Foreign Investment in China – Entry, Operation and Exit Strategy

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Mark Schaub

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PREFACE

"In China ... everything is possible ... nothing is easy."

China expatriate manager

China has witnessed breathtaking changes in recent decades. Rapid development in the economy has not only resulted in China becoming increasingly seen as the world's premier production hub, but also a wealthier local consumer base that attracts more and more foreign companies. China has become an important economic force that can no longer be ignored.

In 1950, China's share of global GDP hovered around 5%. In 2008 it was approaching 25% — a share similar to that enjoyed in the early 1800s. China has gone from being a place few people visited to having 53.0 million international visitors in 2008. From being an impoverished nation, it now sits on USD reserves worth 1.2 trillion. From being a closed-off economy, it has (according to the CIA World Factbook) accumulated foreign direct investment of USD800 billion.

For many Western companies it is no longer a question of "if China" but "when China". Unfortunately many fail to ask the question: "How China?"

Despite China's opening up it seems that doing business in and with China is still very much a mystery for many foreign companies. Some rush headlong to China, some tread with overwhelming fear, others stare blankly from the sidelines. If you have not done any planning, it is probably best to stare blankly. However, if you do wish to stop staring blankly, what can you do?

There is an abundance of information. A multitude of advisors, consultants, lawyers, accountants are chomping at the bit to provide further information. This guide aims to add to this mountain of information.

Novice foreign investors tend to have the preconception that China either has no laws or alternatively that it is addled with red tape and arcane bureaucratic processes. Neither view is accurate. China has an increasingly sophisticated (and unfortunately therefore complicated) legal system which must be considered when planning and implementing a project. It should be noted that although every effort has been made to be accurate, things (including the law) change quickly in China. Before acting upon advice in this guide, you should check that it is still valid law and whether there is not any exception in your particular case.

In summary, this guide aims to provide foreign investors and management in China with guidance as to the basic legal background they should be aware of as well as how to avoid the major and common pitfalls that occur in China.

Much of the content in this guide will be common sense. Much will seem familiar. Much will resemble what you do in your own country. Much has been ignored when doing business in China.

"Make it as simple as possible but no simpler."

— Albert Einstein

25th October 2009

Mark Schaub

About the Author

Personal details

Name:	Mark Schaub
Date of Birth:	5 January 1967
Nationality:	Australian/German
Languages:	English, German, Mandarin

Education

University:	Adelaide University 1984–1987
Postgraduate Studies:	South Australian Institute of Technology 1988
	Freie Universität Berlin 1990–1992
	East China University, Shanghai 1993–1995

Employment history

Supreme Court of South Australia and Federal Court of Australia

Admitted as barrister and solicitor in 1988

Fisher Jeffries, Australia, 1988–1990

Corporate law department.

Hunt & Associates, Berlin 1992–1993

Consulting for UK group involved in M & A restructuring work in East Germany.

Coudert Brothers, Shanghai 1993–1995

Employed as foreign lawyer in Shanghai office.

Wessing, Shanghai 1995–2000

Employed as foreign lawyer in Shanghai. Senior lawyer for Shanghai office. Experience includes negotiating and advising in respect of establishment of joint ventures/WFOE in following industries: pharmaceutical, automotive, building materials, energy, exhibitions, environmental technology, airports, textiles, light industrial, heavy industrial, power stations, etc. Advised in respect of restructuring, transforming and acquisition of Joint Ventures. Advising foreign, Chinese and FIE clients in respect of employment, intellectual property, distribution, tax, arbitration and court issues. Advising in relation to construction of facilities in pharmaceutical, packaging, exhibition, textiles and manufacturing sectors.

Frequent speaker at Shanghai, Beijing and Hong Kong business associations and events.

King & Wood, Shanghai 2000 to present

Senior partner residing in Shanghai office. Co-head of Shanghai office Corporate Group. Member of the Shanghai management since 2002.

Books

Author of *China — Art of Law*, published by Commercial Clearing House 2007 www.china-artoflaw.com

Author of China chapter in *International Corporate Law* published by Aspatore Books Inc.

