

How Much the Accession to WTO Has Facilitated Foreign Investment
in the PRC? —Fruits and Remaining Problems, in Consideration of
Company Law 2006—

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I Introduction

Since the People's Republic of China (hereinafter referred to as "the PRC") declared to take off to the "Socialist Market Economy" in 1992, foreign investments in the PRC have been dramatically increased in the amount as well as in the number. As a result, from January to November, 2005, China approved and set up 39,679 foreign invested enterprises, up by 1.17% than previous year; contractual value of foreign fund was US\$167,212 million, up by 23.99%.¹

In particular, the foreign-related business operations, which procure and bring raw materials and parts into the PRC where they manufacture them into the complete commodities in order to export, have greatly contributed to the trade rendered by the PRC. For example, the share of such foreign-related business organizations in the total amount of import and export by the PRC amounted to 50.8% in the first half of the year of 2001 while it was only 26.4% in the year of 1992².

However, the PRC legal systems including laws and regulations governing foreign investment and the role of government authorities have been neither sophisticated, transparent, nor fair enough to facilitate foreign investment in the PRC, while a lot of efforts have been made to modernize laws relating to economic activities³. Therefore, foreign investors have had to struggle against many legal obstacles.

¹ See the Statistics about China's Absorption of Foreign Fund in 2005 (1-11), available at <http://www.mofcom.gov.cn>.

² The PRC Department of State Statistics, THE PRC ANNUAL STATISTICS REPORT

³ For example, recently many fundamental private laws have been enacted or totally amended such as the Unified Contract Law (1999), Security Law (1995) and Company Law (1993 and amended in 2005).

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However, the PRC's accession to WTO on the 11 December 2001 changed the situation. In order to comply with commitments made by the PRC as part of various WTO Agreements, the PRC became obliged to amend the existing provisions of foreign-related laws and regulations that would otherwise be inconsistent with those Agreements.

Actually, the PRC amended many of those existing laws and regulations⁴ or new legislations were enacted⁵ before and after its accession to WTO.

The objective of this paper is to analyze how much the changes in laws and regulations made in order to comply with WTO Agreements have facilitated foreign investment in the PRC as well as the remaining problems unsolved. First of all, I will overview the recent changes in laws and regulations governing foreign investment in the PRC. Second, I will focus on the progress and remaining problems relating to laws and regulations for Foreign-invested Enterprises. And finally, I would like to give some practical suggestions.

II The Overview of Foreign Investment

1. Forms of Foreign Investment

The possible forms of a foreign-related business organization for investment in the PRC are :

A. Representative Office

B. Branch

⁴ For example, *the Law of the PRC on Sino-Foreign Equity Joint Ventures* (hereinafter referred to as "EJV Law") was amended on 15 March 2001 and so was *the Regulations for the Implementation of the Law of the PRC on Sino-Foreign Equity Joint Ventures* (hereinafter referred to as "EJV Implementation Regulations") on 22 July 2001.

⁵ For example, *the Regulations of the PRC on the Administration of Technology Import and Export* was effective on 1 January 2002.

- C. Foreign-Invested Enterprise (hereinafter referred to as “FIE”)⁶
 - C1 Equity Joint Venture (hereinafter referred to as “EJV”)
 - C2 Co-operative Joint Venture (hereinafter referred to as “CJV”)
 - C2-1 Legal Person Co-operative Joint Venture (hereinafter referred to as “LP-CJV”)
 - C2-2 Non Legal Person Cooperative Joint Venture (hereinafter referred to as “NLP-CJV”)
 - C3 Wholly Foreign-owned Enterprise (hereinafter referred to as “WFOE”)
- D. Holding Company
- E. Branch of the above C (FIEs)
- F. Subsidiary of the above C (FIEs)
- G. Foreign Investment Company Limited by Shares (hereinafter referred to as “FICLBS”)
- H. Assembly and Processing Operations

Among the above, A. B. C2-2, E and H are non-legal person vehicles, especially; C2-2 and H are merely contractual arrangements, whereas C1, C2-1, C3, D, F and G are legal person vehicles.

2. Representative Office vs. Branch

A representative office can be established subject to the least stringent procedures whereas the establishment of a branch is subject to many requirements including minimum capital requirement⁷. However, a repre-

⁶ Some scholars define FIE as to include a Foreign Investment Company Limited by Shares in addition to EJV, CJV and WFOE. For example, J. Zhang & J. Lowe, “Foreign Investment Companies Limited by Shares: The Latest Chinese Organization for Major International Ventures”, 21 J. INTL. L. BUS. 409 (2000), p412. However, the author takes the other position.

⁷ “Branch of Foreign Companies” in Lewis, D., ed., China Investment Manual (2nd Ed.) (1998). P51, V. Chan. “Representative Office vs. Branch Offices vs. Other Business

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representative office may not be engaged in direct business activities and may only play a role of liaison office. In addition, a representative office may not directly advertise nor recruit local staff and must ask a Foreign Enterprise Service Corporation (FESCO) to supply personnel for them⁸.

The restrictions imposed on trading rights prior to WTO accession was based on the “foreign trade operator” system set out by Foreign Trade Law.⁹

In accordance with old Foreign Trade Law, PRC enterprises had to be registered as foreign trade operators (FTOs) to engage in direct foreign trade including trading in goods and technology. Only PRC legal persons were able to apply for this registration (Article 8).

