



CHINA Legal Bulletin

Executive Summary

Finance Leasing in China; Lessor Beware

The idea of a lease for something other than real estate is not widespread in China. However, as the economy grows at a breakneck pace, the ability to make use of machinery and large assets quickly and without allocating a substantial amount of capital is a must for some businesses. Due to this growing interest and developing legal field our article deals with the current state of finance leasing in China and what lessors and lessees can do to minimize their risk.

By Liu Chunhua and Zachary Wortham

Chinese Chops the Ultimate Business Tool

As anyone who has done business in China can tell you, the stamp that a company uses is the most important proof of execution of a document. Because of this fact we have taken the time to devote an entire article to the considerations a company should keep in mind when developing a strategy for stamp use and safe keeping. Also we have detailed some of the serious consequences a company can face if it is not adequately prepared.

By Maarten Roos

NEWS FLASH

China defines conditions for foreign takeovers of banks

Chinas banking regulator has for the first time defined conditions under which foreign financial institutions may acquire control of domestic banks.

According to a draft released for comment by the China Banking Regulatory Commission (CBRC) recently, controlling shareholder will refer to any corporation that directly or indirectly holds more than 25 per cent of a banks voting shares, including foreign financial institutions. Controlling shareholder can also mean those who are entitled to manage a banks financial and operational affairs, hold the right to dismiss and appoint members of the board or similar bodies, have majority voting rights on the board, or any other condition the CBRC defines as having a controlling influence, it said.

Overseas financial institutions that wish to take control of Chinese banks must comply with regulations, the draft stated without elaborating. Other requirements include solid management, sufficient experience and a good record over the past three years. Funds used in the acquisition must be internally generated.

Foreign financial institutions must also follow rules imposed by other Chinese financial regulators.

**YOUR LEGAL
ADVISORS IN
CHINA**

EXECUTIVE EDITOR:
WANG JING

SENIOR EDITOR:
MAARTEN ROOS

EDITOR AND DESIGN:
ZACHARY WORTHAM

Finance Leases in China; Lessor Beware



Financial Leases in Chinese Law

In recent years, the demand for a financial lease - a financial institution acting as the lessor, purchases the capital goods for a third party and then leases those goods back to the third party who then pays usage fees - to bolster operations has become popular in China, and the number of foreign financial institutions entering the Chinese market to engage in this business either directly or through subsidiaries has rapidly expanded. However, as China does not yet have a specific law regarding financial leasing, when disputes arise, authorities can only look to clauses in Chinas *Contract Law*, accounting standards, and financial supervision rules. These guidelines can not fully regulate a financial leasing transaction and for some issues are contradictory.

One of the biggest issues is the proprietary rights of the lessor. Regardless of whether that lessor is in China or offshore, any financial lease transaction where the leased property remains in China, will be considered to be under the jurisdiction of Chinese law and courts. This is significant because the split between the lessors proprietary rights and actual possession of the goods by the lessee can signify a considerable risk to the lessor due to the fact that in China the laws are not clearly described for financial leases and therefore possession of the property is a distinct advantage. This is not only important for foreign-invested leasing companies established in China but also for offshore financial institutions which may be at risk should the leased property be brought into China.

Chinese Law and Financial Leases

While slight variations exist, existing laws and regulations generally accept the definition of a financial lease according to the *PRC Contract Law*:

A financial lease contract is a contract whereby the lessor, upon purchase of the lessee-selected leased property from a lessee-selected seller, provides the leased property to the lessee for its use, and the lessee pays rent therefore.

Accordingly, the lease contract must prove that the lessor has delivered the goods to the lessee, in return for a rent payment. While at the same time under the sales contract, the lessor purchases the property from the seller according to the lessees instruction. As is the case for most transactions there will be evidence of payment for the goods which will validate the transaction. In China however, a court at the local level may find this evidence insufficient to interpret such a complex relationship. To confirm the lessors proprietary rights, the court may and routinely

does insist on being provided with a written contract to prove beyond any doubt the nature and limitations of the relationship between the lessor and the seller.