Honorary positions

Honorary Editor CCH China Legal Watch since inception

Board member of Elster AMCO Joint Venture in Shanghai from since 1995

Board member of Refratechnik Joint Venture in Liaoning province since 1996

Board member of Steiner Optik WFOE in Chongqing from 2002 to 2005

Liquidation Chairman of Joint Venture in Lanzhou 2004

Board member of Red Star Optical in Shanghai since 2005

Board member of Refratechnik WFOE in Shandong province since 2006

Asia Law "Lawyer of the Year" M & A, PRC in 2003

Asia Law "Lawyer of the Year" M & A, Corporate Restructuring in 2004

Asia Law "Lawyer of the Year" M & A and Corporate in 2005

Asia Law "Lawyer of the Year" M & A, Corporate in 2006

Asia Law "Lawyer of the Year" M & A, Corporate Restructuring in 2007

Selection of recent publications

- *Distribution in the PRC*
- *WFOE as an Alternative to the Joint Venture*
- *A Better CIETAC Awaits: The Revised Rules*
- *FIE Mergers in China: More Details, More Questions*
- *"The Ties that Bind" Entering and Terminating Employment Contracts*
- *Investing in State Owned Enterprises — Becoming Easier or More Difficult?*
- *The First Steps to PRC Trade Liberalization*
- *The Enemy Within — Fraud and Corporate Governance Problems within FIEs*
- *The Enemy Within — Risk Minimization within FIEs*
- *New MOFCOM Rules Fill in Legal Vacuum of Foreign Investment Law*
- *Improved MOC Holding Company Regulations*

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(2) *Catalogue on Industry Guidelines for Foreign Investment*, enacted by the State Development and Reform Commission and the Ministry of Commerce and effective as of 1 December 2007 ("*Industrial Catalogue*");

(3) *Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*, effective as of 1 July 1979 and revised on 15 March 2001 ("*EJV Law*");

(4) *Regulations for the Implementation of Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*, enacted by the State Council and effective as of 20 September 1983 and revised on 22 July 2001 ("*EJV Regulations*");

(5) *Law of the People's Republic of China on Sino-Foreign Co-operative Enterprises*, effective as of 13 April 1988 and revised on 31 October 2000 ("*CJV Law*");

(6) *Detailed Rules for the Implementation of the Law of the People's Republic of China on Sino-foreign Cooperative Enterprises*, issued by the Ministry of Foreign Trade and Economic Cooperation and effective as of 4 September 1995 ("*CJV Regulations*");

(7) *Law of the People's Republic of China on Wholly Foreign-owned Enterprises*, effective as of 12 April 1986 and revised on 31 October 2000 ("*WFOE Law*");

(8) *Detailed Rules for the Implementation of Law of the People's Republic of China on Wholly Foreign-owned Enterprises*, issued by Ministry of Foreign Trade and Economic Cooperation, effective as of 12 December 1990 and revised on 12 April 2001 ("*WFOE Regulations*"); and

(9) *Catalogue of Priority Industries for Foreign Investment in Central and Western Region*, jointly issued by National Development and Reform Commission and Ministry of Commerce, effective as of 1 January 2009 ("*Regional Catalogue*").

[¶1-010] History of control

For the first 30 years following the founding of the People's Republic of China ("PRC" or "China"), China prohibited any participation by foreign capitalists in its economic development. The first cracks in this wall were planted in the Second Session of the Fifth National People's Congress in 1979. This meeting marked the start of China's opening up to the world.

The magnitude of the changes wrought by this plenary meeting can be seen by the figures. In 1978 China exported USD97.5 billion — 30 years later in 2008 China exported USD14285.5 billion. China's foreign reserves have gone from a paltry USD1.67billion in 1978 to a unrivalled USD1.95 trillion. Imports have increased from USD108.9 billion to USD 11330.9 billion in 2008. However, perhaps most pertinent to the book at hand, foreign investment increased from USD17.7 billion for the four years from 1979–1982 to USD923.95 billion in 2008. In the span of 30 years China has gone from a no man's land for investment into the world's number one foreign direct investment ("FDI") destination.

Although these figures defy an outsider's expectations the differences within the country are more pronounced still. In the span of half a generation China has developed a sophisticated legal system and moved from wariness towards foreign investment to active encouragement.

Despite these changes China's open-door policy has always retained a door and sometimes this door is slammed shut on certain industries or activities. Although, it has opened up in a way that not even the most ardent Sinophile would have anticipated in 1979 China still maintains specific restrictions on the inflow of foreign capital into the country.

Foreign investors should also bear in mind that almost every step in the establishment process for a foreign investment enterprise ("FIEs") and its resulting operation in China requires approvals from a wide range of Government authorities. In the main this is not onerous control, indeed in many cases the authorities play more the role of a cheerleader than an umpire.

[¶1-030] Pre-2001 industrial sector control

For many years, China did not have a specific piece of legislation which set out the restrictions or encouragement to be granted to specific types of foreign investment. The approval authorities would generally base their decisions on vaguely worded legislation contained in laws or regulations regulating joint ventures ("JVs", including equity joint ventures or EJVs and contractual joint ventures or CJVs) and wholly foreign-owned enterprises ("WFOEs") or upon "internal policies", which were not published, not available to the general public and indeed often thought to be non-existent.