Article 13 of old Foreign Trade Law provides that FTOs shall act as agents or middlepersons for PRC producer and end-user enterprises, which have no trading rights by entering into “entrustment agreement”. Only FTOs may enter into and sign international sales contracts.

In addition, Articles 1 and 2 of Tentative Provisions could lead to the principles that :

In the case where the principal has also the right to trade, the FTO shall sign the sales contract in the principal’s name and General Principles of Civil Law (hereinafter referred to as “GPCL”) shall apply. On the other hand, in the case where the principal has no trading rights, the FTO shall enter into the sales contract in its own name. A question then arises whether the latter is really a legal agency.

Vehicles”, in V. Chan & Co., ed., Establishing Representative and Branch Offices in the PRC (1996), p20.

⁸ Id. “Representative Office vs. Branch Offices vs. Other Business Vehicles”, p24-25, Article 11 of *Administration of Resident Representative Offices of Foreign Enterprises Tentative Provisions* (promulgated on 30 October 1980)

⁹ Promulgated on 12 May 1994 and effective as of 1 July 1994.

Foreign trade operator system was supposed to be abolished because this is incompatible with Protocol and Article III of GATT 1994 (national treatment).

Therefore, at the time of the accession to WTO, the PRC had committed to give all enterprises in the PRC the right to trade within three years after accession.¹⁰ Because of this, it was argued that a representative office will become redundant taking into consideration such an FIE which was to have a trading right¹¹. However, a representative office was still thought to be useful as a pilot office that explores the possibility of new investment opportunity in the PRC, or a substitute for a holding company, the establishment of which is still subject to a substantial barrier although the requirements were greatly relaxed by 7-time amendments in 10 years from the one in May 2001 to the one in 2004, *to the Establishment of Companies with and Investment Nature by Foreign Investors Tentative Provisions* (hereinafter referred to as “1995 Law”), which had been issued by the Ministry of Foreign Trade and Economic Cooperation¹² (hereinafter referred to as “MOFTEC”) on 31 May 1995.¹³

Actually, representative offices of FIE which are incorporated in Bonded Zones had played an important role until the PRC realized this commitment by the substantial amendment to the Foreign Trade Law which made it possible for any (legal) person (including FIE) to have the right to trade by registration on the first of July, 2004 and enactment of the *Management of Commercial Enterprises with Foreign Investment*, which greatly eased the restriction of the establishing a wholesale or retail commercial company by foreign investors and was entered into

¹⁰ Article 5 of China's Protocol of Accession

¹¹ A. Lauffs and A. Singh, “China's WTO Accession: Preparing for Change”

¹² Currently, the Ministry of Commerce (MOFCOM).

¹³ See II 4.

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force on the 1 June 2004.

In other words, before these drastic amendments to the foreign trade right and commercial enterprises with foreign investment, foreign investors have established trading company in Bonded Zone, and substantial business has been handled by their representative offices located in the central city area.

By the way, along with the above amendment, the revised Regulation for the Registration and Administration of Enterprises¹⁴ stopped the registration of representative offices out of Bonded Zone and it made many foreign companies misunderstand that such kind of representative offices became prohibited to be established. However, “Opinion regarding to Application of Law for the Authorization and Registration of Commercial Enterprises with Foreign Investment”¹⁵ clarified that establishment of representative office itself is not prohibited but became unnecessary to take registration procedure as before.¹⁶

While the PRC Company Law¹⁷ permits a foreign company to establish a branch and approval procedures are provided for in implementing Branch Office Measures issued by the State Council on 1 July 1994¹⁸, much is left for the discretion by the approving authority and in the reality, only foreign banks and insurance companies have succeeded in establishing branches in the PRC in accordance with specific laws and regulations¹⁹.

¹⁴ Originally was effective on the 1st of July, 1994 and amended version was effective on the 1st of 2006.

¹⁵ Issued on the 24th of April, 2006.

¹⁶ Tian Hui, “Foreign Investment in trading and Commerce in the PRC”, 834 NBL (2006) p88.

¹⁷ Old Company Law was Effective on 1 July 1994 and New Company Law was enacted on the 27th of October 2005 and effectuated on the 1st of January 2006.

¹⁸ Supra note 7, “Branch of Foreign Companies”, p51.

¹⁹ Id. supra note 7, “Branch of Foreign Companies”, p50.

However, the establishment of branches shall be expanded to the other industries in accordance with “WTO Schedule of Specific Commitments on Services” (hereinafter referred to as “Services Schedule”).

3. FIE

The most matured and comprehensive law systems in the PRC investment laws are available for FIEs. “FIE Legislation”, namely, EJV Law, EJV Implementation Regulations, *the Law of the PRC on Sino-foreign Co-operative Joint Venture Enterprises* (hereinafter referred to as “CJV Law”), *Implementing Rules for the Law of the PRC on Sino-foreign Co-operative Joint Venture Enterprises* (hereinafter referred to as “CJV Implementing Rules”), *the Wholly Foreign-Owned Enterprises Law of the PRC* (hereinafter referred to as “WFOE Law”) and *Detailed Rules for the Implementation of the Wholly Foreign-Owned Enterprises Law of the PRC* (hereinafter referred to as “WFOE Implementation Rules”) provide for detailed rules for establishment, management organizations, dissolution and so on.

The FIE has been the most popular mode of utilizing foreign capital and will be so in the future since the recent amendments to FIE Legislation made in reference with WTO have enhanced to considerable extent the protection of foreign investors²⁰.

