

Examiner's report

F4 Corporate and Business Law (CHN)

December 2011



Specific Comments

Question One

This question required candidates to explain the roles of *judicial interpretation* made by the Supreme People's Court, and state any one of the rules regarding the validity of a contract stipulated in the judicial interpretation of the Contract Law.

Judicial interpretation plays the substantive roles in the judicial practices, such as interpreting any legal issues that are new and uncertain to understand and enforce the laws; adapting the law to changed circumstances and atoning for legislative insufficiency, developing and applying a coherent and unified approach to the application of law and determining the jurisdiction issues, as well as giving guidance as operational criteria.

With respect to the judicial interpretation in relation to the validity of contract, the judicial interpretation includes several provisions in this regard. For instance, the judicial interpretation stipulates that where the approval or registration is required for the validity of a contract, and the parties fail to get approval or registration before the end of the debate in the first instance of court hearing, the contract may be deemed as void by the court. Where the law or administrative regulations required a contract to be registered but do not stipulate that such a contract shall take effect upon registration, the party's omission to register does not affect the validity of the contract, i.e. the relevant contract shall still take effect even if the parties do not register the contract.

Some candidates were able to explain one or two points to part (a) of this question. Most of them could explain the key roles of the judicial interpretation, including the adaption of the law to changed circumstances and the provision of the guidance to the local courts at various levels, although they could not state more roles played by the Supreme Court of China. However, some candidates did not understand the requirements of this part, namely the role of the judicial interpretation. They explained the jurisdiction of people's court.

As to part (b) of this question, it should be noted that candidates were not able to answer this part satisfactorily. Actually, the provisions of the Contract Law in relation to the validity of a contract are not clear enough. The judicial interpretation took a much positive attitude towards the validity of a contract that subjects to approval or registration and should be firmly understood by candidates. Some candidates, however, have confused capacity of a party to a contract with requirement of approval or registration. Since candidates were able to answer limited points in part (a) and part (b), the performance of candidate was not satisfactory.

Question Two

This question required candidates to explain the term right to use the land for construction, state various forms to establish such a right and various forms of disposal of the right to use for construction by a holder of such right under the Property Law.

Most candidates were able to explain the term right to use the land for construction correctly. Some of them even pointed out that this kind of right constitutes usufructuary right under the Property Law of China. Therefore, performances of part (a) of this question were satisfactory.

Part (b) required candidates to state various forms to establish (or create) the right to use the land for construction. In accordance with the Property Law, the establishment (or creation) of the right to use the land for construction can be established by forms of transfer or allotment, etc. Any acquisition of the right to use the land for construction for a commercial purpose shall take the form of transfer, such as auction, bid invitation or any other public bidding method. Under the Property Law, the establishment (or creation) of the right refers to the ways, or forms, to acquire such a right. Since all the ownership of the land in urban areas belongs to the State, any natural persons or legal persons can acquire the usufructuary right through a legitimate way. Therefore, they can acquire such a right through the form of transfer from the State, or transfer from other right holders. Very

few candidates were able to give a correct answer to this part. Hence performance for this part was not satisfactory.

Part (c) of this question was in relation to the disposal of the right to use the land for construction. In accordance with the relevant provision of the Property Law, the holder of the right to use the land for construction is entitled to disposed this right in various ways, such as transfer, exchange, using it as an equity contribution to a company, donation or mortgage, unless the law provides otherwise. Disposal is one of the major rights a holder shall have. Disposal means that a holder shall be entitled to “use” his right for any lawful purposes. Therefore, a holder of the right to use the land for construction shall be entitled to use such a right once again for any lawful purposes, including to donate, provide it as a thing mortgaged, contribute to a company as a form of capital contribution, etc. Most of candidates failed to give a satisfactory answer to this part of question.

Question Three

This question required candidates to explain the circumstances under which a labour contract is concluded that would make it invalid, and the various provisions that would be regarded as invalid, and state the provisions with respect to liquidated damages for breach of contract by an employee that may be incorporated into a labour contract under the Labour Contract Law.

Part (a) required candidates to explain the circumstances under which a labour contract is concluded that would make it invalid. Under the Labour Contract Law, a labour contract shall be regarded as invalid if an employer uses such means as deception or coercion, or takes advantage of an employee’s difficulties, to induce or force the employees to conclude a labour contract, that is contrary to an employee’s true intent. Therefore, the key point to this part of question relates to the circumstances under which a labour contract is concluded, not the provisions contained in such a contract. A lot of candidates did not understand clearly the differences between the circumstances that would result in the invalidity of a labour contract and the provisions of a labour contract that may be deemed invalid for various reasons in part (b). Therefore, performance on this part was unsatisfactory.

