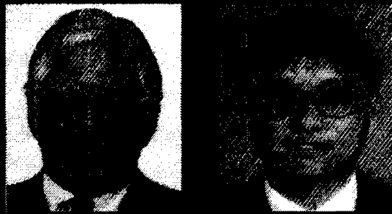
The Corporate Governance Structure of PRC Equity Joint Ventures: An Abnormality

There is a clear contrast between the corporate governance structure of the popular equity joint venture and the corresponding structure stipulated by the *PRC Company Law*. Without further, adequate reform, the corporate governance structure of equity joint ventures will continue to be an abnormality in China. Directors should take note of the potential conflict of interest and liability arising from this.



By Robin H Chambers and Joe Poon
Chambers & Company

Introduction

Despite the fact that the PRC *Sino-foreign Equity Joint Venture Law* (EJV Law) and its implementation regulation have been amended several times since their promulgation in 1979 and 1983, respectively, the statutory corporate governance structure of the widely adopted foreign direct investment vehicle, namely the equity joint venture, remains intact. As compared with the vehicles established under the *PRC Company Law*, the contrast is puzzling: the corporate governance structure stipulated by the Company Law is more modern and in line with the theory of separation of ownership and management whereby the corporate governance organs invariably include the shareholders' meeting, the board and the management. More recently the requirement of establishing the supervisory board has also been imposed in respect of the companies under the Company Law.

The board of equity joint ventures

According to the EJV Law (Article 6) and its implementation regulation (Chapter 5), an equity joint venture shall have a board which is the corporate organ of the highest authority. The directors of the board are appointed and replaced by the parties to the joint venture according to their respective investment proportions. Neither the EJV Law nor the implementation regulation imports the concept of "shareholder" for the corporate governance structure. "Shareholder", as a concept of corporate organ and governance, has no role to play as far as the internal corporate governance structure of the equity joint venture is concerned. Neither has the forum of the shareholders' meeting. The implementation opinions issued by the authorities in 2006 confirmed again the above corporate governance structure principle. The will of the joint-venture parties has to be articulated through their appointed directors on the board.

The above statutory arrangement renders the nature of the board of an equity joint venture the combination of two conventional corporate organs of modern corporations, namely the shareholders' meeting which is the highest authority of a corporation vested with the most crucial powers, and the board which is a collegiate body discharged with the responsibility of general management. Further, more specific and detailed management powers are usually conferred on the board by the joint venture contract and articles of association (for example approving budgets and material contracts). It is also not uncommon that the parties of the joint venture impose limitations of authorities to such an extent that the general manager has to report to and seek approval from the board in a frequent manner. The combined nature of the board entrenches an intrinsic problem to the effect that the boardroom becomes a battlefield between the parties to the joint venture who make every attempt to articulate and protect their interests through their appointees on the forum. Article 15 of the EJV Law reinforces the battlefield scenario by implicating that the board is the site of dispute resolution between the joint-venture parties.

Fused function dilemma

The theoretical and practical question posed here is whether the vendetta mission of the board is beneficial and constructive. It is obvious that the fused function of the board is against the principle of separation of ownership and management, which has been widely accepted for modern corporate governance. While it is recognized that interests of the investment parties need to be taken care of and there should be appropriate channels for their will to be represented, it may not be advisable nor logical to assign an effectively impossible mission to the board directors through the current corporate governance structure. Anecdotal and researched experiences regarding management of equity joint ventures in

China show that board meetings are often turned into shareholders' meetings ending up with unresolved quibbles. Researches have also shown that there has been a trend for foreign investors to go for the Wholly Foreign-owned Enterprise route if there is a choice to avoid the troubles caused by the rift between the investment parties. It is expected that the trend will be more apparent following the further relaxation of the PRC foreign direct investment regime whereby more industry sectors have been open to the wholly-foreign-owned model.

Conflict of interest

Another concern arising from the abnormal governance structure is the potential liability of the directors of the board who are supposed to act in the best interest of the corporation. The host of fiduciary duties has raised the alarm for those serving on the boards of Western corporations. Indeed, the Company Law has also imposed similar duties, especially by virtue of Article 148 of the substantially revised legislation of 2005, albeit in a more succinct manner. Although Article 218 of the Company Law stipulates that provisions of the Company Law shall be applicable to the foreign-invested companies (which include equity joint ventures) except for such matters as already provided by the laws of the foreign investment enterprises, it is difficult to ascertain which exact provisions of the Company Law shall be extended to the foreign-invested companies. However, it is prudent to assume that the directors of the board of an equity joint venture are also subject to the said Article 148 and other provisions of director duties. In this respect, due to the dual roles of the board, the appointees are unavoidably drawn to a dilemma as to who are their masters when they deliberate matters for the joint venture.

The confusion is more than a pure academic interest. As a practical issue, if a director is considering whether a transaction should be entered into, and in what terms, or whether a health, safety or environmental measure needs to be implemented, then in exercising his or her vote, should the instructions from the appointing parties be complied with? It should not be taken for granted that the interests of the joint-venture parties are fully in harmony with those of the equity joint venture, in particular when a joint-venture party is privy to the transaction under consideration. The issue is always further complicated by how the long- and short-term interests of the joint venture should be interpreted and, more problematically, by whom.