4. Holding Company

The law governing the establishment of a holding company in the PRC, *the Establishment of Companies with and Investment Nature by Foreign Investors Tentative Provisions* (hereinafter referred to as “1995 Law”), was issued by the Ministry of Foreign Trade and Economic

²⁰ Details will be discussed in III.

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Cooperation (hereinafter referred to as “MOFTEC”) on 31 May 1995. In accordance with Article 5 of 1995 Law, a holding company is defined as a company (1) not being engaged in a direct production and (2) providing its subsidiaries and its parent company with services.

1995 Law, together with *the Problems Concerning the <Establishment of Companies With and Investment Nature by Foreign Investors Tentative Provisions> Explanation* promulgated on 16 February 1996, had restricted the activities of a holding company set up by a foreign investor²¹.

In particular, the restrictions such as (a) a holding company was able to sell the products manufactured by its subsidiaries not as a wholesaler but merely as an agent and (b) a holding company was unable to import goods to sell, had been substantial obstacles for foreign investors.

However, *<Establishment of Companies With and Investment Nature by Foreign Investors Tentative Provisions> Supplementary Provisions* issued on 24 August 1999 solved the above problem (a) by permitting a holding company to sell the products as a wholesaler as well as an agent.

Furthermore, *<Establishment of Companies With and Investment Nature by Foreign Investors Tentative Provisions> Supplementary Provisions (2)* promulgated on 31 May 2001 (hereinafter referred to as “2001 Supplement”) partially relaxed the restriction (b) above by allowing a holding company to conduct trial sales of a small amount to the same or similar non-quota products imported from their parent companies before the commissioning of their subsidiaries (Article 5).

In addition, 2001 Supplement clearly permits a holding company to hold non-listed shares of these companies (Article 2). The question arises regarding whether this provision means that a shareholder of a holding

²¹ J. Wei and S. Curley, “Permitted Business Activities Expand for Foreign Investors”, *China Law & Practice*, July/August 2001, pp44-48.

company is not allowed to obtain capital gain by transferring her/his share at all. The literature may not allow it, however, the eternal prohibition of obtaining capital gain might hinder the development of holding companies. Some evidences imply the possibility of the future liberalization of holding listed shares. For example, Article III No.4 of *Notice on Some Issues Concerning Foreign Investment Companies Limited* by issued by MOFTEC on 17 May 2001 provides that non-listed foreign capital shares held by foreign-investment companies shall not be transferred into listed shares **temporarily**.

Those rules having greatly eased foreign investors to establish a holding company in the PRC might have been accounted to make up the omission of FICLBSs from the “Horizontal Commitment” of Services Schedule. However, there had remained several substantial obstacles including minimum registered capital requirement (i.e., US\$30 million, Article 6 of 2001 Supplement). That is why I argue that a representative office may sometimes be useful as a substitute for a holding company.

Thereafter, the latest *Establishment of Companies with and Investment Nature by Foreign Investors Tentative Provisions* (hereinafter referred to as “2004 Law”) was entered into force on the 16th of December , 2004 after several amendments, relaxed the extent of activities of a holding company to include the sales of goods produced by its subsidiary companies, import of materials that its subsidiary companies need and so on.²²

A holding Company may be established as a WFOE or a EJV (Article 2 of 2004 Law).

²² Mitsubishi Corporation Q&A ACTUAL SCENES OF CHINA VBUSINESS LEGAL PROBLEMS (2006), p315.

5. Branch or Subsidiary of Existing FIEs

While I discussed about branches established by foreign companies outside the PRC in 2., a branch of the existing FIEs can also be set up. The procedures are provided in the Regulation for the Registration and Administration of Enterprises²³ and its implementing rules.

However, strange enough, EJV Implementation Regulations only have provision regarding establishing branches outside the PRC²⁴. Yet, it will not provide the procedures for approval of establishing a branch of FIEs in the PRC.

On the other hand, a remarkable progress is observed in laws governing the establishment of a subsidiary by FIEs. The *Investment within China by Foreign Investment Enterprises Tentative Provisions* that became effective on 1 September 2000 (hereinafter referred to as “2000 Provisions”) greatly liberalized the rules stipulated by the *Administration of Registration of Foreign Investment Enterprises as Company Shareholders or Sponsors Several Provisions* issued by the State Administration of Industry and Commerce (SAIC) in 1995 (hereinafter referred to as “SAIC Provisions”).

First of all, the 2000 Provisions clarified the requirements for a FIE to establish a subsidiary, namely, (1) requirements regarding a parent company²⁵, (2) foreign investment related policy requirements²⁶, and (3) total amount of investment requirement²⁷ and reduced the room for discretion by approving authority. In addition, whereas the investment in “restricted” sectors requires approval from provincial level authority

²³ Supra, note 14.

²⁴ Article 39

²⁵ Articles 5 and 7 Item 5, etc.

²⁶ Articles 2 para. 3 and 3 para. 2, etc.

²⁷ Article 6, etc.

(Article 9), the investment in “encouraged” or “permitted” categories only needs to apply to the registration authority (i.e., the competent branch of the SAIC) of the place where the invested subsidiary is to be located (Article 7)²⁸.

6. Foreign Investment Company Limited by Shares (FICLBS)

The reason why a FICLBS is separately regulated is that all legal person FIEs, namely, EJV, LP-CJV, and WFOE shall be limited liability companies in accordance with FIE Legislation²⁹.

