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Review

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Establishing a Business Presence in China

FOREIGN INVESTED ENTERPRISES

On October 31, 2007, China issued the Industry Catalogues for Guiding Foreign Investment, which has become effective on December 1, 2007 ("2007 Catalogue") and supersede the 2004 catalogue ("2004 Catalogue"). Both the 2004 and 2007 Catalogues divide the industries into 3 categories: (1) encouraged, (2) restricted, (3) prohibited. Industries which are not listed in the Guiding Catalogue are deemed permitted. In order to determine if the intended foreign investment is Encouraged, Permitted, Restricted or Prohibited under PRC laws, the 2007 Catalogue shoud be the first material consulted.

> Hammonds offer a one-stop shop in terms of legal services in helping clients establishing a presence or business operations in China.

According to the new guidelines, foreign investors will be banned from some resource-intensive or high-pollution sectors while they will be encouraged in high-tech and environment-friendly areas. Foreign businesses are encouraged in high-tech equipment and new material developing while in services, outsourcing and logistics. For those traditional sectors, where the domestic enterprises have developed advanced technologies and high production capacity, foreign investment is no longer encouraged by the government.

Under the guidelines, the restrictions on foreign investment in financial sectors was moderately relaxed. However, China has imposed more restrictions on foreign investment in the construction and operation of high-end hotels, villas, office towers and exhibition halls. Foreign investors engaging in the development of land lots will be required to partner and co-invest with local developers. There will also be tighter restrictions on foreign investments in second-tier real-estate market as well as housing agents and brokerages.

Nevertheless, with fast moving changes such as the Foreign Trade Law and the Foreign Investment Measures, doing business in China under the encouraged, restricted and permitted categories has become more accessible to interested foreign parties. China's Ministry of Commerce (MOFCOM) has continued delegating its approval powers to lower government levels, further streamlining the investment pathways for foreign companies by issuing the Circular such as the Circular on Delegating Matters Concerning the Examination and Approval of Foreign-invested Commercial Enterprises (Circular 51). On 5 March 2009, MOFCOM further issued a notice to delegate its approval power in connection with the establishment and changes of the foreign investment enterprise that fall within the encouraged catalogue to the local government at the provincial level.

Despite this, foreign invested enterprises in China mainly take 3 forms, namely:

- The Wholly Foreign Owned Enterprise (WFOE)
- The Equity Joint Venture (EJV)
- The Co-operative Joint Venture (CJV)

In certain sectors, foreign investors are precluded from establishing WFOEs. In such cases, foreign investors will need to have a Chinese joint venture partner and may need to meet a prescribed minimum registered capital. A good Chinese partner is difficult to find but that has not prevented foreign investors from establishing countless EJVs or CJVs in the past.

Investors should note that there are mandatory ratios between total investment and registered capital of a foreign invested enterprise. Total investment refers to all moneys required to operate the foreign invested enterprise including operational expenses, capital expenditure and loans, while registered capital (akin to the concept of equity capital) refers to the approved total amount of capital to be injected by a foreign investor into the foreign invested enterprise. The following table sets out the current ratios:

TOTAL INVESTMENT	REGISTERED CAPITAL
US$3 million or less	At least 70% of the total investment
Above US$3 million and up to US$10 million	At least 50% of the total investment
Above US$10 million and up to US$30 million	At least 40% of the total investment
More than US$30 million	At least 33.3% of the total investment

In other words, the smaller the investment, the higher the registered capital that is required by proportion. It is important to bear in mind that the total investment amount should take into account the need for any future borrowings of the enterprise. Otherwise the enterprise will need to apply for permission to increase its total investment amount when financing is available which will take the total investment amount above the registered limit.

Noteworthy also is the fact that mandatory minimum amounts for registered capital apply as prescribed by law, regulations or local practice. The registered capital can be contributed in the form of cash, machinery, equipment, industrial property and/or proprietary technology. Capital verification is required to be conducted by registered Chinese accountants to prove such capital contribution.

Registered capital can be made by installments provided that the initial contribution of not less than 20% of the registered capital must be injected within 3 months from the date of issuance of the business licence. The remaining amount must be injected within 2 years from the date of issuance of the business licence. For an investment company, the time limit for the remaining contribution is 5 years.

THE WHOLLY FOREIGN OWNED ENTERPRISE

For industry sectors that allow foreign investors to set up wholly owned subsidiaries in China, the WFOE has emerged as a favoured form of investment vehicle. The WFOE permits maximum autonomy without needing to have a local Chinese partner.

Foreign investors normally establish WFOEs in the form of a limited liability company with a separate legal personality. A WFOE is recognized as a separate legal entity responsible for its own debts and liabilities. There is no recourse to its investors except to the extent of the capital amount injected into the WFOE.

The business scope stated on the business licence of a WFOE sets out the permitted activities of a WFOE. It is therefore of prime importance to draft the same to the maximum extent permitted by law. Unlike companies established in many other jurisdictions, the business scope of WFOEs tends to be quite restrictive and Chinese authorities will scrutinize closely the drafting of the business scope.

The establishment of a WFOE must be approved by the duly authorised government authorities. Generally these are the Ministry of Commerce (MOC) and State Administration for Industry and Commerce (SAIC) or their respective designated local offices (the “Approval Authorities”). In special cases, approval from the supervising authority for a particular industry sector may be required.