Corporate social responsibility and potential claims

The joint venture is a separate legal entity and, as it carries out its business, there are a large number of stakeholders having interests in one way or the other with respect to corporate behaviour and performance. The potential claims from lenders, general creditors, employees and those victims of the operations of, or products manufactured by, the joint ventures should not be perceived as remote. It should be noted that there is no absolute bar to commencement of proceedings against defaulting directors in foreign jurisdictions like those of the United States where cases of class or representative actions are well-known and huge exemplary or punitive damages may be awarded if the claims are successful. In this respect, serving directors should exercise their diligence and judgement not merely based on blind obedience to the instructions of the appointing parties. The newly-added requirement of social responsibility of companies under Article 5 of the Company Law is worthy of deep thought, notwithstanding that it is yet to be observed to what extent this ethical stipulation is applicable to equity joint ventures and how the PRC courts will interpret the same.

The issues and predicaments raised here are not unknown to limited liability companies in general. However, in those companies with a corporate governance structure designed on the basis of separation of ownership and management, players in the respective corporate organs are able to articulate their interests and discharge their duties on a variety of forums vested with distinct rights, powers and responsibilities. It is then, in the normal circumstances, more conducive for the shareholders and other officers (including the directors) of the companies not to confuse their roles. At times of conflict, the rules of the game under the separation of ownership and management notion can be resorted to, so that external pressure exerted by sectional interests (in particular the parties to the joint ventures) may be relieved to a certain extent. On the contrary, the confused arrangement under the equity joint venture model has been dictated by the legal provisions of the EJV Law and its implementation regulation. It is then more difficult for the directors to balance the conflicting interests.

It is also disturbing that a document issued in December 2000 jointly by the Chinese Communist Party and other government authorities has stressed, among other things, that the representatives deployed to equity joint ventures by Chinese parties (including the directors), in the first place, should be accountable to and realize the intents of the Chinese parties. Nothing in the document addresses the issue of conflict nor acknowledges the abnormality of the corporate governance structure.

Conclusion: a statutory overhaul

Given the project purpose nature in almost all cases, equity joint ventures are quite similar to partnerships whereby a couple of investors are committed to achieving certain business goals and bearing the ancillary risks. It may therefore be argued that, despite the separate legal entity notion, the interests of the investors are

deemed to be those of the equity joint venture, and vice versa. It follows that it is superfluous to establish distinct corporate organs for the purpose of decision making. However, from the corporate governance perspective, it is doubtful as to whether this proposition can convincingly justify that the principle of separation of ownership and management should be dispensed with.

It should be noted that a partnership (subject to the limited partnership exception) is not entitled to the benefit of limited liability while investors or shareholders of a limited liability company are always able to hide behind the shield under the doctrine of separate entity.

Attention should also be paid to the fact that equity joint ventures may be mega-project companies whose operations have immense impact on the economy in general as well as the communities and residents in the vicinity. In this regard, the interests of owners or investors of corporations may need to be balanced against those of other stakeholders to the effect that corporations, acting through their agents, are expected not to merely take sectional interests into account. Perhaps that is the fair price paid for the entitlement of limited liability.

Other than historical drafting reason, it seems that there is no categorical legal argument to countenance the premise that the corporate governance structure of equity joint ventures should be distinct from the scheme under the Company Law. It seems that an opportunity was wasted for an overhaul of the regime in 2001 when the EJV Law and its implementation regulation were amended. Instead, at that time the focus was just on amendments to those provisions relating to China's World Trade Organization commitments, such as issues regarding foreign exchange, export ratio and local purchase requirements.

It is anticipated that, without a proper reform, the corporate governance structure of equity joint ventures will continue to be an abnormality. Above all, the serving directors are advised to bear in mind the foregoing caveat of conflict of interest and potential liability at all times.

About the authors

Robin H Chambers is the senior partner and founder of the Melbourne international law firm, Chambers & Company. He has advised many PRC state-owned enterprises related to natural resources, regarding their investment and other business activities in both Australia and China. He is also the board director of various listed and unlisted Australian companies. He can be reached at rhchambers@chamberslaywers.com

Joe Poon is a China Project Management adviser to Chambers & Company and was formerly the head of legal of a large PRC equity joint venture, namely the "Nanhai Project" between CNOOC and Shell. He is now researching corporate governance issues related to PRC state-owned enterprises at the Law School of the University of Melbourne. He can be reached at JPoon@chamberslawyers.com

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Fax 86(10) 6530 8849
Email zglee@chamberslawyers.com

Melbourne
Level 43, ANZ Tower
55 Collins Street
Melbourne VIC 3000
Australia
Tel 61 (3) 9654 1988
Fax 61 (3) 9650 3958
rhchambers@chamberslawyers.com

Perth
Level 2, Fortescue House
50 Kings Park Road
West Perth WA 6005
Australia
Tel 61 (8) 9320 4988
Fax 61 (8) 9321 6688
clumsdon@chamberslawyers.com

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