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CHINA UPDATE

Squire, Sanders & Dempsey L.L.P.

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Inside

China Regulates Financing Guarantee Companies

Key Points:

- ***Interim rules aim to strengthen supervision of financing guarantee companies***
- ***Financing guarantee companies must meet requirements under the Interim Rules by March 31, 2011***

On March 8, 2010 the China Banking Regulatory Commission (CBRC), National Development and Reform Commission (NDRC), Ministry of Industry and Information Technology (MIIT), Ministry of Commerce of the People's Republic of China (MOFCOM), State Administration for Industry and Commerce (SAIC), People's Bank of China (PBC) and Ministry of Finance (MOF) jointly issued the Interim Rules About Administration of Financing Guarantee Companies (Interim Rules), which aim to strengthen the supervision and management of financing guarantee companies in China. The hope is that these companies can eventually provide financing services to midsize and small private companies, which often find it hard to obtain financing support from banks.

The Interim Rules require a financing guarantee company to have registered capital of at least RMB 5 million (about US$730,000). Upon approval by the relevant authority, a financing guarantee company may provide a guarantee for a loan, acceptance of bill, trade financing, project financing, letter of credit financing, etc. On the other hand, the Interim Rules clearly prohibit these companies from absorbing deposits, providing loans and providing entrusted loans, for example.

The Interim Rules also set forth detailed rules on the operation of financing guarantee companies and risk prevention measures these companies must take. Among other requirements, the Interim Rules provide that the maximum guarantee liability a financing guarantee company may take is 10 times its net assets.

Financing guarantee companies have until March 31, 2011 to meet the requirements under the Interim Rules.

The Interim Rules went into effective beginning March 8, 2010. Since the breakout of the global financial crisis, China's State Council has supported the establishment of a multi-tier guarantee system and the provision of financial aid to midsize and small entities. Despite the new Interim Rules, some observers are still concerned about financing guarantee companies' willingness to provide assistance to midsize and small private entities.

– Jennifer Liu

Highest People's Court Proposes New Rules Related to Foreign-Invested Enterprises

Key Points:

- ***New rules will be binding for all courts in China***

On November 23, 2009 the Highest People's Court issued for pubic comment a new rule on the interpretation of laws related to foreign-invested enterprises (the Proposed Rule). Following a one-month comment period, the Highest People's Court announced it received about 100 comments from the public. That number is considerably smaller than the feedback received for most other rules that are open for public comments.

The Proposed Rule, once officially promulgated, will be binding on all courts in China. Its importance cannot be underestimated. Following are some of the key points.

Side Agreements and Supplemental Agreements

Article 1 of the Proposed Rule provides that any contract related to a foreign-invested enterprise (FIE) shall not be deemed binding or valid before it receives the required approvals by the relevant government authorities pursuant to China's laws and regulations. If the FIE parties reach a supplemental agreement or side agreement and fail to obtain the required approvals, the court shall deem the agreement to be valid if the agreement does not significantly or substantively change the approved contract. Examples of substantive and significant changes include changes to registered capital, type of corporation, business scope, term of operation, investor's equity interest proportion, merger or division of the company, equity transfer, and change of address that would move the FIE beyond the jurisdiction of the original approval authority.

Partners who enter into a joint venture agreement often reach a separate agreement on issues such as capital or loss allocation. If this Proposed Rule is adopted, such supplemental or side agreements will likely be deemed invalid.

Approved Contracts

Article 2 states that even if a contract is approved by the relevant authority, it may still be invalid under standard contract law if there is evidence of fraud or material misunderstanding or the contract is determined not to be in the public interest.

Right of First Refusal in Equity Transfer Transactions

Article 8 states that if one of the joint venture partners transfers its equity interest to a third party and the transferring documents have been approved by the relevant authority, courts shall rule in favor of any complaining partner if its right of first refusal is not duly honored. Article 8 further

provides that courts shall not apply this rule to complaints made by the transferring partner or the third-party transferee.

In practice, this kind of situation most likely would not occur often because the relevant authority generally would not give approval unless all joint venture partners give consent.

Pledge of Equity Interests

Article 9 states that the shareholder of an FIE may pledge its share with its creditor, and whether the pledge is approved by the relevant authority should not affect the legal status of the pledge. The pledge shall become effective only when it is registered or recorded. On the other hand, the pledge contract becomes effective from the time it is executed. The parties may rely on the pledge contract to perform their obligations even before the pledge of equity interest is registered or recorded. This means that whether or not the pledge is registered or recorded does not affect the legal status of the pledge contract, but the pledge itself is subject to registration.

Entrusted Investment in FIEs

If a party (the actual investor) engages another party (the entrusted investor) to invest in an FIE, as long as the purpose of such an arrangement does not violate PRC law the entrusted investment shall be valid, according to Article 10 of the Proposed Rule. However, unless the actual investor can work with the relevant authority to replace the entrusted investor before the court's first hearing, courts shall not deem the actual investor to be the shareholder of the FIE. Courts may hold in favor of the actual investor to force the entrusted investor to comply with the contract between the two. In addition, the actual investor may not directly claim its equity interest or shareholder power against the invested FIE.

This rule will not help foreign companies that wish to circumvent the PRC's restriction on foreign investment. For example, PRC law restricts foreign investment in automobile makers from exceeding 50 percent. Even if a foreign automobile maker entrusts a PRC company to make part of its investment to circumvent the 50-percent cap, this most likely will be viewed as a violation of China law, and the courts will hold the entrustment contract invalid.

