companies or partnerships, such as requirements for directors and senior executives prescribed in the *Company Law*, and requirements for general partners prescribed in the *Partnership Enterprise Law*;

(d) Requirements for banking, securities, funds, insurance professionals in the financial field, such as COI regulated in the *Securities Investment Fund Law*;

(e) Requirements in the field of food and drugs, for example, the *Drug Administration Law* prohibits the drug procurement personnel from accepting bribes.

Although there are laws and regulations which govern COI in the above fields, most laws and regulations only set out general requirements on COI. Currently, only the following regulations have enumerated specific circumstances of COI:

(a) *Several Provisions of the Supreme People's Court on the Implementation of the Code of Ethics by the People's Courts to Prevent Conflicts of Interest*, providing that court staff shall not take advantage of his/her influencing power to engage in specific activities;

(b) *Measures on Punishment of Lawyers and Law Firms for Illegal Acts*, providing that a lawyer shall not represent legal affairs in conflict with the interest of himself/herself or his/her close relatives;

(c) *Interim Provisions on the Prevention of Conflicts of Interest of Government Officials in the Ministry of Industry and Information Technology*, providing that government officials shall not carry out various activities in conflict with the interest of administrative organizations.

(2) Contractual COI

Apart from statutory COI stated above, COI between companies and their members are contractually established in most cases. Generally, as the core rules of staff management, COI policies are stated in labor contracts entered into between the members and the companies, administrative polices or labor rules of the companies (collectively, “COI policies”). In contractual situations, factors such as the members' activities, identities and kinship are mainly considered in defining COI matters. Contractual COI may arise out of the following circumstances:

(a) a member wants to seek his/her own economic interest;

(b) there is kinship or other personal relationships between a member and third parties;

(c) there are certain types of relationships such as employment between a member and third parties;

(d) a member operates or controls other business entities;

(e) a member commits acts of infringement against the company.

3. Main types of COI

In practice, there are six types of COI between a company and its members: breaching non-compete obligations, self-dealing, infringing trade secrets, accepting bribes, making personnel decisions by request, and illegally misappropriating and encroaching company property.

(1) Breaching non-compete obligations

Non-compete obligation means that a member shall not engage in any business that is identical or similar to the business of the company by which he/she is employed. There are statutory and contractual non-compete obligations. For example, as for statutory non-compete obligations, both the *Company Law* and the *Partnership Enterprise Law* provide that specific persons have non-compete obligations; as for contractual non-compete obligations, the *Labor Contract Law* provides that an employer and its employees who shall undertake confidentiality obligations may enter into non-compete agreements or include non-compete provisions in the labor contracts.

There are mainly three forms of non-compete violations:

(a) a member or his/her interested party (including but not limited to the member's immediate or collateral relatives, and immediate relatives of the member's couple) has direct or indirect economic interest in external companies in competition with the company, including a holding of equity interest, creditor's rights, share of property in partnerships, etc.;

(b) a member or his/her interested party serves as the director, senior executive or supervisor of other companies in competition with the company;

(c) a member works in other companies in competition with the company or provides services for such companies, and engaging in business activities in competition with the company.

If a member breaches non-compete obligations, the company will handle it in accordance with non-compete agreements or COI policies; if a director or senior executive breaches non-compete obligations, he/she may violate the duty of loyalty to the company, and the illegal gains shall belong to the company; non-compete violations by members of state-owned enterprises may constitute a crime of illegally operating similar business.

(2) Self-dealing

Self-dealing means that a member enters into a contract or deals with the company in violation of the articles of association of the company or without the approval of shareholders' meeting or shareholders' general meeting, an act of which causes damage to the company's interest. Self-dealing by directors or senior executives is expressly forbidden in the *Company Law*.

There are mainly three forms of self-dealing by a member:

(a) the member or his/her interested party has direct or indirect economic interest in the company's suppliers or client companies, including a holding of equity interest, creditor's rights, share of property in partnerships, etc.;

(b) the member or his/her interested party serves as the director, senior executive or supervisor of the company's suppliers or client companies;

(c) the member or his/her interested party works in the company's suppliers or client companies or provides services for such companies, and enters into a contract or deals with the company in violation of rules and regulations.

Self-dealing by a director or senior executive may violate the duty of loyalty. Consequently, shareholders are entitled to bring a shareholder derivative suit to cancel the transaction; under serious circumstances, self-dealing by the company's members may constitute a crime of vocational embezzlement, and self-dealing by members of state-owned enterprises may constitute a crime of unlawful profit seeking for relatives or friends.

(3) Infringing trade secrets

Trade secrets are technical information and business information that is not known to the public and has commercial value, and for which the owner has adopted confidentiality measures. Trade secrets are protected by laws such as the *Contract Law*, the *Anti-unfair Competition Law* and the *Criminal Law*. The *Labor Contract Law* provides that an employer may agree on confidentiality obligations with its employees. Below are the main forms of trade secret infringement.

(a) the member uses the company's trade secrets acquired based on the employment relationship, and competes or deals with the company;

(b) the member discloses, exposes or transfers the above trade secrets to third parties so that third parties are able to compete or deal with the company;

(c) the member seeks benefits by using the company's trade secrets for his/her own company or the company where he/she serves as director or manager.

A member's breach of confidentiality and infringement of the company's trade secrets may violate confidentiality agreements or COI policies, or may subject the member to administrative penalties for violating the protection of trade secrets by the *Anti-unfair Competition Law*. Under specific circumstances, the member's conduct may constitute a crime of infringing trade secrets.

(4) Accepting bribes

COI involving accepting bribes manifest as a member soliciting or accepting third parties' property, commissions, loans, frequent and luxury entertainment or other interest by taking advantage of his/her position to seek profits for bribers. The member's bribery usually causes damage to the company's interest.