The foremost important step for setting up a WFOE is to decide on its location. The Approval Authorities of that chosen area will have jurisdiction in deciding on the exact application procedure and documentary requirements. Generally, the following documents are needed:

- completed application form;
- articles of association;
- feasibility report;
- letter of appointment of the WFOE’s “legal representative” (this does not mean the WFOE’s counsel; rather it means the person having authority to bind the WFOE, which is usually the chairman of the board of directors);
- biography of the legal representative;
- undertakings of the legal representative regarding his personal credentials;
- letter of appointment of directors;
- power of attorney of the chairman of the investor authorizing the application procedure;

- WFOE name pre-approval certificate;
- incorporation documents of the investor;
- board resolutions of the investor regarding the set up and operations of the WFOE; and
- some proof of the intended address of the WFOE e.g. lease or land use rights certificate.

Within 30 days of issuance of the certificate of approval by the Approval Authorities, the foreign investor must apply for registration and issuance of a business licence with SAIC. A WFOE is duly incorporated upon issuance of the business licence. The WFOE can then apply for custom registration, corporate seals, opening of bank accounts, foreign currency authorisation, tax and other registrations.

Typically, the foreign investors in a WFOE will invest through an offshore company that owns 100% of the WFOE. The rights and obligations of one foreign investor against another will be governed by a shareholders agreement relating to that offshore company, which means the shareholders' relationships are kept offshore.

THE EQUITY JOINT VENTURE

Where a Chinese partner is considered necessary or desirable, either an EJV or a CJV can be established, bearing certain legal restrictions.

In an EJV, itself a Chinese legal person, there is no recourse to the joint venture parties except to the extent of their respective capital amounts in the registered capital (akin to the concept of shareholding).

Under an EJV, the joint venture parties share profit, losses and risks in accordance with their respective shareholdings. Certain industry sectors (notably in parts of the telecommunications, banking, and securities sectors) require foreign invested enterprises to be EJVs.

Generally, an EJV takes the form of a limited liability company. The registered capital can be contributed in the form of cash, property, machinery, equipment or other materials, land use rights, intellectual property and other proprietary technology. The investment of the foreign party into an EJV must generally be more than 25% of the registered capital.

The relationship between the joint venture parties is governed by a joint venture agreement, which is typically prepared in Chinese and English versions. Under Chinese law, the joint venture agreement must be governed by Chinese law and must at the very least cover the following:

- details of the joint venture partners;
- address and name of the EJV;
- purpose and business scope of the EJV;
- total investment amount and registered capital of the EJV;
- form of the EJV (such as a limited liability company);
- subscription schedule and form of contribution to be made by each party;
- respective obligations of the parties;
- management structure of the EJV;
- organisation and powers of the board of directors;
- dividend policy; and
- other mandatory provisions prescribed by law.

The parties should first agree on the contents of the joint venture agreement and articles of association of the EJV. This is often the most drawn out aspect in the entire process of establishing an EJV.

It is usual for the Chinese party to undertake the liaison with the Chinese authorities to establish the EJV. Once approved, the Approval Authorities will issue an approval certificate to the parties setting out, among other things, the respective shareholdings of the parties. Within 30 days from the date of the approval certificate, the parties must apply for registration and a business licence with SAIC.

Investors should note that the EJV is only deemed duly incorporated upon the issuance of its business licence by SAIC and various contingencies will therefore need to be built in to take this into account.

Because an EJV does not offer the flexibility of proportioning profits and liabilities for joint venture parties other than in accordance with their investment in the EJV, many investors prefer to use the CJV structure discussed below.

THE CO-OPERATIVE JOINT VENTURE

A CJV is viewed as a preferred form of investment vehicle for projects where the parties wish to have the flexibility of sharing profits and risks other than in accordance with their respective investment in the CJV. In some cases, the parties are obliged in law to use this form of joint venture.

A CJV may, but need not, be established as a separate legal person. A CJV with separate legal person status takes the form of a limited liability company and is distinct from its investors. A CJV without separate legal person status takes the form of partnership of the joint venture partners whereby the partners are responsible for their own liabilities, risks and losses in accordance with their agreed proportion.

Under Chinese law, the following terms need to be addressed in the joint venture agreement concerning a CJV:

(a) Investment and co-operation terms;

(b) Distribution of profits or products;

(c) Sharing of risks and losses;

(d) Method of management; and

(e) Ownership of the properties upon termination of the CJV.

If it is stated in the joint venture agreement that the ownership of all of the CJV's assets shall pass to the Chinese party (without compensation to the foreign party) at the expiration of the term of a CJV, the foreign party may recoup its investment prior to the expiration of the term of a CJV. Hence the foreign party may have a larger share of profit out of proportion to its investment during the term of a CJV, while its and its Chinese party's liabilities can be proportioned in some other way.

A CJV needs to have either a board of directors or a joint management committee as its highest management authority. A CJV without separate legal status must establish a joint management committee. The authority of the board of directors or the joint management committee should be stated in the articles of association of the CJV.

CJVs are generally subject to the same application procedures as those applicable to EJVs.

OTHER BUSINESS ARRANGEMENTS

Foreign parties may establish representative offices in China for the purpose of conducting market research and liaison services. A representative office is not permitted to conduct profit-making activities (except as strictly permitted by law) and is not regarded as having established a business presence in China.

Foreign parties may have direct franchising, licensing, distribution and collaboration arrangements with their Chinese parties without having a business presence in China. Care must be taken to structure these business dealings appropriately in order to comply with Chinese law and regulations which are being continually revised in today's fast changing economic and political climate.

The author wishes to thank her colleague, Anthony Chan, for his contributions to this Article.

FURTHER INFORMATION

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