An alternative arrangement often seen in China is to conclude a three-party sales contract between the seller, the lessor, and the lessee. This allows the lessee to be the direct beneficiary of any warranties provided by the seller, and it allows the parties to reconfirm, from a legal perspective, that the lessor is the actual owner. Such a contract should include the terms and conditions for when the lease will terminate and thus avoid negotiations in the future.

Risks for the Lessor: Unlawful Disposal of the Rights to Leased Goods

After the lease contract is signed, the leased property then belongs to the lessor, however since the lessor does not have the property in its possession, it cannot easily safeguard itself against illegal actions such as; mortgage, resale, re-lease; or even use of the property as collateral for a subsequent investment. Under Chinese law, proprietary rights generally belong to whoever has possession of the property, and therefore there is the risk that the lessee in any financial leasing transaction could give the property to another and that party could claim ownership of the goods based on the doctrine of Acquisition in Good Faith.

According to the doctrine of Acquisition in Good Faith as mentioned in the *Law on Real Property*; a third party may keep ownership of property in their possession, if they meet all of the following conditions and unless it is otherwise prescribed by law: they accepted the property in good faith; they purchased the property at a reasonable price; and finally the property was successfully delivered and if necessary, registered properly.

The only legal provision that sets financial leasing as an exception to this doctrine is Article 10 of the *Provisions of the Supreme Peoples Court on Several Issues Concerning the Trial of Dispute Cases Involving Financing Lease Contracts*:

Before completing the performance of the lease contract, the lessee, without the lessors consent, may not mortgage, transfer, re-lease or invest as contributed capital the leased property. The lessor is entitled to get back the leased property and require the lessee to make compensation for any losses. Third parties are entitled to require the lessee to make compensation for losses they suffer as a result of invalid acts conducted by the lessee.

LEGAL/BUSINESS Civil Procedure Law and Update on Wages

Implementation of the Civil Procedure Law underway

All Chinese judges including the Supreme Peoples Court have received training for the implementation of the amended Civil Procedure Law. Articles relating to the cause and time limit of retrials have been added to the new law. Jurisdiction over retrial cases has also been clarified: clients can now only apply for retrial to the Peoples Court at one level higher than the original hearing court.

In December 2007, the Supreme Peoples Court released a notice requesting that courts at various levels apply the new law even if contradictions are found in the original laws and legal interpretations. Chapter Nineteen, entitled Bankruptcy Procedures for Enterprises, has been abolished. The Supreme Peoples Court will modify the format of the relevant legal documents and issue them to courts at various levels, who will also adopt a new control system for the new law and will separate the power of enforcement supervision from the power of enforcement.

Wages not increasing at the same pace as profit

A recent survey found that more than 26 % of workers had not received a pay rise in the past five years, despite the economy growing at an average annual rate of 10.6 per cent. Chinas inflation surged to a 12 year high of 8.7 per cent in February 2008.

However, change is in the air as last year, half of Chinas provinces, municipalities and autonomous regions increased their minimum wage payments by an average of 10 per cent. This may be a direct result of the fact that the number of disputes over contract violations, workplace injuries, work-related illness, low pay and long hours, is rising at about 20 per cent a year.

Finance Leases in China; Lessor Beware cont.



The question for the Chinese court then becomes, are the interpretations of the Supreme Peoples Court sufficient to make financial leasing an exception to Article 106. This view is controversial as China has a civil law system, and therefore interpretations by the Supreme Court do not constitute a law. Creating a situation wherein the only way for a lessor to confirm its rights is to prove that the transferee does not meet the statutory requirements with respect to a third party in good faith. And since leased property does not need to be registered then the transferee only needs to show that they took possession of the property in good faith and paid a reasonable consideration for it. As these two points would be relatively easy to prove, courts are free to deny an exception to proprietary rights under a financial lease in favor of recognizing the rights of a third party acting in good faith.

On the other hand, if a court decides to uphold the interpretations of the Supreme Court, the lessor would still have to bear the responsibility to produce evidence to prove that the case involves a financial lease relationship rather than a normal lease, including a sales relationship between the lessor and seller, and a lease relationship between the lessor and lessee.

