eiger

FOREIGN INVESTMENT VEHICLES IN CHINA – OVERVIEW OF THE LEGAL FRAMEWORK

Tian XU

Emanuel SCHIWOW

September, 2009

Initial Publication GesKR, Dike Publishing House, Switzerland, in December 2006

FOREIGN INVESTMENT VEHICLES IN CHINA – OVERVIEW OF THE LEGAL FRAMEWORK

1. The Chinese legal system related to foreign investment

Foreign investment in China has become a major issue in the global economy in the past few years, with China ranking among the world's top countries with regard to foreign capital allocation. A significant part of the investments are undertaken through investment vehicles fully or partially owned by foreign entities. The following article provides an overview of China's foreign investment law with a focus on its investment vehicles.

China began to liberalise and open its economy to foreign investment in the late 1970s. While the first decade of the opening period was characterized by a "wait-and-see" spirit, foreign investment has continuously increased since the 1990s and peaked in the past few years. China's economic rise has been accompanied by several significant and fundamental legal reforms[1]. As to the Chinese legal system related to foreign investment, four key aspects are worth mentioning:

1) China has adopted a civil law system. The legislation process, however, has not been systematically planned from the beginning. As a result, the legislation seems to be a patchwork of different laws and regulations rather than a well-structured unity.

2) The National People´s Congress ("NPC"), China's highest state authority, is generally confined to basic legislation and delegates legislative power to different governmental bodies with regard to concrete regulations and implementation rules. Therefore, the influence of sub-legalisation by different administrative bodies is huge, especially in the economic law. In fact, there are different local and central administrative authorities involved in the legislative process, which leads to a rather confusing and rapidly changing system of regulations and sub-regulations. The PRC[2] Ministry of Commerce ("MOFCOM"), China's highest foreign trade administration body, plays a proactive voice in the sub-legislation process.

[1] Before the Open Door Policy, China's publicly available laws of general application (both civil and criminal laws) comprised one slim volume. Nowadays, several hundreds of general applicable regulations are in force.
[2] People's Republic of China.

3) Within the framework of the general economic legal system, the Chinese economic legal system has been developed as a bifurcated system, featuring a domestic system with regulations on domestic economic affairs, and a foreign-oriented system with regulations on foreign-related economic affairs. From a historical perspective, the development of the legal system occurred "backwards", with the foreign system being developed before the enactment of the domestic legal framework[3]. In the future, those two systems are likely to merge gradually into one.

4) China's legal reforms have been (and still are) boosted by China's accession to the WTO in 2001[4]: with the WTO accession, China has committed itself to an incremental opening of various industries, particularly the service sector, to a reduction of tariff charges and to a further reform of the legal system. The WTO accession is supposed to accelerate the legal reforms substantially, to increase the legal certainty and to make China adopt general international legal principles and standards[5].

2. Industry Policy and Foreign Investment Guidance Catalogue

As opposed to generally freely accessible markets in the Western hemisphere, foreign investment in China is still subject to the influence of planned economy elements. Whether a foreign investor may invest in certain industrial sectors and what the requirements for the investment in such sectors are, largely depends on the intention of the state in promoting or inhibiting the foreign investment in a particular industrial sector. As a result, the legal framework for foreign investment in China is substantially driven by its planned economy.

[3] The PRC Company Law entered into force relatively late, in July 1994; at that time, foreign-related laws already constituted the governing law for nearly ten years. For further historical information, see: Brown/Xin, Introduction to Company Law, in: CCH Asia Pte. Ltd. (Editor), China Company Law Guide, Singapore, 2004, Section 10, para. 110 et seq.

[4] After 15 years of preparations and negotiations, China joined the WTO as its 143rd member on December 11, 2001.

[5] According to article 38 para.1 of the PRC Law on Administrative Approvals, promulgated on 1 July 2004 (note: after the WTO accession), decisions of administrative bodies in approval procedures are now subject to judicial review (theoretically, at least). China's WTO commitment also includes a complete abolition of the so-called "neibu"-rules (administrative rules and by-laws, binding for decisions of administrative bodies, which are not disclosed to the public. "Neibu"-rules were widespread in the past).