Part (b) related to the provisions in a labour contract that may be regarded as invalid, such as the provisions under which an employer may disclaim its legal liability or deny the rights of an employee, or the provisions that violate the mandatory provisions of laws or administrative regulations. Comparatively speaking, most of candidates were able to point out the provisions that violate the mandatory law and administrative regulations, but failed to point out the provisions under which an employer may disclaim its legal liability or deny the rights of an employee.

Part (c) of this question required candidates to state the special circumstances under which a labour contract may stipulate a provision on an employee for liquidated damages. As a general principle under the Labour Contract Law, no provisions of liquidated damages for breach of labour contract may be incorporated for an employee. Only under very special circumstances that meet the conditions as prescribed in the Labour Contract Law can a labour contract contain the provisions of liquidated damages for breach of contract by an employee. These circumstances include that an employer provides funds for an employee’s training or gives the professional training and the labour contract contains a special provision as to the obligation of confidentiality by an employee with necessary compensation to be granted by the employer for such special obligation. The common errors for this part of question include:

- Confusing the liability of an employer with the liability of an employee for breach of labour contract;
- Failing to understand that, as a general principle, a labour contract shall not stipulate a provision of liability for breach of contract by an employee.

Question Four

This question required candidates to explain the term ‘liquidated damages’ and state the nature of them, and state the rules relating to the award of liquidated damages as well as the rule relating to the award of liquidated damages for delay in performing under the Contract Law.

In part (a) ‘Liquidated damages’ refers to one of the legal liabilities as incorporated in a contract and to be borne by a party who breaches the contract. The nature of liquidated damages is compensatory, not a punitive one. This part of the question was answered correctly by most of the candidates. However, most of them were unable to state that the nature of liquidated damages is compensatory. This point is important and constitutes the basis for answering part (b) of this question. Since the nature of liquidated damages is compensatory, the party to a contract may request the court or arbitral tribunal to increase or reduce the agreed amount of liquidated damages where the amount of liquidated damages is excessively lower than the actual loss or is excessively higher than the actual loss respectively.

Part (b) required candidates to state the rule relating to the award of liquidated damages. In accordance with Article 114 of the Contract Law, the parties may agree that one party pays liquidated damages to the other in the case of breach of contract according to the circumstances of the breach, they may also agree on the calculating method of damages caused by the breach. If the agreed amount of liquidated damages is excessively higher than the actual loss, a party may apply for adequate mitigation. If the agreed amount of liquidated damages is excessively lower than the actual loss, a party may apply to the People's Court or an arbitration tribunal for an adequate increase. Most of candidates failed to state the said rule.

Part (c) of this question related to the form of liability for breach of contract by delay to perform the contractual obligation. According to the Contract Law, where the parties agreed upon the liquidated damages for delay in performance, the party shall still perform its contractual obligation after paying the liquidated damages, unless the delay to perform reached the level of fundamental breach of contract. Some candidates stated merely that the breaching party should pay the liquidated damages as agreed, but failed to state further the party should still perform its contractual obligation. Therefore, they did not perform satisfactorily.

Question Five

This question required candidates to state the special circumstances under which a company may purchase its own shares, and state the reasons why the Company Law set up such a special rule. This is question, was not answered satisfactorily. It seems that most of candidates had not familiarised themselves with this special rule.

According to the Company Law, as a general principle, a company shall not purchase its own shares. Only under the following circumstances can a company purchase its own shares:

- where the company is to reduce its registered capital;
- where the company merges with another company holding shares of this company;
- where the company is to offer its shares to its employees as a reward; or
- where any shareholder of a company has objections to the resolution on division or merger of the company adopted by the general shareholders’ meeting, and requires the company to purchase his/her shares.

The reasons that a joint stock company is generally not allowed to purchase its own shares are as follows:

- To purchase its own shares by the company would confuse the legal relationship between company and its shareholders. By this way the company would become a shareholder of the particular company.
- Where a company holds the shares of its own would result in such a situation in which part of the capital of the company, represented by the particular shares, is in a false position. It is not in conformity with the capital system of the Company Law.

- Where a company becomes a shareholder of its own, it may control the price of shares traded in the stock market and harm the interests of public investors by using the inside information of the company.