Risk Mitigation of the Lessors Property Rights

Offshore financial institutions with business in China as well China-registered, foreign-invested, finance leasing companies should be extremely cautious and ensure that the following are in place to minimize their inherent risks.

A comprehensive financial lease contract - Financial institutions do not generally enter into individual sales contracts with the sellers of the leased goods, since in most jurisdictions the sales relationship can be proved by means of the sellers commercial invoice and delivery certificate. Similarly, rather than entering into individual financing lease contracts, institutions may choose to use irrevocable L/Cs and general lease contracts. However, since Chinese judicial practice emphasizes the express requirements for sales and financial leases, there should be a written sales contract and a written financial lease contract to safeguard against adverse consequences.

Preservation of evidence - The lessor should preserve documents and materials pertaining to the purchase of the leased property, such as invoices, bills of lading, and insurance policies, to strengthen its claim to proprietary rights in case of a dispute.

Obtaining licenses - According to Chinese law, offshore financial institutions may not directly engage in financial lease activities in China, which means that they may not lease goods directly to a Chinese-registered company as the end-lessee. Instead these foreign companies must work through a licensed Chinese leasing intermediary, or establish a foreign-invested enterprise in China with prior approval from the Ministry of Commerce.

If an offshore financial institution leases goods directly to a Chinese-registered entity, the risk is that a court may regard the transaction as null

and void and while technically the goods should then be returned to the lessor or seller, in practice courts are not eager to assist offshore enterprises in regaining possession of goods.

Conclusion

The legal relationships in financing lease transactions are relatively complicated, primarily due to the fact that the lessor reserves the proprietary rights to the leased goods but loses actual control, exposing it to risk. Therefore enterprises engaging in financial leasing should pay considerable attention to the evidence in their possession detailing these relationships. As a final note, the promulgation of the draft law on financing lease currently under revision, may considerably alter the legal framework. For now, companies are urged to be cautious, and ensure that all documentation is in order.

By Liu Chunhua and Zachary Wortham

Chinese Chops The Ultimate Business Tool

An important difference in business practices between China and many western countries is the value that courts and officials give to the stamp (in China often referred to as the chop or seal). We introduce the rules and practice, and some suggestions on how to manage your risk.

For many western companies, the signature of its legal representative is the ultimate mark of authority. Not so in China. The value of the company stamp is far greater. Every company in China, after it is established, will make and register its company stamp with the local authorities (in this case the Public Security Bureau). Towards third parties, this company stamp represents the company, therefore

documents bearing this stamp will generally be legal and binding upon that company whether that document bears a signature or not!

The company stamp is not the only stamp that can represent the company. For specialized functions, companies may decide to carve and register other stamps. Common examples are the contract stamp (for stamping contracts), the finance stamp (for making payments, accessing bank accounts) and the customs stamp (to make customs declarations). These are particularly important for larger companies where different people carry the final authority to deal with different matters. As long as they are registered, these stamps serve a similar function as the

company stamp: to represent the company in relations with external parties.

Individuals can have stamps as well. A Chinese companys legal representative, for example, should have registered his stamp to be used on documents or papers (including checks) that he executes in his official capacity. Usually the stamp of a legal representative will be a print of his name rather than a print of his signature, though some authorities will accept the latter as well. In any case, the bearing of the legal representatives stamp presumes the agreement of the legal representative.

Chinese Chops The Ultimate Business Tool cont.



Stamp Keeping - Internal vs. External Liabilities

The stamp can be a useful tool for companies as it marks authority when the company official representatives are not available: third parties may presume that a document is legally executed if it bears the relevant stamp. On the other hand, except where that third party knows or should have known that the person using the stamp is not authorized to do so (including if it is specified in the company's registered Articles of Association), the stamping of a document also creates a direct liability onto the company or individual represented by that stamp. If the document is stamped, then the company is bound by its terms.

Therefore a company can and should create a system of internal guidelines to control the use of stamps and assign consequences for misuse or abuse. For example, internal rules /contract can prohibit a sales manager from signing contracts valued above a certain limit; if he goes beyond this limit without prior approval from the general manager, then he will bear the liability for any damages towards the company he misrepresented. If the contract becomes subject to dispute, the company would still be liable towards the third party, but that company could in turn claim against the sales manager.