The planned economic policies with regard to foreign investment are embodied in the so-called PRC Foreign Investment Industrial Guidance Catalogue ("PRC Guidance Catalogue") and the PRC Guiding Provisions[6]. The PRC Guidance Catalogue contains a comprehensive compilation of business activities and defines whether a foreign company is allowed to engage in a business field as well as which investment vehicle is approved for the respective business field (certain activities can be undertaken by a foreign investor only if it teams up with a Chinese partner). In general, foreign investment projects are divided into four categories: encouraged, permitted, restricted and prohibited. Encouraged, restricted and prohibited foreign investment projects are included in the PRC Guidance Catalogue; foreign investment projects that do not fall into the encouraged, restricted or prohibited category are of the per mitted category[7]. Such categorizations are relevant for defining the responsible approval authorities and the possible tax preferential treatments the projects may be entitled to. The Guidance Catalogue has been updated in 2005 thus demonstrating the tendency of an enhancement of China's economic opening and its increasing compatibility with its WTO commitments.

3. Legal vehicles for foreign investors in an overview

There are different categorizations of foreign investment vehicles in China, following different criteria. According to the legal form of the investment vehicles, a foreign investor may either set up a representative office ("RO"), a company with limited liability ("LLC") or a company limited by shares ("CLS").

[6] PRC Guiding the Direction of Foreign Investment Provisions ("PRC Guiding Provisions"), promulgated on 11 February 2002 and amended on 30 November 2004. The PRC Guidance Catalogue is accompanied by the "Guiding Foreign Investment in the Dominant Industries of the Central and Western Regions Catalogue", which emphasizes the facilitation of investments in China's economically and infrastructurally underdeveloped central and western provinces. The central and western provinces cover 60% of the country's territory.

[7] Article 4 PRC Guiding Provisions; for further information regarding the Guidance Catalogue, see: Guanxi Zheng, China Investment Vehicles, in: CCH Asia Pte. Ltd. (Editor), China Company Law Guide, Singapore, 2004, Section 1, para. 005 et seq.

The ROs are restricted to conducting non-profit-making activities such as coordination, marketing, market research etc. Since they are not incorporated and thus do not have the status of a legal person, liabilities incurred by a RO are borne by the foreign investor company. An individual is appointed by the foreign investor as chief representative, he is the person in charge of the activities of the RO. Incorporation procedures are faster and less complex compared to LLC or CLS.

Whereas both LLC and CLS are legal persons[8] and may carry out profit-making business activities, the LLC is more popular due to its significantly lower requirements for registered capital. For the purpose of this article, only investment vehicles in the legal form of a LLC are introduced below. The incorporation of a CLS is worthwhile particularly where the company plans to go public on a Chinese stock exchange at a later stage.

Another categorisation distinguishes foreign invested enterprises ("FIE") from domestic companies. The FIE comprise the following three main investment forms: equity joint venture ("EJV"), cooperative joint venture ("CJV") and wholly foreign-owned enterprise ("WFOE"). These forms are usually chosen according to the intended participation of the foreign investor and the PRC Guidance Catalogue. As far as the various types of business activities that a FIE plans to carry out are concerned, a FIE may be engaged, inter alia, in production, service, distribution, retail, wholesale or in the holding of participations. Foreign investors have been given a number of incentives, including primarily tax incentives, to encourage production activities in China[9].

---

[8] According to Art. 36 para. 1 and Art. 54 et. seq. of the PRC General Principles of Civil Law ("GPCL"), promulgated on 12 April 1986, a legal person is an organisation that possesses legal capacity and the capacity to perform civil acts, and, in accordance with the law, enjoys civil rights and assumes civil obligations. It may be a party in civil proceedings. Thus, the Chinese understanding of the meaning of the term "legal person" is similar to the definitions employed by Western civil law doctrine.