A FICLBS has most of advantageous that are shared by a company limited by shares in general, including ability to quickly raise large amount of capital. However, there are many restrictions imposed by the relevant laws and regulations.³⁰ Among them, (a) the establishment of a FICLBS is subject to the approval of the State, (b) the minimum amount of total investment is Renminbi 30 million, (c) the foreign shareholder(s) must hold at least 25% of the registered capital whereas at least one domestic shareholder is required, and (d) the scope of business shall comply with the State industry policy provided for in the *Guiding the Direction of Foreign Investment Provisions* promulgated by the State Council on 11 February 2002 (hereinafter referred to as “2002 Provisions”), which has greatly liberalized WFOE investment, but still limits their activities to certain sectors.³¹

²⁸ D. Markel & T. Mahorny, “New Opportunities for FIE Investment”, China Law & Practice, October 2000, p18

²⁹ The provisions that require to form as a limited liability company are : Article 4 of EJV Law, Article 16 of EJV Implementation Regulations; Article 14 of CJV Implementing Rules; and Article 18 of WFOE Implementation Rules.

³⁰ *Provisional Regulations on Several Issues Concerning the Establishment of Foreign Investment Companies Limited by Shares* promulgated and entered into effect on 10 January 1995.

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In addition, FICLBSs are excluded from the “Horizontal Commitment” of Services Schedule.

7. Assembly and Processing Operations

Assembly and processing operations are entrustment contractual arrangements, mainly in two ways, namely (a) in which the foreign party (the entrustor) provides the entrustee party with raw materials or semi-finished goods and the latter will then process them (“進料加工”), or (b) in which the entrustee party supplies raw materials and processes them (“来料加工”). Furthermore, the entrustee party is not necessarily a purely PRC domestic enterprise and there are arrangement in which the entrustee party is a FIE that, in most cases, has been established (partially) by the entrustor. Therefore, there are both pure assembly and processing operations in which the entrustee is a pure PRC party and the combination of assembly and processing operations and FIE arrangement. The latter arrangement increases in order to overcome the disadvantages of the former that are explained below³². In addition, the entrustee party should not necessarily only one. There are many arrangements in which the foreign party enters into the contract for assembly and processing simultaneously with plural PRC parties so that the former can scatter the risks. Likewise, the entrustee party can enter the contract with different entrustors at the same time so that the entrustor does not have to be responsible for supplying sufficient job to the entrustee.

The principal governing laws and regulations are : *Administration of*

³¹ Supra, note 6, “Foreign Investment Companies Limited by Shares: The Latest Chinese Organization for Major International Ventures”, pp431-432.

³² For example, Sony chooses the latter structure more than the former. (from the interview with Mr. A. Kitashiro, the former General Manager of Sony Electronic Devices (Hong Kong) Ltd.)

*the Examination and Approval of Processing Trade Tentative Procedures*³³ and *Administration of the Examination and Approval of Domestic Sale of Bonded Materials and Parts Imported for Processing Trade Tentative Procedures*³⁴.

The advantages of this arrangement compared to pure FIE arrangement are :

- (1) Approval procedures are much simpler and it may be approved at the county or district level where the relevant PRC party is situated, provided that the relevant local approval authority (namely COFTEC) has joined the PRC International Electronic Commerce Network.
- (2) It is also easy to exit from the arrangement (i.e., simply by the termination of the contract).
- (3) There are a lot of significant tax advantages including the exemption of the PRC income taxation that FIEs would be imposed on net profits at a 33% effective tax rate.

On the other hand, the following disadvantages may be borne :

- (1) Approval is relatively difficult to obtain for manufacturing the goods to be sold in the PRC domestic market.
- (2) The tax advantages above referred to are not applicable if the foreign party is considered to have “permanent establishment” by either regularly dispatching staff into the PRC or existence of facility such as a warehouse for continuously more than 6 months.
- (3) The staff dispatched by the foreign party to supervise the operations of the entrustee have no lawful right to management and personnel of the factory and it often results in failure to maintain

³³ Issued by MOFTEC on 27 May 1999 and entered into effective on 1 June 1999.

³⁴ Id.

the quality of goods.

In conclusion, the pure assembly and processing operation with a PRC party is useful in the cases where (a) the products are to be exported, (b) the required technology is neither advanced nor complicated, (c) no long-term established equipment is necessary, but concentrated labor is required, and (d) rapidly-staled goods are targeted. That is why this arrangement is typically utilized for textile industry.³⁵

However, the assembly and processing operation is the second most popular mode next to FIEs and its share amounts to 3.7% in capital value out of all possible forms for foreign investment in the period of January to July of the year of 2000 and actually, the total capital value invested in the assembly and processing operation in the period of January to July of the year of 2000 was increased by 12.7% compared with the same period of the previous year³⁶.

8. Overall Observance

While the other forms other than FIEs are to some extent useful and some of the laws and regulations governing them have recently amended to lead to better solution, there are still considerable obstacles that cannot be ignored. Therefore, this paper will concentrate on how FIE legislation has been improved and what have been left unchanged.

III Recent Improvement of FIE Legislation

1. WFOE

(1) Popularity

³⁵ Power Trading Co., Ltd. GUIDE FOR INVESTEMENT AND ESTABLISHING ENTERPRISES IN THE PRC (2000), p45.

³⁶ Supra note 1.

A WFOE is the single most popular form for foreign investment and it occupies the share of 54.5% in the number of items and in the capital value 37.7% out of all possible forms for foreign investment in the period of January to July of the year of 2000. Its popularity is mainly owing to the fact that a sponsor can have exclusive control on its operation and does not have to be intervened by the PRC party.

