

Profits distribution in China: several rules to understand



ASIA

The provisions regarding profits distribution in China are scattered among various laws and regulations and especially in the *Interpretation No. 5 of the Supreme People's Court on Different Issues Concerning the Application of the Company Law of the People's Republic of China* (hereinafter referred to as "Interpretation No. 5") which came into force on April 29, 2019.

■ RIGHT OF CLAIM FOR PROFITS DISTRIBUTION WHEN AN EFFECTIVE RESOLUTION HAS BEEN ADOPTED

Article 4 of the Interpretation No. 5 is a further supplement to Article 14 of the *Interpretation No. 4 of the Supreme People's Court on Different Issues Concerning the Application of the Company Law of the People's Republic of China* (hereinafter referred to as "Interpretation No. 4") issued in 2017. These two articles intend to protect the right of shareholders, especially minority shareholders, to benefit from profits distribution when an effective resolution to this effect has been made.

When a resolution specifying the distribution plan has been adopted by the shareholders meeting, and such resolution has not been carried out, Article 14 of Interpretation No. 4 allows shareholders to request the distribution of profits through litigation. In case the company refuses to distribute profits in violation of the provisions of the resolution, and it can not justify

such conduct, the court is entitled to order an imposed profits distribution to shareholders in accordance with the provisions in the resolution.

In addition, Article 4 of the Interpretation No. 5 specifies that the company shall complete the profits distribution within the time limit expressly stated in the resolution. If no time limit is specified in the resolution, the provisions in the articles of association shall prevail. If no time limit is specified in both the resolution and the articles of association, or if the time limit specified lasts for more than one year, the company shall distribute the profits within one year from the date when the resolution is passed. Lastly, if the time limit specified in the resolution exceeds that in the articles of association, shareholders may, according to Paragraph 2 of Article 22 of the *Company Law of the People's Republic of China* (hereinafter referred to as the "Company Law"), bring lawsuits to the court to, as a first step revoke the time limit specified in the resolution, and as a second step require to apply the time limit in the articles of association. However, in order to be acceptable, the lawsuit shall be brought to the court within 60 days after the resolution is adopted.

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Minority shareholders who do not agree with the time limit for profits distribution specified in resolution but can not affect the content of such resolution due to methods of deliberation and/or

voting rights can, if such voted time limit violates the above mentioned provisions, bring a lawsuit to the court to require the profits distribution within a lawful time limit.

On the contrary, majority shareholders shall make sure that the time limit specified in the resolution does not exceed the one in the articles of association, and in all cases shall not exceed one year from the date of adoption of the resolution.

■ RIGHT FOR PROFITS DISTRIBUTION IN LACK OF RESOLUTION

According to Article 15 of Interpretation No. 4, the court will dismiss the claim of a shareholder requesting an imposed distribution in lack of resolution approving the profits distribution, unless the failure to distribute the profits is attributed to any shareholder's abuse and may result in losses suffered by other shareholders. In fact, the court respects the principle of liberty for company to distribute profits or not, and can not interfere with such a decision only in case of abuse of one of the shareholders. According to the interpretation made by Supreme People's Court during the press conference for the issuance of Interpretation No. 4, shareholder's abuses may include the cases when company does not distribute profits, but the directors and senior management personnel receive excessive salaries, or the controlling shareholder manipulates the company to purchase property or services unrelated to the operation of the



company for his/its own use or consumption, or conceal or transfer profits, etc.

Finally, if a limited liability company has not distributed any profits to the shareholders for five consecutive years but has made profits every year during such period and conforms to the profits distribution conditions of the Company Law, Article 74 of the Company Law gives right to shareholder who votes for profits distribution, while the other shareholders vote for the contrary which results in a resolution of the shareholders meeting rejecting the distribution, to require the company to repurchase his/its equity in the company at a reasonable price. If the shareholders fail, within 60 days following the date on which the resolution is adopted, to reach an agreement on the purchase price of equity, the selling shareholder may initiate a legal action against the company within 90 days following the date on which the resolution is adopted to require the company to repurchase his/its equity.

■ DISTRIBUTION OF PROFITS ACCORDING TO THE PROPORTION OF

CAPITAL CONTRIBUTION?

According to Article 34 and Article 166 of the Company Law, the profits in a limited liability company shall be distributed in proportion to each shareholder's capital contribution unless otherwise expressly agreed among all the shareholders, and shall be distributed in a joint stock limited company in proportion to shares held by each shareholder unless otherwise stipulated in the articles of association.

Thus, in the case of a domestic company or of a wholly foreign owned enterprise (WFOE), shareholders can decide to distribute profits not according to the proportion of capital contribution of each shareholder. This is also the case for sino-foreign cooperative joint ventures, for which the Law of the People's Republic of China on Sino-Foreign Cooperative Joint Ventures gives possibility to distribute profits in accordance with the methods willingly fixed in the cooperative enterprise contract.

On the contrary, sino-foreign equity joint ventures which represent the vast majority

of joint ventures, are currently obligated, pursuant to Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, to distribute profits strictly according to the proportion of capital contribution of each shareholder.

However, from January 1, 2020, sino-foreign equity joint ventures will be subject to the *Foreign Investment Law of the People's Republic of China* (hereinafter referred to as "Foreign Investment Law"), which will allow them, if they wish, to distribute profits according to proportions not reflecting the capital contribution of each shareholder, as provided in Articles 34 and 166 of the Company law.

■ ALLOCATIONS MADE TO THE RESERVE FUND

Companies can distribute profits only after payment of corporate income tax, compensation for losses from previous years, and allocation to the different funds listed in the table below:

	Domestic limited liability companies - Joint stock limited companies	Sino-Foreign Joint Ventures (equity and cooperative)	Wholly Foreign-owned Enterprises (WFOE)
Legal basis	Article 166 of the Company Law	Article 8 of the <i>Sino-Foreign Equity Joint Ventures Law</i> , and Article 76 of the <i>Implementing Regulations of this law</i>	Article 56 of <i>Implementing Rules for the Wholly Foreign-owned Enterprises Law</i>
		Article 1.10 of the <i>Supplementary Provisions on the Implementation of the New Enterprise Financial Systems by Foreign-Invested Enterprises</i>	
Rules of allocations to different funds	<p>Statutory common reserve: 10% of after-tax profits, within the limit of 50% of the registered capital, no more obligation of allocation beyond this limit</p> <p>Discretionary common reserve: percentage of allocation can be decided at discretion by shareholders meeting</p>	<p>Reserve fund - Employee bonus and welfare fund - Enterprise development fund:</p> <p>The percentage of allocations to be decided at discretion by the board of directors.</p>	<p>Reserve fund: 10% of after-tax profits, within the limit of 50% of the registered capital, no more obligation of allocation beyond this limit</p> <p>Employee bonus and welfare fund: the percentage of allocation to be decided at discretion by shareholders meeting</p>



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After the coming into force on January 1, 2020 of the Foreign Investment Law, all of the foreign invested companies (joint ventures and WFOE) will have a period of five years to complete their compliance with this law and with the Company Law.

Thus, the joint ventures which currently have no obligation to draw 10% of after-tax profits to the reserve fund, will have to conduct such allocation like all other companies under Chinese law as of January 1, 2020.

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