

MEMORANDUM

To : Mr. Henk Westerhof - Royal Anthos
From : Jan Holthuis, Li Jiao - Buren
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Re : The External Liability of Directors under the Chinese Law
File : 036278

Please find hereby our assessment of legal grounds available in Chinese law for the Dutch flower bulbs exporters to hold the directors of the three defaulting Chinese companies personally liable for debts owed to the Dutch exporters, provided that it can be established that the tax evasion / irregular practice of the defaulting Chinese companies is committed under the decision and instruction by the directors.

I. Legal Status of Directors

Under the Chinese law, an executive director or a board of directors acts as the internal executive organ of a company¹ who shall be responsible for the company's management and report to the shareholders.² In general, directors will not be personally liable for the business activities of the company towards any external third party, even though such business activity is under the decision and instruction of the directors. The company itself shall assume the civil liability arising thereof³, though the company has the right to claim the damages back from the directors in fault afterwards.

Unlike in a Dutch B.V. where directors may individually or jointly represent the company to act externally towards a third party with the binding effect to the company, there is only one person who assumes the position of legal representative ("LR") is entitled to such authority in a Chinese company (in fact the "executive director", other are in fact "non-executive directors" as we would qualify it under Dutch law). A LR is a peculiar concept under Chinese law and a unique organ under Chinese corporate governance. It is the only corporate organ recognized by law that is capable to represent the company externally with any third parties without any special authorization. In other words, any legal relationship entered into, changed or terminated by the LR in the name of the company will be directly binding to the company itself.⁴ However, the LR will not be personally liable towards third party but the company itself.

Pursuant to Chinese Company Law, the company can appoint its chairman of the board of directors, its executive director or its general manager as its legal representative.⁵ This means that a director can at the same time act as the legal representative of the company.

II. Director's Liability

Although there is no general provision on the personal liability of directors under Chinese law, in practice it has been accepted by the Chinese courts as a principle that a director shall be liable for the

¹ Article 81 of General Rules of the Civil Law

² Article 46 of Company Law

³ Article 43 of General Principles of Civil Law

⁴ Article 61 of General Rules of Civil Law

⁵ Article 13 of Company Law

damages caused by his willful misconduct or gross negligence. However, the said legal principle will only be applied by the Chinese courts in connection with the relevant provisions stipulated by the Company Law of the PRC (the “Company Law”) or the Enterprise Bankruptcy Law of the PRC (“the Enterprise Bankruptcy Law”). The said legal principle, although consistent with Article 6 of Tort Law of the PRC (the “Tort Law”) which sets out the general rule on the tort liability⁶, to date the said Article 6 is not applied by the Chinese courts as a legal base to hold the directors liable towards the third parties for the company debts⁷.

While the Company Law provides the legal base for the personal liability of a director towards the company and the shareholders but not including the creditors, the Enterprise Bankruptcy Law opens the door to possible personal liability of a director towards the creditors for company debts. According to Article 125 of Enterprise Bankruptcy Law, a director shall bear civil liability pursuant to the law if he violates the duties of loyalty and diligence and such violation has caused the bankruptcy of the company.

There are not so many court judgments published in which the said Article 125 was applied. So far there is no further interpretation or guidance released by the Supreme People’s Court of China (the “SPC”) on the application of the said Article 125. Nevertheless, it is generally held that the personal liability of a director as stipulated by the said Article 125 should not be limited to the liability towards the company, but be expanded to the company’s creditors; otherwise the wording “towards the company” should have been added to “civil liability”. However, it is worth noting that in a recent final decision rendered by the appeal court in Shanxi Province⁸, the judge did not support the claimant to hold the director of the debtor company liable for the company debts based on the said Article 125. Based on the published judgment, its reasoning is that there is no contractual relationship between the creditor (claimant) and the legal representative of the debtor company, and the said Article 125 does not suggest that a legal representative who does not hold a contractual relationship with a creditor shall be liable towards such creditor.