(2) **Improvements**

The following improvements have been made basically in compliance with WTO commitment, however, (a) and (b) are also inevitable in the viewpoints of fulfillment of autonomy of FIEs in accordance with “Socialist Market Economy”.

(a) **Exportation Requirement**

There had been several obstacles that disturb the foreign party from choosing a WFOE prior to the amendment to WFOE Law on 31 October 2000 and that to WFOE Implementation Rules on 12 April 2001. Among them, the old Article 3 provided that advanced technology and equipment must be used or all or most of the products must be exported. As a result, foreign investors who intend to manufacture products for exportation in many cases had to choose either EJV or CJV. However, the new Article 3 stipulates “The State encourages the establishment of export-oriented foreign investment enterprises and foreign investment enterprises with advanced technology” and the new Articles 3, 43 and 44 of WFOE Implementation Rules have accordingly been amended or removed³⁷.

³⁷ Article 3 provides that “The State encourages the WFOE to adopt advanced technology and equipment, engage in the development of new products, achieve product upgrading and replacement, and economize on the use of energy and raw materials. The State also encourages the establishment of export-oriented WFOE. The old Article 45 stating that WFOEs shall not allowed to sell products domestically more than the sales Quota was abolished.

(b) **Autonomy**

In addition, the new WFOE Law has abolished the submission requirement of production and operation plan by removal of the old Article 11 paragraph 1.

So-called “Local Content Rule” has also been removed by amendment to Article 15 from “Raw materials, fuel and other such goods and materials required by a WFOE and which come within the approved scope of business may be purchased in the PRC and they may also be purchased in the international market. All other conditions being equal, preference shall be given to purchase in the PRC.” into “WFOE may purchase, either in the domestic market or from the world market and, in accordance with the principle of fairness and reasonableness, raw and semi-processed materials, fuels and other materials they require within the approved scope of business.” Accordingly, the literature of the new Article 42 of WFOE Implementation Rules was amended. It was because such “Local Content Rule” is incompatible with Article III of GATT 1994 and Article 2 of *WTO Agreement on Trade-Related Investment Measures* (TRIMs).

(c) **Foreign Exchange Balancing Requirement**

The old Article 18 paragraph 3 stipulating that WFOEs shall balance their foreign exchange receipts and payments on their own has been removed. It was because such requirement is incompatible with Article 2 of TRIMs and Article 2 (b) of the Annex to TRIMs.

(d) **Reduction of Capital**

The old Article 22 has been amended so that the reduction of capital is no longer prohibited but is subject to approval by the competent authority.

(3) **Remaining Problems**

Nevertheless, still foreign investors have no free choice in regard

with scope of business (Article 3 paragraph 2 of WFOE Law). It shall be subject to 2002 Provisions.

2. EJV

(1) Presence

EJVs are also one of the popular forms for foreign investment and it occupies the share of 37.2% in the number of items and in the capital value 28.0% out of all possible forms for foreign investment in the period of January to July of the year of 2000.

EJVs must bear onerous problems incurred by the collaboration with management representing the PRC party, which would constitute the motivation of foreign party to opt out for WFOE. However, EJVs are inevitable or useful tool for a foreign party who intends to be involved in business which falls into restricted or prohibited sector or needs to use the connection with local government, domestic markets or a land use right of a PRC party. Particularly, a land use right is crucial. The only “granted” land use right can be transferred while “allocated” land use right cannot in accordance with amended (on 12 April 1988) Article 10 of *Constitutional Law, the Interim Regulations Concerning the Assignment and Transfer of the Right to the Use of the State Owned Land in Urban Areas and the Interim measures for the Administration of the Foreign-Invested Development and Management of Tracts of Land* (both were adopted on 19 May 1990) . If a foreign party intends to contribute a land use right as a capital contribution that it has not yet obtained, it should apply to the competent authority in order to be granted a land use right. However, such kind of approval is hardly obtained unless the targeted land will soon be developed.³⁸ On the other hand, Article 45 of EJV

³⁸ J. Huan “China on the Horizon: Exploring Current Legal Issues: Article: An

Implementation Regulations stipulates that if the PRC party already has the right to the use of land for the EJV, the PRC party may use it as part of its investment. “The right to the use of land” should be construed to indicate “granted” right to the use of land in accordance with the above mentioned Regulations. However, the fact that the literature of Article 45 does not limit the scope of right to the use of land has, in practice, allowed PRC parties to contribute “allocated” right to the use of land as part of capital without any further procedure in order to change the feature of the land use right into “granted” one³⁹. Such kind of practice has enhanced the bargaining power of the PRC parties.

(2) Improvements

The amendments to EJV Law and EJV Implementation Regulations, respectively on 15 March 2001 and 22 July 2001 also show a remarkable progress.

(a) Amendments in the Same Line with the Other FIE

The following amendments in the same line with WFOE have been made for the same reasons explained in 1. Above :

- Removal of the ratio of products sold within the PRC to those sold abroad (the old Article 14 paragraph 1 Item 7 of EJV Implementation Regulations)
- Removal of submission requirement of production and operation plans to the relevant authority (the old Article 3 of EJV Law and Article 56 of EJV Implementation Regulations)
- Abolishment of “Local Content Rule” (the old Article 9 of EJV Law and Articles 57 , 58, 61, 64 , 65 and 66 of EJV Implementation

Introduction to Foreign Investment Laws in the People’s Republic of China”, 28 J. Marshall L. Rev. (1994) 471, at pp 485-889.