[9] Possible tax incentives include exemption and reduction of enterprise income tax, reduced tax rate and exemption or reduction of import duty and import VAT within total investment of a FIE.
Instead of establishing a FIE, an investor can also enter into the Chinese market through the acquisition of a domestic company or an FIE. Possible tax incentives include exemption and reduction of enter prise income tax, reduced tax rate and exemption or reduction of import duty and import VAT within total investment of a FIE.

4. Equity Joint Venture and Cooperative Joint Venture

EJV and the CJV are joint venture forms, designed for foreign investors who wish (or are committed) to team up with a local partner. Both EJV and CJV feature at least one Chinese and one foreign partner[10]. From a legal point of view, the EJV is set up as a LLC; the operation and legal structure of the LLC are comparable to limited liability companies in other countries over the world, with the following peculiarities: 1) there is no general shareholders' meeting (all competences are directly executed by the board of directors or the general manager), 2) the partners merely hold equity interests and not shares. The highest body of the EJV / CJV is the board of directors, which shall consist of at least three members[11]. The liability of the parties is limited to the registered capital[12]. The CJV can be set up both as a limited liability company or as a joint venture without independent legal status[13]. In the latter case, there is no limitation of the liability of the partners, similar to the liability in partnerships in different western legal systems.

Whereas the proportion of the capital participation in the EJV reflects the control over the company, thus restricting the parties' flexibility, the CJV Law allows the partners to establish a tailor-made company structure with regard to liabilities, risks, responsibilities and the share of profits. The key differentiating features of a CJV compared to an EJV are: 1) the parties of a CJV may allocate profits and losses as they choose rather than in proportion to their respective contribution to the registered capital and 2) the foreign party may apply to recover its investment capital during the term of the venture (in some cases before payment of income taxes). CJVs are especially suitable for short-term projects, the exploitation of resources, build-operate-transfer ("BOT") projects, hotel projects and, in general, investments where equipment delivered by the foreign investor is paid out of the distributable profits.

[10] Article 1 PRC Sino-foreign Equity Joint Venture Law ("EJV Law"), promulgated on 1 July 1979 (!), amended on 4 April 1990 and 15 March 2001 and article 1 PRC Sino-foreign Co-operative Joint Venture Law („CJV Law"), promulgated 13 April 1988, amended 31 October 2000.

[11] Article 6 EJV Law, article 30 et seq. of the PRC Sino-foreign Equity Joint Venture Law Implementing Rules ("EJV Implementing Rules"), promulgated on 20 September 1983, amended on 15 January 1986, 21 December 1987 and 22 July 2001, / article 12 CJV Law, article 24 et seq. of the PRC Sino-foreign Co-operative Joint Venture Law Implementing Rules ("JVC Implementing Rules"), promulgated on 4 September 1995.

[12] Article 4 of the EJV Law and article 16 of the EJV Implementing Rules.

[13] Article 4 and article 14 of the JVC Implementing Rules.

5. Wholly Foreign-Owned Enterprise

The use of a WFOE grants the investor a maximum level of determination power over the investment vehicle, since a WFOE is entirely owned by a foreign legal entity without participation of a Chinese partner[14]. Therefore, the foreign investor may fully determine the business activities of the WFOE and at its own discretion within the scope of Chinese law. The WFOE is primarily governed by the WFOE Law and its implementing rules, and secondarily by the PRC Company Law.

The legal form of a WFOE is usually set up as an LLC. The main legal bodies of the WFOE are the board of directors and the management; the WOFE does not feature a general shareholders' meeting. While the board of directors, formed by at least three members, is the highest organ of the WFOE, the management (general manager and deputy managers) is in charge of the daily business[15]. In addition, a supervisory board has to be formed or, alternatively, a supervisor appointed. Powers and duties of the legal bodies are mainly defined in the articles of association and additionally follow from the mandatory provisions in the WFOE Law.

