



## Legal Representatives: Understanding the Risks and Responsibilities

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### Introduction

At Lehman, Lee and Xu we frequently advise clients on all issues relating to foreign direct investment in China. One of these issues coming up time and time again is the concept of the legal representative. Since there is no real equivalent in common law countries, many of our clients initially have little understanding of the legal representative's role. Clients are often surprised to learn of the extent of the powers of the legal representative, and how difficult it can be to replace an uncooperative legal representative. Failure to properly understand the powers and responsibilities of a legal representative can lead to a situation where foreign investors are held to ransom. Unfortunately in our experience, such situations are not uncommon.

### What is a Legal Representative?

A legal representative is, put simply, a natural person appointed to act on the company's behalf. Article 38 of the General Principles of Civil Law of the People's Republic of China defines the role as the "responsible person who performs the duties and powers on behalf of a legal person in accordance with the law or the constituent documents of the legal person". Under the Company Law of the People's Republic of China (the '**Company Law**'), all businesses established in China must have a legal representative.

The legal representative of a company may be the chairman of its board of directors, an executive director or its general manager, as provided by the company's articles of association. The legal representative must also be registered with company authorities. Companies need to select their legal representative carefully, and legal representatives should be made aware of the responsibilities and liabilities that come with the position.

In addition recent amendments to the Company Law now require all companies to appoint a supervisor, whose role is to monitor the activities of the legal representative.

### The Legal Representative's Powers & Company Liabilities

The Company Law does not precisely define the metes and bounds of a legal representative's power. However, it is clear that a legal representative is authorized to perform all acts regarding general administration of the company and in accordance with the corporate purpose. For example, the

legal representative can: take whatever actions are legal and necessary for the conservation or exploitation of the company's assets; execute powers of attorney on the company's behalf and authorise legal representation of and litigation by the company; and execute any legal transactions that are within the nature and scope of that company's business.

It is important to be aware that a company will generally be held liable for the unauthorized actions of a rogue legal representative. The Contract Law of the People's Republic of China specifically provides that "[i]f the Legal Representative ... of a [company] creates a contract in excess of authority limits, such representative action is valid except where the counterparty knows or should know that it exceeded authority limits."

Generally speaking a company's articles of association and related corporate documents, filed with the local Administration of Industry and Commerce, set forth the limits of the authority of its legal representative. In practice, counterparties may justifiably argue that they have limited capacity to view these documents to determine the legal representative's authority. However from a legal perspective it is nevertheless important to specifically limit a legal representative's authority in the articles of association. For further protection companies may wish to publish the limits of their legal representative's authority on their corporate website, in order to provide further public disclosure and thereby help to overcome the presumption of validity.

### **How to Select a Legal Representative**

Different foreign investors have different preferences for their legal representative: some prefer an existing employee, even if no-one with Chinese management experience is available; whereas others will recruit directly from mainland China. We generally advise against the latter however, preferring someone highly familiar with the parent company's culture and – more importantly – who is trusted completely.

A director of the parent company is often a prudent choice for legal representative, since they also hold separate duties to the parent company under the laws of its place of establishment. The investor may then select a different with person greater local market experience as general manager. The Company Law provides that the company's chairman, executive director or general manager can be its legal representative; however this may be further constrained by the articles of association.

### **Liabilities of Legal Representatives**

To be a legal representative does not only mean power and glory; that person will also undertake substantial risk to themselves. The law holds legal representatives to a higher standard of care and competence than other personnel, and they will bear civil, administrative and even criminal liability for wrongful acts – both the company's and their own. Accordingly the legal representative may be subject to fines and penalties accrued by the company. Importantly, the liabilities of a legal representative extend to bankruptcy.

### **The Supervisor**

Under the Company Law, the role of the supervisor or board of supervisors is as follows:

1. to inspect the company's finances and related information;

2. to exercise supervision over the acts of the directors and managers carried out in performance of their corporate duties to ensure that they do not violate any laws, regulations or the company's articles of association;
3. to demand remedies from a director or manager when the acts of such director or manager are harmful to the company's interests;
4. to propose the convening of an interim shareholders' meeting; and
5. other powers as specified in the company's articles of association.

Furthermore, supervisors may attend board meetings and present inquiries or proposals regarding issues to be determined by the board of directors.

The supervisor is also entitled to supervise and constrain the legal representative, and it is arguable that a supervisor reduces the risk borne by the legal representative as a consequence of their individual actions taken on behalf of the company.

### **Recommendations for Avoiding Problems with Legal Representatives**

Our key corporate governance tips to clients with respect to legal representatives are as follows:

1. Take extreme care in selecting the person who will be your legal representative.
2. Ensure that the articles of association sufficiently limit the legal representative's powers.
3. Prepare resignation documents for the legal representative to sign upon appointment.
4. Ensure that the company seals are kept in a secure location and establish a transparent procedure for their use, including the use of logbooks to record all transactions. We often advise clients to store their company seals with our office to avoid misuse, and many find that the security offered by this approach outweighs the possible inconvenience.
5. Take every effort to understand your China business, rather than simply relying upon your senior people based in China.

Lehman, Lee and Xu's *Briefing Paper Series* aims to provide readers with summaries of various China-related legal issues, designed to answer the questions most commonly asked by our clients.

For more information on the topics discussed in this briefing paper, please contact our Corporate Governance team.

**Lehman, Lee and Xu's Corporate Governance team has experience and expertise in advising Chinese and international clients on all aspects of corporate governance in China, helping them to ensure accountability and transparency in their organizations.**

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