³⁹ T. Soga, SEMINARS ON THE PRC BASIC LAW: QUESTIONS AND ANSWERS, vol. 3, p71.

Regulations)

- Removal of foreign exchange balancing requirement (the old Article 75 of EJV Implementation Regulations)
- The old Article 22 of EJV Implementation Regulations of has been amended so that the reduction of capital is no longer prohibited but is subject to approval by the competent authority.

(b) Removal of the Provisions Regarding the Department in Charge of the EJV

The primary step for approval by the Department in charge of the EJV was removed (the old Article 9 of EJV Law) and now, the both parties shall submit the application directly to the competent examining and approving authority. So was the provision requiring technology transfer agreement to be examined and approved by the Department in charge of the JV (the old Article 46 of EJV Implementation Regulations).

(c) Equality of Parties

The old Article 6 of EJV Implementation Regulations providing that unless otherwise provided⁴⁰, the government Department in Charge of the PRC party shall be the Department in charge of the EJV was abolished. Accordingly, the old Article 30 of EJV Implementation Regulations requiring the in-kind capital contribution by the foreign party to be examined and approved by the Department in charge of the PRC party

⁴⁰ If different wording “Department in charge of JV” used in the old Articles 9 and 46 of EJV Implementation Regulations are construed to be “otherwise provided” referred to in Article 6 of EJV Implementation Regulations, the Department in charge here might not be the Department in charge of the PRC party, whereas the wording such as “Department in charge of the PRC party” (i.e., Article 30 EJV Implementation Regulations) must be the Department in charge of the PRC party. However, if the different word usage of Articles 9 and 46, from Article 30 of EJV Implementation Regulations is just the result of a poor drafting, the removal of the old Article 30 shall be discussed in Section (b).

was removed.

The old Article 9 of EJV Implementation Regulations providing that the PRC party shall be responsible for submission the application was amended so that the both parties shall be responsible.

The other discriminatory treatments regarding the in-kind capital contribution by the foreign party were removed (Articles 27 and 28 of EJV Implementation Regulations).

(d) **The Other Autonomy Aspects**

- Removal of submission and commitment of basic infrastructure plan (the old Articles 55 and 56 of EJV Implementation Regulations)
- Removal of requirement relating to Bank of China (the old Articles 74, 77 and 79 of EJV Implementation Regulations)
- The insurance requirement was also amended from “the PRC insurance company” to “insurance company in the PRC” (Article 9 paragraph 4 of EJV Law). —The old WFOE Law and old CJV Law had already fulfilled this liberalization (respectively, Article 16 and Article 18).

(e) **Trade Union**

The new provision regarding Trade Union was added as Article 7 to EJV Law. —The old WFOE Law and old CJV Law had already fulfilled this liberalization (respectively, Article 13 and Article 14).

(f) **Arbitration**

The new provision regarding arbitration was created as Article 15 paragraph 2. —The old CJV Law had already fulfilled this liberalization (Article 26).

(g) **Clarification**

- “A JV shall be governed by the laws, decrees and pertinent rules

and regulations of the PRC” into “A JV shall be governed by the laws and regulations of the PRC” (Article 2 paragraph 2 of EJV Law) —The old WFOE Law and old CJV Law had already fulfilled this liberalization (respectively, Article 4 and Article 3).

- “Procedures governing the employment and discharge of the workers and staff members of a JV shall be stipulated according to law in the agreement or contracts concluded between the parties to the JV.” into “Procedures governing the employment and discharge of the workers and staff members of a JV shall be stipulated in contracts concluded in accordance with the law.” (Article 6 paragraph 4 EJV Law) —The old WFOE Law and old CJV Law had already fulfilled this liberalization (respectively, Article 12 and Article 13).

(h) **Prompt Amendment**

The provision empowering solely the National People’s Congress (NPC) to amend EJV Law (Article 15) was removed to secure the prompt amendment by the Standing Committee of NPC and deprived MOFTED of the power to interpret the EJV Implementation Regulations (the old Article 117 of the EJV Implementation Regulations).

(i) **Contribution by Technology**

As mentioned above (b), the requirements for a foreign party to contribute technology as part of capital contribution were relaxed by new FIE Legislation.

In addition, a further remarkable liberalization is now available by the *Regulations of the PRC on the Administration of Technology Import and Export* issued by the State Council on 10 December 2001 with effect from 1 January 2002 (hereinafter referred to as “2002 Regulations”). 2002 Regulations repealed the above mentioned provisions of EJV Implementa-

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tion Regulations as well as the preceding regulations and Procedures issued in 1985⁴¹, 1987⁴² and 1996⁴³.

2002 Regulations, for the first time, established the principle of free importation of technology except for the technologies subject to prohibition or restriction (Article 3).⁴⁴

In addition, it made the registration no longer the condition precedent for the effectiveness of the contract (Article 17) and abolished the restrictions that (1) the duration of the contract shall be within 10 years and (2) a contract shall not prohibit the licensee from continuously using the technology.

Although there still remain unclearness because the *List of Technologies That are Prohibited or Restricted from Being Imported* is neither exhaustive nor comprehensive, 2002 Regulation is a fabulous achievement from the view of foreign party to transfer technology into its JV.

(2) Remaining Problems

Yet there remain a lot of problems and they will be discussed in IV.

3. CJV

(1) Amendment

The amendments to CJV Law were made only as follows:

- Addition of “in accordance with the principle of fairness and

⁴¹ The PRC, *Administration of Technology Import Contracts Regulations*, promulgated by the State Council on 24 May 1985.