EJV and WFOE legislation

The *EJV Regulations* (prior to the 22 July 2001 amendment) and *WFOE Regulations* (prior to the 12 April 2001 amendment) provided only the very broadest of brushstrokes as to what was allowed.

The *EJV Regulations* proposed a vague list of permitted JV projects (ie energy development, building materials, chemicals, metallurgical industries, machine manufacturing, instrument and meter assembly industries and offshore oil exploitation equipment, manufacturing, electronics & computer industries and communication equipment manufacturing, light industry, textile, foodstuffs, medicine, medical apparatus and packaging industries, agriculture, animal husbandry and aquaculture; and tourism and service industries).

This vague list was largely ignored and EJVs were established in a wide range of industries.

The lack of specific regulations was probably due to a mix of the authorities not sure as to what they were doing and fear of the consequences of allowing the door to be too wide open. Foreign investors also were unsure of how to invest in China and had an opposite fear from that of the Chinese authorities who feared their entry into China. The foreign investor's major concern was whether they would be allowed out again.

However, as both sides gained in experience the regulations outlining the means by which investments may be made were being improved. The provisions of the *WFOE Regulations* represented a better approach than the *EJV Regulations* in that they sought to list prohibited and restricted sectors and not all permitted sectors.

The *WFOE Regulations* were in many ways a forerunner of the *Industrial Catalogue* (discussed below) which sets out whether a particular type of business is open to foreign investment and whether certain encouragements or restrictions exist.

[¶1-060] *Investment Direction Procedures* and *Industrial Catalogue*

China began to issue the *Investment Direction Procedures* and its accompanying *Industrial Catalogue* in 1995. This gave foreign investors a far clearer picture regarding the Chinese Government policies and "internal guidelines" in respect of their planned foreign investment.

This first ever *Industrial Catalogue* clarified that some industrial sectors, many of which were regarded as being lucrative, were barred from having foreign investment.

In essence, the *Investment Direction Procedures* divides foreign investment into four categories:

(1) Encouraged;

(2) Permitted;

(3) Restricted; and

(4) Prohibited.

The "encouraged", "restricted" and "prohibited" categories are listed in the accompanying *Industrial Catalogue* (the latest version came into effect on 1 December 2007 and will be discussed below in more detail). Any sector not listed in the *Industrial Catalogue* is deemed to fall within the "permitted" category.

The *Investment Direction Procedures* also provide a general description and different treatment for a project depending upon its category. As part of China's efforts to implement its WTO obligations, the *Investment Direction Procedures* were also revised to take into account China's undertakings under such treaty.

The importance of the *Industrial Catalogue*

As the primary legislation determining whether a specific foreign invested project will be allowed, restricted or encouraged, the *Investment Direction Procedures* and the *Industrial Catalogue* are the initial regulations to be considered by any potential foreign investor.

In some cases a proposed project will be "prohibited" (eg news agencies, TV, satellite uplinking stations, microwave stations etc).

In other cases the proposed project may be restricted (eg animal husbandry, cotton (raw cotton) processing, certain types of mining, gold exploration etc) whereas other projects may be encouraged (eg storage and processing of vegetables, production of new anti-cancer medication, manufacturing of mine trolleys for mining, etc) and such classification will be a major criteria in determining whether the project will benefit from Customs duty and related VAT exemption (further details to be discussed in **Taxation and Customs duties** from ¶28-005 to ¶28-080).

Since its inception the *Industrial Catalogue* has undergone a number of revisions, including 1995, 1997, 2002, 2004 and 2007.

2007 Industrial Catalogue

[¶1-110] General introduction

At the end of 2007, the National Development and Reform Commission ("NDRC") and Ministry of Commerce ("MOFCOM") jointly issued the latest version of the *Industrial Catalogue*. This revised version replaced the *2004 Industrial Catalogue* and became effective as of 1 December 2007. As always the changes in the *2007 Industrial Catalogue* reflected shifts in China's economic and industrial policies.

In 2007 China's foreign direct investment policy changed from export led growth to quality investment supporting domestic led growth. As Ma Kai, Minister of NDRC stated, "the focus is on strength, not scale". The general economic policy was set by the 11th Five-Year Plan which set a course away from projects that:

(1) Rely upon cheap Chinese raw materials or energy;

(2) Are wasteful or lead to high level of pollution;

(3) Manufacture export-orientated products; or

(4) Manufacture low-tech products with little value added.