The decision made by Shanxi court cannot represent a commonly held view under the China practice, and actually it is inconsistent with the general view that the liability under Article 125 is not based on contract. However, the discretionary power of the local judges to interpret the said Article 125 in a way favorable to the local company should also be considered as a litigation risk in China.

Since the external liabilities of a director towards the creditors under the Chinese law are related to Enterprise Bankruptcy Law, we will elaborate on the possible application of the said Article 125 of Enterprise Bankruptcy Law in the present cases⁹.

⁶ A doer whose negligence has harmed the civil rights and interests of others shall bear tort liability. Where the provisions of the law presume that a doer has committed negligence and the doer cannot prove that it has not committed negligence, the doer shall bear tort liability.

⁷ Unlike the current practice in China, we understand the Dutch Supreme Court has affirmed that personal liability of a managing director for liabilities of a company towards third parties will arise if that third party has been prejudiced by the company and ‘serious blame’ can be attributed to the managing director in respect of those damages. Whether such ‘serious blame’ can be attributed depends on the nature and severity of the violation of the standards that the director should observe and the other relevant circumstances of the case. In case of unpaid creditors, the Supreme Court has developed a specific criterion for personal liability of the managing director.

⁸ Case (2018) Jin 08 Min Zhong No. 1476

⁹ Another provision regarding directors’ liability towards creditors under Article 128 states that the legal representative of the debtor company and the person who is directly responsible will bear the liability for compensation if the debtor company commits an act that constitutes void or voidable actions to the detriment of creditors. As it is not related to the director’s liability arising from the illegal acts during the normal operation in the present cases, we will not elaborate on the said Article 128 in this memo.

Application for the Bankruptcy

To put the debtors into bankruptcy is the premise for any further discussion about the director's external liability under the said Article 125.

According to our search on the date of this memo in the official information website operate by the SPC¹⁰ about the bankruptcy cases, there is no information regarding the bankruptcy procedure involving any of the three debtors. Besides, according to Article 14 of Enterprise Bankruptcy Law, the court accepting a bankruptcy application shall within 25 days from the date of acceptance, notify all of the known creditors. Therefore we believe the three debtors have not initiated the bankruptcy procedures or any other creditors have applied for the bankruptcy of the said debtors.

The application for bankruptcy can be initiated by the Dutch creditors to put pressure and get their debts recognized as a priority. According to Enterprise Bankruptcy Law, a creditor who applies for bankruptcy against its debtor shall produce evidence to prove the debtor is unable to repay debts that are due¹¹. Apart from any final and binding judgement or arbitral award in which the existence of any debts is already determined by the court or tribunal as facts, in practice, the evidence acceptable by the Chinese courts can also be documents on which the creditor's debt is based including the documents incorporating the underlying transactions, the demand letters issued by the creditor or its lawyers to claim for the payment, or the acknowledgement of debt by the debtor itself.

A debtor who is unable to repay debts that are due, and in any of the following circumstances shall be deemed to meet the requirements for bankruptcy by the court:

- 1) It assets are insufficient to discharge all of its debts; or
- 2) It clearly lacks the capacity to discharge such debts.

In the case that the balance sheet, audit report or assets evaluation report of a debtor shows that all of its assets are insufficient to discharge all of its debts, it shall be deemed by the court that its assets are insufficient to discharge all of its debts, expect for the there is opposite evidence showing that the debtor's assets are sufficient to pay off all of its debts¹². On accepting an application for bankruptcy, the court will order the debtor to submit its statements on financial status, checklist of debts and creditors' right, the financial statements and any other related materials.

In practice, the local courts could set certain additional conditions beyond the statutory conditions as mentioned above required for the filing of bankruptcy, although such additional conditions have been explicitly disallowed by the SPC¹³. To initiate the bankruptcy procedure, the consultation with the local competent courts can be arranged by us to confirm whether the ongoing investigation by the government into the debtors would materially obstruct the acceptance of bankruptcy application by the courts.