⁴² The PRC, *Administration of Technology Import Contracts Regulations Implementing Rules*, approved by the State Council on 30 December 1987 and promulgated on 20 January 1988.

⁴³ *The Administration of Trade in Importation of Technology and Equipment Tentative Procedures*, promulgated by MOFTEC on 22 March 1996.

⁴⁴ B. Tong, “China’s New Technology Import and Export Legislation: A Step Toward a Freer Market”, *China Law & Practice*, February 2002, p36.

reasonableness” to Article 19.

- Removal of foreign exchange balancing requirement (the old Article 20).

(2) **NLP-CJV**

NLP-CJV is merely a contractual arrangement that is similar to partnership arrangement.

The advantages of NLP-CJV are (a) profit distribution can be freely determined without reference to the actual capital contribution ratio so that a foreign party can minimize capital exposure risk and can recover the investment early, (b) tax benefit that is similar to partnership arrangement.

On the other hand, it has disadvantage that unlimited liability shall be borne.

In conclusion, NLP-CJV arrangement is suitable for the project which require initial heavy capital investment (i.e, construction of toll road, electricity plant, etc.

(3) **LP-CJV**

LP-CJV is very similar concept to EJV and actually the presence of LP-CJV has recently become less and less significant. And actually, it occupies only the share of 8.2% in the number of items and in the capital value 12.8% out of all possible forms for foreign investment in the period of January to July of the year of 2000.

However, several points of deference might draw attention :

First, the notorious “Deputy General Manager” system remaining with EJV (Article 37 paragraph 3 of EJV Implementation Regulations) is not found with CJV.

Second, CJV has “Deemed Attendance” system (Article 28 of the CJV Implementing Rules) which could be helpful to avoid the deadlock situa-

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tion. However, what is deemed is merely attendance and it cannot be counted as an affirmative vote to reach unanimous consents required by Article 29 of the CJV Implementing Rules.

IV Remaining Problems with FIEs

1. Relation with Company Law

Article 218 of Company Law⁴⁵ stipulates that despite the applicability of the Company Law to FIE, if other laws regarding FIEs have other provisions, the other provisions apply.

Many legal arguments may arise from this arrangement because the structures and contents of Company Law and FIE Legislation are too different to conclude that the relationship between these two sets of laws is merely a “General Rules and Special Rules Relationship”

(1) Is Choice of Law Available ?

First of all, if someone observes that establishing a joint venture enterprise in accordance with Company Law is more advantageous than in accordance with EJV Law, can s/he choose Company Law as the governing law of incorporation ?

Although some scholars argue so⁴⁶, I do not take this position because such kind of free choice may deteriorate the whole structure of FIE Legislation. This argument is not practical, either, because this argument is unlikely to be accepted by the relevant approving authority. Even if a

⁴⁵ New Company Law was enacted on the 27th of October 2005 and effectuated on the 1st of January 2006.

⁴⁶ (a) A. Yuan, “Perspective : Foreign Direct Investment in China ? Practical Problems of Complying with China’s Company Law and Laws for Foreign-invested Enterprises”, 20 J. INTL. L. BUS. (1999) 475 and (b) J. Brink and X. Li, “China on the Horizon : Exploring Current Legal Issues : Article : A Legal and Practical Overview of Direct Investment and Joint Ventures in the ‘New’ China”, 28 J. Marshall L. Rev. (1994) 567.

foreign party has established a joint venture corporation in compliance with only company law, there is always a possibility to be invalidated by the government for the reason that it did not fulfill the requirements set out in FIE Legislation that should have been applied to that enterprise.

Based on the assumption that parties have no choice of law, there might be three possible situations⁴⁷ : (X) where the Company Law is silent, the FIE Legislation shall apply ; (Y) where the FIE Legislation conflicts with Company law, the former shall apply ; then, the biggest controversy will arise with (Z) where the FIE Legislation is silent.

Let me discuss the several problems.

(2) **Corporate Governance**

(a) **Shareholders' General Meeting**

While Article 30 of EJV Implementation Regulations stipulates that the board of directors is the highest authority of EJV and Article 24 of CJV Implementation Regulations stipulates the same provision for CJV, Article 37 of Company Law provides that the authority of the company belongs to shareholders' general meeting. Although the latter does not use the word "highest", it is reasonably understood to mean the highest authority. Therefore, regarding the hierarchy between these two organs, there is contradiction between FIE Legislation and Company Law (the situation (Y) above). Accordingly, EJV and CJV Legislation shall prevail.

However, the conflict lies only with the provision regarding relationship between the board of directors and shareholders' general meeting. As a result, one can argue that the existence of shareholders' general meeting within EJV or CJV itself does not constitute a contradiction with EJV and CJV Legislation as long as the functions of the general meeting do not threaten the superiority of the board of directors, while there is not a

⁴⁷ Id. Article (a), p482.

single provision regarding shareholders' general meeting in FIE Legislation.

Nevertheless, many provisions in EJV and CJV Legislation to protect minority shareholders such as Article 33 of EJV Implementation Regulations (a veto is given) prove that the intention of legislator of FIE Legislation is to make the board of directors substitute for the role of shareholders' general meeting. Therefore, EJV and CJV do not have to organize shareholders' general meeting⁴⁸.

