

Change of Legal Remedies for Declaratory Action Filed by Undisclosed Investors of Foreign-Invested Enterprises

By Peiming Yang and Eve Zhang

Case Brief

In 1992, Mr. Zhang from Taiwan, intended to set up a company in Shanghai with Company A (a domestic company). In order to circumvent the limits imposed by the Taiwan authorities on investment in the mainland, Zhang acquired Company B in Hong Kong and Company B established Company C (a Sino-foreign equity joint venture) with Company A. According to Company C's approval certificate and registration document, Company A and B hold 45% and 55% equity of Company C, respectively. However, the registered capital subscribed by Company B was invested by Zhang, who is the actual investor. Company C has been jointly managed and operated by Zhang and Company A since its establishment. Company B has never been involved in the management and operation of Company C. Zhang held that as the actual investor in Company C, he should hold 55% equity of Company C.

Two Lawsuits

In 2006, Zhang applied to the court, claiming that his rights as the actual investor were infringed by Company B, the nominee shareholder. Zhang requested the court to affirm that he was Company C's shareholder and that Company B was not an eligible shareholder of Company C. At first instance, the court rejected Zhang's application and held that: (i) as a foreign-invested enterprise, the shareholder's declaratory action relating to Company C would involve a change in ownership of Company C's equity. Therefore, the success of the claim would depend on the approval of competent administrative departments. Any change without such approval shall be void; (ii) Zhang's claim as the shareholder of Company C actually undermined the specific administrative act conducted by administrative departments; and (iii) Zhang's claim shall be resolved through administrative review and administrative procedures rather than civil action. Zhang was not convinced by the judgment and instituted an appeal. The second instance court rejected the appeal.

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In 2009, Zhang brought another shareholder's declaratory action, and requested the court to affirm that he was the shareholder holding 55% equity of Company C and submitted that Company C go through approval procedures to register him as the shareholder of Company C. The first instance court upheld Zhang's claim through court trial. Company B was not convinced by the judgment and instituted an appeal. The second instance court rejected the appeal.

Be Cautious

The court did not uphold the first declaratory action filed by Zhang in 2006, which indicates that at that time, the court regarded the approval certificate issued by the approval authorities as the basis for affirmation of a shareholder's rights in a foreign-invested enterprise. Since the actual investor was not the shareholder recorded in the approval certificate, the court could not uphold Zhang's declaratory action. However, as Zhang's attorneys, we admit that the declaratory action brought by the shareholders of a foreign-invested enterprise involves the overlapping of civil jurisdiction and administrative approval authorities. Nevertheless, administrative approval only influences credibility in the civil suit through registration. It is not an administrative declaratory act and will not affect the content of the civil suit. Therefore, administrative approval cannot reflect the true intention of the civil subjects.

The Supreme Court issued *Provisions on Several Issues Concerning the Trial of Disputes Involving Foreign-invested Enterprises (1)* (关于审理外商投资企业纠纷案件若干问题的规定(一)) on 5 August 2010.

Article 14 specifies that, where the parties have agreed that one party makes actual investment while the other party acts as a nominee shareholder of the foreign-invested enterprise and the actual investor requests to confirm its shareholder status in the foreign-invested enterprise or requests to change the shareholders of the foreign-invested enterprise, the people's court shall not uphold this request, unless the case meets following conditions: (1) the actual investor has actually made investment; (2) the shareholders other than the nominee shareholder recognize the shareholder status of the actual investor; and (3) during the litigation period, the people's court or the party concerned has obtained the consent of the examination and approval authority for foreign-invested enterprises on changing the actual investor into a shareholder.

According to this provision, where the particulars specified in the approval certificate of the foreign-invested enterprise are inconsistent with the agreements between the parties, the approval certificate will not be the only basis for affirmation of the rights, if the case satisfies those four conditions. Such a substantial change could direct the handling of issues concerning undisclosed shareholders existing widely in the foreign-invested enterprises, and provides a new legal remedy for undisclosed shareholders (i.e. the actual investors) to protect their legitimate rights and interests.

According to the judgments based on the facts of this case, we think that, before an undisclosed shareholder of a foreign-invested enterprise becomes a registered shareholder, the undisclosed shareholder should expressly ascertain the agreement with the nominee shareholder, actually fulfil its investment obligations and preserve relevant evidence. In addition, the undisclosed shareholder should obtain written confirmation of its shareholder's position from other shareholders. Implementation of these protective measures will better protect the legitimate rights and interests of the undisclosed shareholders, should they seek to commence a declaratory action.

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