On the other hand "green is the new black" when it comes to the projects that are being encouraged. Encouraged projects include:

(1) Energy-saving;

(2) Environmental protection;

(3) Transportation infrastructure development;

(4) Hi-tech manufacturing;

(5) Logistics;

(6) Business outsourcing; and

(7) Improvements in agricultural technology.

A quick glance at the *2007 Industrial Catalogue* shows the affect that the 11th Five-Year Plan had. For example "real estate" and "products directly exported" were deleted from the encouraged category. This made sense for China's economic situation in 2007 before the global economic crisis began to bite. In 2007 China was facing enormous international pressure in respect of its currency. China's encouragement to its export-orientated industries and the massive current account surplus was adding further pressure on the authorities for a RMB appreciation. In addition China was facing bottlenecks in respect of resources and energy. There were concerns that China was in effect importing pollution by being the world's factory.

Another strategic concern of the PRC authorities was to stem the inflow of international "hot" money into China. Due to expectations of an appreciation in RMB there had been a rush by foreign investors to bring money into China, particularly into the overheating real estate sector. The PRC authorities had major concerns that this would further contribute to building further asset bubbles within China.

Just as the move away from export and real estate industries signalled deeper policy concerns, such concerns could also be seen in the areas that were upgraded to encouraged status. The list of encouraged sectors included services and higher value added services such as "leasing and commercial services", "bank and telecommunications back office service, software development and related contracting business"; "culture, sports and entertainment", "management and operation of public show facilities, sport centres, and training facilities, as well as related intermediary services" have been added to the encouraged category.

These changes showed China's intended move in 2007 from a "quantity economy" to a "quality economy" and concern for the environment with reference to a "green GDP".

[¶1-130] Encouraged category

The *2007 Industrial Catalogue* has substantially followed the categorisation methodology used in the *2002* and *2004 Industrial Catalogues*. Although the industrial sectors under this category remain very much the same (reduced from 13 to 12), the total number of items under the "encouraged" category and the contents have significantly changed. The total number of encouraged sectors has been significantly increased from 246 to 351, with the following allocation:

- agriculture, forestry, animal husbandry and fishery (12 items);
- mining (9 items);
- manufacturing (282 items);
- generation and supply of electricity, gas and water (7 items);
- transportation, storage, and post (14 items);
- wholesale and retail (2 items);
- leasing and commercial services (3 items);
- scientific research, technological services and geological survey (14 items);
- water resources, environmental and public facility management (4 items);
- education (1 item);
- health, social security and social welfare (1 item); and
- culture, sports and entertainment (2 items).

Details as to the additions and deletions are as follows:

- under the heading of "generation and supply of electricity, gas and water", "sea water utilisation, industrial waste water disposal and utilisation" has been added, whereas deleted items are "construction and operation of thermal power plants with a single generator capacity of more than 300 megawatts" and "construction and operation of natural gas power plants";
- under the heading of "transportation, storage, and post", while "comprehensive maintenance of infrastructural facilities for high speed railways, railway cargo transportation lines, and inter-city railway lines" has been added, "construction and operation of petroleum docks" has been deleted;
- under the heading of "wholesale and retail", "modern logistics" has been added; and
- under the heading of "scientific research, technological services and geological survey", there are four newly added items, including "biology energy development technology" and "ocean chemical energy comprehensive utilisation technology".

More significant changes have occurred under the "mining" headings, under which a total of five items have been added, including "mine gas utilisation" and "exploration and development of ocean bottom inflammable ice". At the same time, a total of five "traditional mining" items have been deleted, including "exploration and development of coal and its associated resources", "exploration and extraction of low grade and hard-to-extract gold mines", "exploration and development of copper, lead and zinc", and "exploration and development of alumina".

Since the "manufacturing" heading contains more than half of the total items under the encouraged category, it is worthwhile to further discuss this heading, which consists of the following subheadings:

- agricultural and non-staple food processing (3 items);
- food manufacturing (3 items);
- beverage processing (1 item);
- tobacco product processing (3 items);
- leather and fur products (3 items);
- wood processing and bamboo, cane, palm and straw manufacturing (1 item);
- paper making and paper products (1 item);
- petroleum processing and coking industry (1 item);
- chemical feedstock and chemical product manufacturing (26 items);
- medicine (16 items);
- chemical fibre manufacturing (6 items);
- plastics products (3 items);
- non-metal mineral products (20 items);
- non-ferrous metal smelting and rolling processing (2 items);
- metal products (3 items);
- ordinary machinery manufacturing (19 items);