A director or senior executive's acceptance of bribes is a violation of duty of loyalty to the company, and the illegal gains shall belong to the company. If the amount of bribes is relatively large, the act of accepting bribes may constitute a crime of accepting bribes or a crime of accepting bribes by non-state personnel.

(5) Making personnel decisions by request

COI involving personnel decisions manifest as a member affecting the hiring, firing, promotion of enumeration of the member's interested party. If such interested party does not actually provide labor services to the company, the member's act may constitute a crime of vocational embezzlement.

(6) Illegal misappropriating and encroaching company property

Illegal misappropriating and encroaching company property means that a member takes possession of the company's property by taking advantage of his/her positions. Specifically, it is reflected in the following situations:

(a) a member uses or allows others to use the company's personnel, equipment, service, product or goodwill for his/her own purpose or interest;

(b) a member abuses the company's reimbursement policy for his/her own purpose or interest;

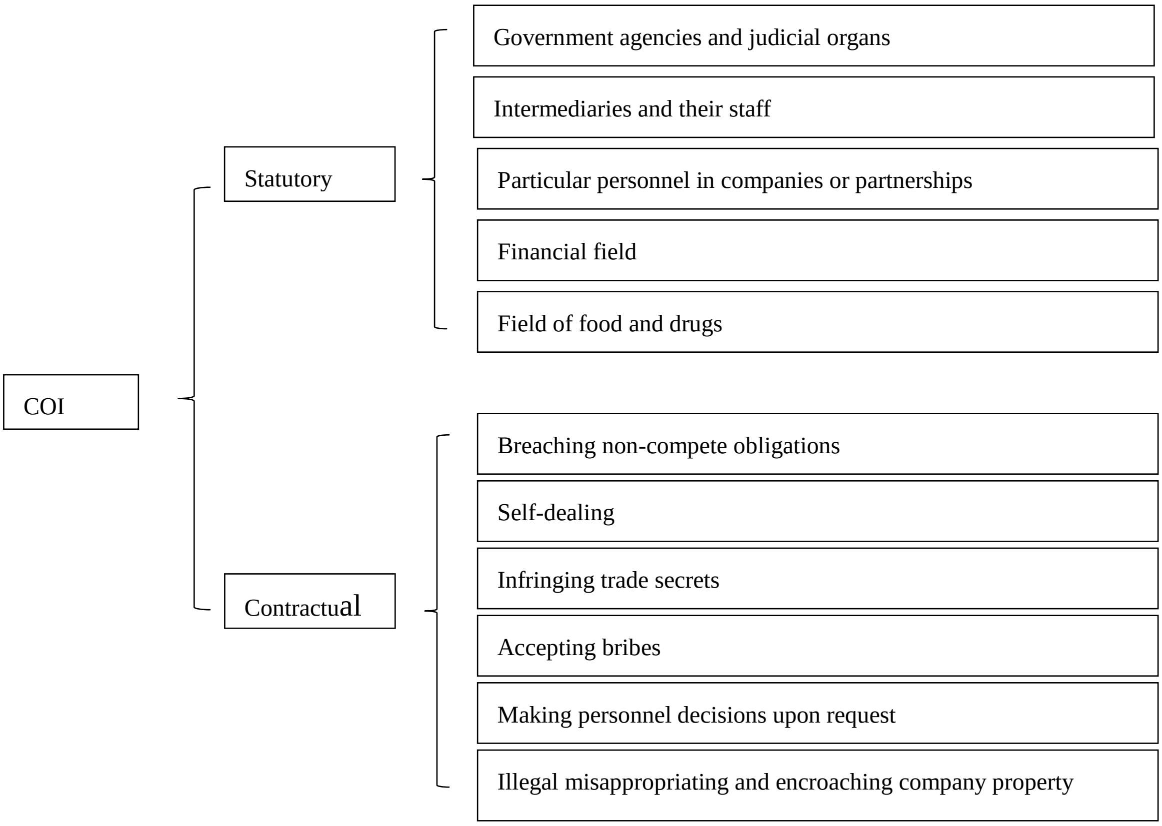
(c) a member improperly makes use of the company's reputation, information or the work experience in the company to write books and articles, give speeches, participate in chambers of commerce or other activities, and receives remunerations, royalties, gifts or other economic interest;

(d) a member encroaches the company property by stealing cash, misappropriating company property, falsifying financial accounting books, etc.

If a member illegally misappropriates and encroaches the company property, he/she may violate COI policies. Under serious circumstances, the member's act may constitute a crime of vocational embezzlement.

4. Conclusion

The provisions on COI, which scatter across Chinese law, are mostly general provisions. Among them, COI between administrative organizations and public officials mostly apply to statutory situations, while COI between companies and their members most apply to contractual situations. If a member carries out activities involving COI, possible consequences include punishment for violation of the company's rules and regulations, liability for breach of contract with the company, or administrative or criminal liability under serious circumstance.


COI
Statutory
Government agencies and judicial organs
Intermediaries and their staff
Particular personnel in companies or partnerships
Financial field
Field of food and drugs
Contractual
Breaching non-compete obligations
Self-dealing
Infringing trade secrets
Accepting bribes
Making personnel decisions upon request
Illegal misappropriating and encroaching company property

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[1] For example, the *Interim Provisions on the Prevention of Conflicts of Interest of Government Officials in the Industry and Information Bureau*.

[2] https://iccwbo.org/content/uploads/sites/3/2018/08/icc-conflicts-of-interest-guidelines-july-2018.pdf, last visited on May 6, 2019.