In recent years, WFOE has become the most popular investment vehicle in China. The number of established WFOEs has increased from around 10´000 by the end of 2001 to over 30´000 by the end of 2005[16]. This may be due to the growing confidence of foreign investors in being able to succeed in the Chinese market without local "help", and to sometimes disappointing experiences foreign investors may have had in joint venture projects. A further reason for the popularity of the WFOE among foreign investors is the larger accessibility of business fields previously reserved to joint venture companies by the PRC Guidance Catalogue: with China fulfilling its WTO-commitments, service sectors become more accessible and certain services are now open for establishment of WFOEs.

[14] Article 1 of the PRC Wholly Foreign-owned Enterprise Law ("WFOE Law"), promulgated on 12 April 1986, amended on 31 October 2000.
[15] For corporate governance aspects, see: Lam/Ketong, Introduction to Company Law, in: CCH Asia Pte. Ltd. (Editor), China Company Law Guide, Singapore, 2004, Section 160, para. 110 et seq.
[16] Behind the China Kaleidoscope, A Guide to China Entry and Operations, OSEC Business Network Switzerland et. al (Editors), Shanghai, 2006, p. 81.

As of December 2004, foreign investors are permitted to set up WFOEs to be engaged in wholesale, retail, commission agency and franchise. Since then China has seen an upsurge of foreign investment in distribution sectors.

Large foreign companies, namely listed companies, which have already significantly invested in China and which intend to provide general services such as business consultancy, technical training, transportation, warehousing or assistance in seeking loans or guarantees may set up the WFOE as a foreign invested holding company, provided that they meet the high thresholds regarding its total assets value and aggregate investment in China[17]. Foreign invested holding companies benefit from access to restricted business fields and possess a wide-ranging business license, allowing them to act more liberally in many respects compared to ordinary service companies.

6. Minimum capitalisation of EJV, CJV and WFOE

Failing higher capital requirements for FIEs in particular industrial sectors or for FIEs of a particular type in the special laws or regulations, the PRC Company Law provides for a minimum registered capital for all kinds of companies including FIEs in the amount of RMB 30'000[18]. However, since the establishment of FIEs in China does not involve a simple registration, but rather entails prior approval(s), the registered capital has to correspond to the intended business activities. To prove this, the local approval authorities frequently insist on capital requirements which turn out to be much higher than the minimum threshold provided in the PRC Company Law. For example, the minimum registered capital for various types of FIEs set up in Shanghai Pudong New Area has been USD 140'000 for years[19].

[17] The foreign investor intending to establish a foreign invested holding company shall must either have a total asset value of no less than US$400 million in the year prior to the application and have established foreign-invested enterprise(s) in China with a paid registered capital of more than US$10 million or have already established 10 or more foreign-invested enterprises, with a paid registered capital of more than US$30 million.

[18] Art. 26 PRC Company Law; RMB 30'000 correspond to USD 3'800, approx.

[19] Although it is expected that after the 2005-revision of the PRC Company Law the respective approval authorities may loosen these requirements, foreign investors still tend to meet the same requirements so as to ensure the approval is obtained.

To regulate the proportions between equity and debt financing of a FIE, the PRC laws regarding FIEs adopt the concept of “total investment”, which means the aggregate sum of registered capital and the permitted amount of loans. The required ratio between the registered capital and the total investment defines the registered capital to lie between 70% and one third of the total investment (the higher the total investment amount, the lower the percentage of registered capital has to be)[20]. Therefore, the minimum registered capital always depends on the whole business project in question. Exceptions to the normally applicable capital-debt-ratios exist in respect of foreign invested holding companies as well as foreign invested CLS.

7. Incorporation process of EJV, CJV and WFOE[21]

The first (and often difficult) step in the incorporation process of an EJV or CJV is negotiations between the investor and the Chinese partner. The distribution of powers and duties and the representation of the two parties on the board of directors and the management according to the articles of association have a big impact on the future joint venture company. The negotiation phase is usually terminated by the signing of a (legally not binding) letter of intent. On the other hand, the incorporation of a WFOE naturally does not necessitate negotiations. The proper process of incorporation is a project of its own with different administrative bodies involved, which is more coordination-intensive and time-consuming than it would be in the Western hemisphere. The submission of documentation to a number of authorities during various stages constitutes an essential element of the foundation process. Foreign investors should bear in mind the high influence of administrative authorities on their business project: their understanding, support and approval are crucial in the foundation process as well as during the whole business activity within China[22].