Individuals stamps are similar in particular for legal representatives. Others may be authorized to use this stamp on the representatives behalf, and a third party may presume such authorization from the legal representative. If the user of the stamp is acting beyond such authorization, it will be an internal matter.

However in many situations, even if a company does claim against an employee for abuse of authorization, the harm is done. For this reason, it is extremely important to have a system in place which establishes the authorization levels for use of the stamps and also manages the physical control of the stamps.

Valuable Lessons

Stamps are often needed in the course of doing business, therefore companies need to find the right balance between convenient access and restricting use. This is especially the case when the legal representative is away. One lesson that many companies have learned the hard way: Never Leave Important Stamps in the Hands of People That You Do Not Completely Trust!

In one recent case, a Client established a wholly foreign-owned manufacturing company in Zhuhai, appointing a local employee as general manager and placing all stamps in his possession. After a year of operation the company found that the employee had used the chop to sign unapproved contracts with third parties. When the company terminated the employment contract with this general manager, they found that he had used the company stamp to renegotiate his own contract entitling himself to larger compensation should the contract be terminated early for any reason. While this is an extreme example it does illustrate just how powerful the stamp can be in China.

If a stamp needs to be available for emergency purposes while the usual keeper it is away, it is a good idea to leave it with your accountant, law firm, or a trusted colleague. This arrangement can be made stronger by signed orders that the stamp may only be used for matters specifically mentioned or separately confirmed, and any use must be recorded in a ledger. In this way a company can share liability and still be able to act quickly when it is necessary. In the above mentioned case, when the newly-appointed foreign manager is away the stamps are kept in our law firm safe, and usage is controlled under a detailed retainer agreement.

By Maarten Roos

GUANGZHOU

Tel. (+8620) 8760 0082
Fax (+8620) 8778 4482
info@wjnc.com

SHANGHAI

Tel. (+8621) 5887 8000
Fax (+8621) 5882 2460
shanghai@wjnc.com

TIANJIN

Tel. (+86 22) 2532 3818
Fax (+86 22) 2532 3820
tianjin@wjnc.com

SHENZHEN

Tel. (+86 755) 8882 8008
Fax (+86 755) 8284 6611
shenzhen@wjnc.com

QINGDAO

Tel. (+86 532) 8666 5858
Fax (+86 532) 8666 5868
qingdao@wjnc.com

XIAMEN

Tel. (+86 592) 268 1376
Fax (+86 592) 268 1380
xiamen@wjnc.com

FUZHOU

Tel. (+86 591) 8781 2260
Fax (+86 591) 8781 2210
fuzhou@wjnc.com

HAIKOU

Tel. (+86 898) 6672 2583
Fax (+86 898) 6672 0770
hainan@wjnc.com

This newsletter is published by the Corporate & Commercial Group of Wang Jing & Co, a PRC law firm assisting Chinese and multinational clients in business operations in China and abroad.

GOVERNMENT UPDATE: **China/NZ Trade Agreement and Super Ministries**

China and New Zealand Sign Trade Agreement

This Free Trade Agreement is the first between China and a developed country, the product of 15 rounds of negotiations over three years, and was completed on April 10th by Helen Clark, Prime Minister of New Zealand, and her Chinese counterpart Wen Jiabao. Details of the agreement have been kept secret but it is likely to involve the removal of all tariffs over time. China's tariffs on New Zealand goods range from 10% to 20%. The agreement may also cover investment, rules of origin, trade in services and non-tariff barriers such as licensing and

China to set up five new Super Ministries

China has established five new Super Ministries at the National Peoples Congress on the 11th of March.

According to the plan the five new Super Ministries will consist of the Ministry of Industry and Information, the Ministry of Human Resources and Social Security, the Ministry of Environmental Protection, the Ministry of Housing and Urban/Rural Construction, and the Ministry of Transport.

To strengthen the governments management of the energy sector, a high-level inter-ministerial coordinator, the national energy commission has also been established. A National Bureau of Energy will now work under the National Development and Reform Commission.

The State Council will have 27 ministries and commissions, excluding the General Office.