¹⁰ <http://pccz.court.gov.cn/pcajxxw/index/xxwsy>

¹¹ According to the SPC Provisions on Several Issues Concerning the Law on Enterprise Bankruptcy, a debtor shall be deemed to be unable to repay debts by the court when the following conditions are satisfied simultaneously:

- 1) The debtor-creditor relationship has been established according to law;
- 2) The period of the debtor to fulfill the obligation has expired; and
- 3) The debtor has not been able to clear off all of its debts.

¹² Article 3 of the SPC Provisions on Several Issues Concerning the Law on Enterprise Bankruptcy

¹³ Notice of the Supreme People's Court on Issues Concerning the Filing and Acceptance of Bankruptcy Cases

Violation of duty of loyalty and diligence

To claim the liability of a director, either internal or external, it is crucial to prove the director's willful intent or gross negligence. In practice, the Chinese courts will find a director has willful intent or gross negligence if such director has violated his statutory duties as broadly defined under the Company Law, which include¹⁴:

- 1) To comply with the laws, administrative regulations and articles of association of the company;
and
- 2) Duty of loyalty and diligence towards the company.

Pursuant to Article 149 of Company Law, a director who violates the provisions of law and administrative regulations in his performance of duties and powers which has caused the company to suffer damages shall be liable for such damages towards the company.

It is widely held by the Chinese courts that a director who violates the law and such violation has caused damages to the company shall be deemed to violate his duty of loyalty and diligence towards the company in a broad sense and normally will be found to have willful intent by the courts.

As we understand the three debtors are under the investigation in relation to the tax crimes, and it is highly likely that the relevant directors will be given criminal punishments as the persons who are directly in charge. It is worth noting that the SPC has clarified in an official notice¹⁵ that the "persons directly in charge" under the Article 31 of Criminal Law of China¹⁶, should be the persons who have made the decision about, approved, incited, connived at, or led the crime and who are normally the person in charge of the business including the legal representative. Based on the forgoing, the determination of "persons directly in charge" under the said Article 31 is not based on the positions such persons have taken in the company, but their illegal acts committed. Therefore it is evident that the relevant directors who are found to be the "persons directly in charge" will be deemed to violate the laws.

Even if the relevant director will not be found guilty at the end, given the apparent serious damages suffered by the debtors due to the continuing criminal investigation and the preservation measures taken by the judicial authorities during the investigation process, it should not be difficult to substantiate the claim that the directors have violated the duty of loyalty and diligence towards the company.

III. Conclusions

- 1) Under the current Chinese law, Article 125 of Enterprise Bankruptcy Law is the only legal base available for the creditors to claim the external liability of directors arising from the violation of the duty of loyalty and diligence by the directors during the operation prior to the bankruptcy. Since such claim is bankruptcy-associated, the Chinese courts will not support a creditor's claim to hold the director liable for the company debts based on tort when the company is still in normal operation.
- 2) To claim the directors' liability pursuant to the said Article 125, it is crucial to have the competent local courts accept the bankruptcy application initiated by the creditor(s) and substantiate the claim of the failure to comply with the statutory duties under the Company Law by the relevant

¹⁴ Article 147 of Company Law

¹⁵ SPC Notice on the Meeting Minutes of Trial of Financial Crime Cases

¹⁶ Article 31 of Criminal Law stipulates that where a unit commits a crime, it shall be fined, and the persons who are directly in charge and the other persons who are directly responsible for the crime shall be given criminal punishment.

directors. In our view in the present cases the acceptance of bankruptcy application by the competent local courts is comparatively unpredictable. Prior consultation with the local competent courts can be arranged to get more certainty on the prospect of bankruptcy application.

- 3) Apart from the possible application of the said Article 125, it is expected that the acceptance of bankruptcy cases by the courts may also create certain leverages for the creditors, including to detect more reliable property clues due to the comprehensive financial information and statements required by the courts to be disclosed and submitted, and to push for the debt settlement provided that the debtors are willing to make efforts to avoid bankruptcy.

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