WFOE established by a single entity does not have to establish shareholders' general meeting according to the new Company Law⁴⁹. On the other hand, if shareholders are more than one, corporate governance must be in line with Company Law (Article 3 of "Opinion regarding to Application of Law for the Authorization and Registration of Commercial Enterprises with Foreign Investment"⁵⁰

(b) Supervisor or Supervisory Board

First of all, FIEs with a few shareholders or small amount of registered capital can opt out for supervisor(s) rather than having supervisory board (Company Law Article 52).

Then, it turned to be a question whether or not FIEs must have at least supervisor(s). Different from shareholders' general meeting, the existence of supervisory board does neither affect the superiority of the board of directors, nor can be replaced by the board of directors. Therefore, if a PRC party insists having supervisor(s) or supervisory board,

⁴⁸ Yoshio Iteya, "New Corporate Law in China", Journal of the Japanese Institute of International Business Law 33-12 (December 2005), p1622.

⁴⁹ See (3).

⁵⁰ Issued on the 24th of April, 2006. Masami Kitagawa "Important Points in the Practice of Establishment and Management of Commercial Enterprises with Foreign Investors" 840 NBL (2006) p57.

there is no lawful reason for a foreign partner to reject it.

(c) Duties of Directors

Whereas Company Law provides for duties of directors (Articles 148—151), FIE Legislation have several further detailed provisions such as Articles 37 paragraph 4 and 38 of the EJV Implementation Regulations and Articles 33 paragraph 2 and Article 34 of the CJV Implementing Rules. Those FIE Legislation exemplify the typical breach of fiduciary duty and does not affect the application of the relevant provisions of Company Law to FIEs.

(3) One Shareholder Company

Whereas only one foreign party can establish WFOE (Article 2 of WFOE Law), Article 20 of old Company Law set out the minimum number of shareholders (namely, two). The FIE Legislation had been supposed to apply because here the exception to a certain provision of Company Law is given by FIE Legislation⁵¹. However, the recent amendment to the Company Law solved this problem. Article 58 formally admits a one share holder company and Article 62 stipulates that one shareholder company does not have to establish shareholders' general meeting.

(4) Investment in Kind

(a) Extent

Article 27 of New Company Law stipulates that “Investors may contribute currency or non-currency property that can be estimated in currency and can be transferred in accordance with law including investment in kind, intellectual property right or right to use land.”

However, Article 22 of EJV Implementing Regulations still provides “Buildings, factories, equipment or materials, industrial property right,

⁵¹ Id. P508.

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know-how, right to use land and so on may be contributed.” Therefore, regarding establishment of EJV, the extent of investment in kind is not clarified.⁵²

(b) **Ratio**

Article 27 of New Company Law stipulates that “The ratio of investment in kind shall be 70% of registered capital or less.” However, the gap of extent of investment in kind between New Company Law and EJV Implementing Regulations as above mentioned makes it difficult to apply this ratio to EJV.⁵³

(5) **Conclusion**

There are a lot of practical problems on interpretation of Article 218 of Company Law and clarification by new law or interpretative authority is necessary.

2. Local Content

As discussed above, the “Local Content Rule” was abolished for all types of FIEs.

However, the phrase “in accordance with the principle of fairness and reasonableness” was added to all the relevant provision of FIE Legislation (Article 10 of the EJV Law, Article 19 of the CJV Law and Article 15 of WFOE Law). This phrase had not existed in the Draft of Amendment to FIE Legislation submitted by the State Council.

This inclusion is so ambiguous that it might give the PRC party or the relevant authority a good reason to argue the validity of procurement of raw materials and so on by FIEs.

⁵² Supra note 22, pp264-265.

⁵³ Id. P265.

3. Equity Ratio

Another ambiguity is regarding the word “in general” included in the provisions regarding equity ratio of a foreign party (i.e., 25% or more ; Article 4 paragraph 2 of EJV Law and Article 18 of CJV Implementing Rules) .

There are two problems regarding (a) which cases shall be regarded as “not in general” is not clear and (b) which kind of laws shall apply to the EJV or CJVs in which the equity ratio of a foreign party is less than 25% is not provided.

4. Check and Balance

Whereas the old paragraph 2 of Article 34 stating that if a chairperson of the board is appointed by one party, the other party shall appoint vice-chairperson was deleted from EJV Implementation Regulations, the provisions imposing such a “check and balance” arrangement regarding both chairpersonship and general manager remains unchanged (i.e., Article 6 of EJV Law).

It might be argued as to whether such kind of arrangement is no longer mandatory regarding chairpersonship only, or both chairpersonship and general manager, or still mandatory for both. If the second option is correct, the notorious deputy general manager system (Article 37 paragraph 3 of the EJV Implementation Regulations) can be substantially avoided.

V Practical Advises

Foreign parties who have already incorporated FIEs in the PRC must amend the JV contracts already entered into so that they comply with the new FIE Legislation.

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Particularly, the contracts that were drafted heavily in reference with MOFTEC Model JV Contract (Model Contract) must be amended as follows :

- (1) The provisions based on Articles 15—19 of Model Contract must be amended as soon as possible because they are incompatible with Section 7.3 of Protocol on the Accession of the PRC (hereinafter referred to as “Protocol”), Article 2 of TRIMs as well as 2002 Regulations on technology transfer. Consequently, it might amount to invalidate the whole JV contract.
- (2) The provision following Article 20 of Model Contract must also be amended, since such export ratio requirement does not comply Section 7.3 of Protocol and Article 2 of TRIMs.
- (3) Please do not forget that the amendments to the contract shall be examined and approved by the relevant authority (Article 14 of EJV Implementation Law).