[20] Article 19 et seq. WFOE Implementing Rules and the Provisional Regulations concerning the Ratio between Registered Capital and Total Amount of Investment of Sino-foreign Equity Joint Ventures, promulgated on 1 March 1987, which are also applicable to WFOEs.
[21] The incorporation process for joint venture companies and WFOEs have some significant differences, which shall, however, be overlooked in this general overview.
[22] At least, nowadays, the famous “guanxi” (personal relationships) with administrative bodies are loosing of their importance.

The foundation process includes the following key steps: reservation of a Chinese company name, submission of a project proposal[23], feasibility study[24], articles of association (and in case of EJV and CJV of the joint venture contract) and other related documents[25] in pursuit of a certificate of approval. Upon obtaining the certificate of approval, the foreign investor shall undergo the registration procedures at the competent State Administration of Industry and Commerce (“SAIC”), which will issue the business license of the intended FIE.

As of the issuing date of business license, a FIE is established as a legal entity and may commence its business activities. It is worth mentioning that the business scope set forth in the business licenses defines (and restricts) the business activities that the FIE is permitted to engage in[26]. The term of the business licence is limited and subject to renewal. Before starting the incorporation process, foreign investors shall consider whether it is suitable to found the FIE as a direct affiliate of the foreign company (onshore model) or whether an offshore vehicle should be interposed (offshore model) especially for tax optimisation purposes[27].

[23] The project proposal is a preliminary study describing the project.

[24] The feasibility study shall show/prove that the business project is likely to be successful. Its content is detailed information on the entire business project.

[25] Such related documents include a bank reference letter for the foreign investor to demonstrate his financial strength, environmental impact appraiser report demonstrating the environmental compatibility of the project, a list of imported equipments and appointment documents regarding board members, supervisors and general manager, etc.

[26] While the business scope of a company in the cement industry in Western Europe could simply be “*manufacturing and sale of cement products*”, in China, a respective business scope reads, for example, as follows: *“Manufacturing, transportation, storage and sale of cement products; utilization of heat energy (produced during the production process of cement), operating the powerhouse to generate electric power and producing steam for self-use; providing the technical consulting services as well as the manufacturing know-how related to the above-mentioned cement products.”* If, for example, the word *“sale”* were missing, the sale of cement would not be covered by the business scope and would as a result be illegal.

[27] The choice of the right set up strategy is pivotal (also for tax reasons) and should include considerations about an eventual exit of the investor (“exit strategy”). In practice, however, FIE set-ups through an offshore vehicle, situated for example in Hong Kong, are common.

8. Summary

In a nutshell, China's foreign-related corporate law provides a limited, but reasonable choice for foreign investors to establish companies and conduct business activity within China. The investment vehicles range from cooperation forms with different degrees of Chinese participation to wholly foreign-owned affiliates. Entering into its fifth post-WTO-accession year, China offers a wider range of business opportunities and a market with steadily increasing legal certainty from which the investors can benefit in the long run. On the other hand, steady changes in the legal system and proactive bureaucracy call for continuous alertness and awareness as well as enhanced flexibility from investors when choosing suitable investment vehicles. Or, as an old Chinese saying goes: “gong yu shan qi shi bi xian li qi qi” - to be a successful craftsman, one must carefully select the right tool and always look after it, in order to keep it sharp.

* * * * *

* * *

*

DISCLAIMER

This publication is not intended to provide accurate information in regard to the subject matter covered. Readers entering into transaction on the basis of such information should seek additional, in-depth services of a competent professional advisor. Eiger Law, the author, consultant or general editor of this publication expressly disclaim all and any liability and responsibility to any person, whether a future client or mere reader of this publication or not, in respect of anything and of the consequences of anything, done or omitted to be done by any such person in reliance, whether wholly or partially, upon the whole or any part of the contents of this publication.