Candidates did not perform well in this question. Common errors for this question included:

- Failing to understand the requirements of this question by stating the restrictions on the senior executives of a company to sell their shares during the terms of office;
- Failing to give the major points in part (a) as to the special circumstances under which a company may purchase its own shares, especially those in relation to the reduction of its registered capital;
- Confusing the rule that permits a company to purchase its own shares under the special circumstances with the forms of incorporation of a joint stock company.

Question Six

This question required candidates to state the rules with respect to the declaration of creditor's rights, including what is not required to declare, under the Enterprise Bankruptcy Law. It also required candidates to state the rule as to the credits/debtors are involved in several and joint liability during the course of declaration of the creditor's right.

Under the relevant provisions of the Enterprise Bankruptcy Law, where the application of bankruptcy is accepted by a competent court all the following items, all creditors shall declare their credits within the period of time as prescribed by the law. However, the following items need not be declared during the course of declaration of the creditor's rights: employees' wages, subsidies for medical treatment, fundamental pensions and insurance premiums as well as other funds to the employees as prescribed by laws and administrative regulations. The bankruptcy administrator shall work out a checklist of the above items and make an announcement. According to other provisions of this Law, these items shall be settled in the second highest priority. The purpose of such a rule stands for the protection of the rights and interests of the employees.

Part (b) of this question required candidates to deal with the debts which are involved in several and joint liability during the course of declaration of creditor's right. According to the Enterprise Bankruptcy Law, the following rules should be complied with:

- The joint and several creditors may be represented by any one of them to declare their creditors' right or may jointly declare the creditors' right.
- Where the guarantor of a debtor or any other joint and several debtors has cleared off the liabilities on behalf of the debtor, the relevant party may declare its creditor's right on the basis of its right to recourse against the debtor.
- Where the guarantor of a debtor or any other joint and several debtor has not yet paid off the debts on behalf of the debtor, it may declare its creditor's right on the basis of its future right to recourse against the debtor, unless the creditors have declared all the creditor's right against the bankruptcy administrator.
- Where several joint and several debtors are ruled to be governed by the procedures as prescribed in the law, the creditors have the right to declare their creditors' rights as a whole in each bankruptcy case respectively.

Performance in this question was not satisfactory. Their common errors for this question included:

- Failing to state any points as to the items that need not declare during the process of the declaration of the creditor's rights;
- Failing to state the rules of the declaration of the creditors' right in relation to several and joint liability;
- Confusing the rules of the declaration of the creditors' right in relation to several and joint liability with the order of priority to settle the bankruptcy assets.

Question Seven

This question required candidates to state the rules as to the disclosure of information under the Securities Law.

In accordance with the Securities Law, directors and senior executives of a listed company shall confirm in writing on the regular reports of the company. Its supervisory board shall examine and approve the company's regular reports worked out by the board of directors and shall put forward its opinion in writing on examination and approval. The directors, supervisors and senior executives of the company shall ensure the truthfulness, accuracy and completeness of the information disclosed by the company. Therefore, all these persons are under a strict duty, not only to disclose the information, but also to ensure the truthfulness, accuracy and completeness of information.

Part (b) of this question required candidates to state the administrative liabilities of a listed company or other obligor of information disclosure for their wrong-doings regarding information disclosure. These of the administrative liabilities include: to make a rectification; to be given a disciplinary warning, etc.

As a whole, candidates did not perform well in this question. Common errors of this question included:

- Failing to understand the requirement of the question;
- Failing to understand that the relevant persons are under a duty to secure the truthfulness, accuracy and completeness of information;
- Failing to point out the nature of liabilities is the administrative one, not the civil or criminal one.

Question Eight

This question required candidates to state the legal issue with respect to the transfer of ownership for movables under the Property Law. On the one hand, performance of candidates in this question was satisfactory; on the other hand, there was still room to improve, especially the reasons to support their conclusion.

Part (a) of this question required candidates to deal with the legal issue with respect to the effect of contract for the transfer of movables. According to the Property Law, the creation or assignment of ownership of a movable shall come into effect upon delivery, unless otherwise prescribed by the law. The requirement for registration of the transfer of motor vehicle would not affect the validity of a contract. This means that Mr Liu and Mr Feng should register their transaction after the conclusion of the agreement. However, the agreement should be an effective one between the two parties even though it was not registered.

Common errors of this question included:

- Failing to state directly whether the relevant agreement was an effective one or not;
- Failing to give a correct conclusion that the relevant agreement was an effective one, due to the non-registration of the transaction;
- Failing to provide reasons to support their conclusion even if the conclusion was correct.