Article 13 of the Proposed Rule further provides that if the entrustment contract is considered to be invalid, the court must order the entrusted investor to return all entrusted funds to the actual investor. If there is any profit or loss, both the actual investor and entrusted investor shall share in accordance with their contributions to the FIE's business.

Governing Law of Contracts Between Foreign Investors for Formation of FIEs

Article 17 of the Proposed Rule provides that PRC law must be the governing law of contracts for the

formation of FIE among foreign investors. Under current PRC law, two or more foreign investors may form a wholly foreign owned enterprise (WFOE) without a China-based party. Unlike Sino-foreign joint ventures, in which one of the parties must be based in China and the joint venture contract must be approved by the relevant authority, in a WFOE situation the contract between or among the foreign investors does not have to be approved by the relevant authority. It is believed that a contract among foreign investors for the formation of a WFOE can be governed by any law the investor chooses. This rule will change many of the current practices.

– *Weiheng Jia*

SAIC Promulgates Detailed Rules on Foreign-Invested Partnerships

Key Points:

- ***The SAIC's New Regulations related to FIP formation and operation aim to clarify several areas of uncertainty***

As discussed in our December 2009 *China Alert*, "China Releases Rules Allowing Foreign-Invested Partnerships," the State Council promulgated the Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals (FIP Measures) in December 2009. The FIP Measures provide the legal framework for the formation of a foreign-invested partnership enterprise (FIP).

However, we also noted that many uncertainties with respect to the formation and operation of an FIP need to be clarified. In January and February 2010 the State Administration for Industry and Commerce (SAIC) released the Provisions on Administration of Foreign-invested Partnership Registration and a notice on the relevant issues with respect to the implementation of the FIP Measures (collectively, the New Regulations) to detail the new rules.

The FIP Measures state only that an FIP should comply with foreign investment policies. According to the New Regulations, establishment of an FIP that falls within the scope of "prohibited," "cooperation only," "joint investment and cooperation only," "shares must be held by the Chinese party," "certain number of shares must be held by the Chinese party" or "proportion of foreign investment restricted" as provided under the Catalogue on Guiding Foreign-Invested Industries is prohibited.

The permissible forms of capital contribution are unclear under the FIP Measures, which state only that contributed currency shall be freely convertible currency or RMB obtained lawfully. The New Regulations make it clear that in addition to cash the investments may be made in kind through intellectual property rights, land use rights or other

assets. The value of such investments is determined by an agreement among all partners or based on an assets appraisal by a qualified assets-appraisal firm. In addition, the New Regulations allow general partners to contribute labor to the partnership.

According to the New Regulations, there are several scenarios in which the SAIC should consult the relevant authorities concerned before it approves the formation of the FIP: 1) entry into the industry in question falls under other authorities' supervision or 2) entry is restricted in the Catalogue on Guiding Foreign-Invested Industries. In addition, if an FIP intends to invest in fixed-asset projects, an approval from a relevant development and reform commission will be needed. Except for these circumstances, the New Regulations provide that the SAIC should approve or reject registration applications within 20 days after such applications are accepted.

In summary, the New Regulations have clarified some uncertainties in the FIP Measures. With the implementation of the FIP Measures together with the New Regulations, it is expected that the authorities may formulate more detailed rules to cope with various problems in implementation of the laws and regulations regarding FIPs.

– *Daniel Yao*

Articles, Publications and Other Media

Amy L. Sommers co-published an article in the March issue of the ACC Docket's *Asian Briefings* newsletter regarding best practices for in-house counsel focused on mitigating IP loss exposure in emerging markets such as China.

Charlie R. McElwee II published an article in *China Economic Review* regarding China's climate change position as expressed at the recent summit in Copenhagen.

Past Events

On February 24, 2010 Squire Sanders hosted a roundtable discussion in its Los Angeles offices: "Obama Administration's 2010 Trade Policy: Opportunities and Pitfalls." **David M. Spooner,** former Assistant Secretary of Commerce for Import Administration, and **Robert D. Lehman,** former chief of staff for both the Office of Management and Budget (OMB) and the US Trade Representative (USTR), provided insights into the Obama Administration's trade agenda with a focus on China, Korea and other areas in Asia.

Upcoming Events

On April 10-11, 2010 Squire Sanders lawyer **Brad Y. Chin** will be attending the China Low Carbon Economy Forum 2010, "Low Carbon City, Low Carbon Industry and Low Carbon Finance," which focuses on research and forecasts for the development of China-based and global low carbon cities and low carbon economies, establishing a platform for low carbon businesses to be more effectively connected with financial capital, information sharing among low carbon pioneers, and seizing investment opportunities in the emerging low carbon industry. Mr. Chin will be available to discuss any questions you might have about Squire Sanders and the low carbon future.

Squire Sanders is presenting a complimentary webinar on April 19, 2010 titled "Intellectual Property Protection in China." **Song Zhu**, a partner in the firm's Beijing, San Francisco and Palo Alto offices, and **Amy L. Sommers**, a national partner in the Shanghai office, will address the following questions:

- Is it worthwhile for US companies to register their IP in China?
- If US companies do register their IP in China, will China protect their rights?
- How effective is IP protection in China?
- What should US companies do if their IP is stolen or infringed?
- What are the forums for IP enforcement in China?

- Do China's courts favor companies based in China?
- Is IP litigation slow and expensive in China?
- If US companies prevail in court, will judgments be enforced?
- What steps can US companies take to prevent theft of their IP by their competitors in China, business partners and employees?

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The information in this bulletin was compiled by the China offices of Squire, Sanders & Dempsey L.L.P.

This newsletter provides free information on the influence of certain aspects of the Chinese legal environment and does not constitute legal advice.