In part (b) candidates were required to make a determination as to the ownership of the motor vehicle. After the conclusion of the agreement, Mr Feng duly delivered the car to Mr Liu and the ownership of the car passed to him simultaneously. Although the sale of the car was subject to registration with the relevant government agency and the parties failed to do so, the mere fact that the non-registration of the car would neither affect the transaction between the two parties, nor affect Mr Liu's ownership along with the delivery of the car. Since there was no any *bona fide* third party coming to challenge the ownership of the car, Mr Liu should be the legitimate owner of the car. However, a few candidates answered that the ownership was held by Mr Feng, as the transaction was not registered by the parties.

The answer to part (c) of this question was based on the conclusions of part (a) and (b). Since Mr Liu was the legitimate owner of the car, his property right is protected by the law. The repair shop should be liable to Mr Liu for the damages to the car if it was caused by the defect of the air conditioner. Most of candidates were able to give a correct answer to this part.

Question Nine

This question required candidates to state the nature of set-off presented by Appliance Co and the conditions to be met for the statutory set-off under the Contract Law of China. Since candidates have been familiarised with the rule of statutory set-off, performance for this question was satisfactory. It seems, however, that candidates did not understand that there exists another form of set-off, namely the agreed set-off.

In part (a) candidates were required to give a determination with respect to the nature of set-off. Under the Contract Law, there are two forms of set-off: statutory set-off and agreed set-off. Statutory set-off means that in case the conditions as prescribed by the law are satisfied, the right of set-off is established. As to the agreed set-off, it means that the set-off is carried out and based on a special agreement with respect to the set-off of the debts between the relevant parties. In this case when Appliance Co claimed the set-off of the debts, there was no such a special agreement between the two parties in this regard. Therefore, it was a form of statutory set-off. Most of candidates were unable to state differences between the two forms of set-off, as well as the nature of set-off as claimed by Appliance Co to be a statutory one.

In part (b) candidates were required to state the conditions to be met for a statutory set-off. According to the Contract Law, when Appliance Co was claiming the right of set-off, some conditions should be met, such as: both Appliance Co and Department Store owed the opposite party some amount of monetary debts; the debts have become due; the nature of the debts is identical, Appliance Co has issued a notice to Department Store; there is no statutory prohibition of such set-off. Hence, Appliance Co was entitled to claim the set-off of credits and debts with Department Store. The major error in this part stands for the nature of the debts between Appliance Co and Department Store. Some candidates held that the nature of the debts is not identical, because Appliance Co owed Department Store an amount of price for goods, while Department Store owed Appliance Co a sum of rental. However, it was a misunderstanding. Although the legal relationships were different between the two parties which resulted in the debts between the two parties, the nature of the debts was same, i.e. the monetary debts. Therefore, the nature of debts met the statutory set-off as prescribed by the law. It is obviously some candidates did not distinguish between the legal relationships and the nature of debts that comes out of the transactions with the different legal relationships.

Question Ten

This question required candidates to determine the legality of the resolutions adopted by the board of directors for approval by the general shareholders' meeting under the Company Law of China.

Performance in this question was satisfactory, as some candidates were able to give a correct determination with reasons to support their determination.

Part (a) of this question required candidates to determine whether the resolution (i) was in conformity with the law. According to the relevant provision of the Company Law, the resolution of the board of directors on the distribution of dividends was not in conformity with law. Under the Company Law, when a company distributes the annual after-tax profits, it shall allocate 10% of its profits to its statutory common reserve fund. After a company makes up its losses and makes allocations to the statutory common reserve fund, a limited liability company or a joint stock company may distribute the remaining after-tax profits to its shareholders according to the provisions of this Law or the articles of association.



In this case Stationary Company intended to distribute all its after-tax profit, failing to allocate 10% of the profits to its statutory common reserve fund and failing to make up its previous loss. Therefore, the resolution was not in conformity with the provisions of the Company Law.

The answer to part (b) of this question is that the resolution of the board of directors on placing the shares as a pledge for a loan was not in conformity with law. Under the Company Law, shares are the certificates of right held by shareholders when they make their capital contributions to the company. The company cannot be a holder of the shares it issued to its shareholders and cannot dispose of the shares of its shareholders through a resolution, no matter if there is a resolution of the board of directors or a resolution of the general shareholders' meeting. Hence, any company is not allowed to place the shares of its shareholders as a pledge for a loan agreement by a resolution of the general shareholders' meeting. Though some candidates were able to give a correct conclusion, they failed to give reasons to support their conclusion.