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2024 Doing Business in China Comprehensive Guide

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DOING BUSINESS IN CHINA

INTRODUCTION

On January 1, 2020, the *Foreign Investment Law of the People's Republic of China* and its implementing regulations became effective, ending a 30-year era during which foreign investment in China was governed by a series of laws specially formulated for foreign-invested enterprises ("**FIEs**"). In this paper, we describe in detail the evolution of the Chinese legal system, with particular emphasis on the current status of the law, policy, and practice relating to foreign investment in the People's Republic of China ("**PRC**" or "**China**", which, for purposes of this paper, does not refer to the Hong Kong Special Administrative Region, the Macao Special Administrative Region, or the Taiwan region). We also discuss the relevant considerations involved in choosing the form of doing business in China, identify major issues confronting prospective foreign investors, and present the legal requirements and practical issues associated with various methods of investment from establishment to exit.

Notably, on December 29, 2023, the National People's Congress (the "**NPC**") formally adopted revisions to the Company Law (as revised, the "**Revised Company Law**"), which came into effect on July 1, 2024. This paper has been updated to account for the changes that have become effective as of July 1 pursuant to recent revisions made under the Revised Company Law. Unless the context indicates otherwise, all references to the Company Law in this paper are to the Revised Company Law.

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CHAPTER 1 PRC LEGAL SYSTEM AND JUDICIARY

I. PRC Legal System

The Chinese imperial system of government, dating back to roughly two centuries before the Common Era, came to an end with the democratic revolution spearheaded by Sun Yatsen, which led to the founding of the Republic of China in 1912. Nearly 40 years of political chaos, social upheaval, world war, and civil war followed, culminating in the reunification of China in 1949 under the leadership of the Communist Party of China. The People's Republic of China was proclaimed and officially established on October 1, 1949.

At its founding, China was devoid of a functioning legal system – there was no contract law, corporate law, tax law, labor law or commercial transactions law; and China belonged to few international treaties or agreements. It was only until the economic reform and opening-up policy, adopted under the leadership of Deng Xiaoping in 1978, that China began to formulate a comprehensive set of laws governing most aspects of civil and commercial life within the country. Initially, particular attention was placed on laws promoting foreign investment in China. In time, legislative drafting efforts turned toward reforming China's domestic economy so that it was both regulated by market mechanisms and governed by a comprehensive legal system. China's constitution was amended several times to permit investment by foreign entities and individuals in China, and to balance the relationship between state and private ownership.

China consists of one legal jurisdiction subject to a uniform set of national laws, with an exception for the special administrative regions of Hong Kong and Macao and the Taiwan region. The PRC legal system is based principally on a written constitution and the laws and decisions adopted by the NPC and its standing committee. The State Council, which serves as the country's top administrative authority, promulgates administrative regulations to implement national laws. Several dozen administrative departments constituting and under the State Council are also authorized to formulate departmental rules, decisions, and directives. People's congresses at the provincial and

municipal levels have the power to promulgate local rules and regulations that are effective within the relevant provinces and municipalities to the extent they are compatible with national laws and administrative regulations. Unlike common law jurisdictions, judicial opinions in China generally have no binding force of precedent. An exception to this is judicial opinions rendered as published "typical cases", which are considered to have de facto binding force on courts of all levels for similar cases.

II. PRC Judiciary

The PRC judicial system is composed of the Supreme People's Court, local courts, military courts, and other special courts (such as financial courts, internet courts, railway courts, and maritime courts). Local courts are divided into three levels: higher courts, intermediate courts, and basic courts. Higher-level courts are responsible for the supervision of lower-level courts. The Supreme People's Court is the highest judicial authority in the PRC judicial system and exercises supervisory power over the activities of lower-level courts.

China has adopted a "two instances" trial system. Cases are first heard by a court having jurisdiction over the dispute. If a litigant does not accept a judgment (including rulings) of first instance, the litigant may appeal to the court at the next higher level before the judgment takes effect, except where the first-instance judgment is rendered by the Supreme People's Court. The people's procuratorate may also file a protest to the court at the next higher level. In the absence of an appeal or protest within the statutory period, the judgment will become effective. Once appealed or protested, the next higher court must try the case. The judgment of the second instance is final and cannot be appealed. However, a litigant may file a complaint against an effective judgment or the president of the ruling court, in which case the higher-level court at a higher level and/or the Supreme People's Court may initiate a re-trial if errors exist in the judgment. Procuratorates at a higher level and the Supreme People's Procuratorate may also request a re-trial pursuant to the trial supervisory procedures.

The procuratorates exercise the role of public prosecutors during criminal proceedings and supervise courts' activities by filing protests against first-instance judgments or against effective judgments pursuant to trial supervisory procedures. The

procuratorates approve arrests made by the public security bodies, carry out investigations of, institute, and prosecute criminal cases, and supervise the enforcement of sentences. The Supreme People's Procuratorate exercises supervisory power over the activities of lower levels of procuratorates.

The Supreme People's Court and the Supreme People's Procuratorate have the power to interpret the application of laws arising in judicial practice. Interpretations of the Supreme People's Court and the Supreme People's Procuratorate are divided into specific interpretations (which are binding on specific types of cases) and general interpretations (which carry general legal effect).

PRC courts will recognize and enforce effective civil and commercial foreign judgments (including rulings) on the application of a party to the foreign judgment or the foreign court which made the judgment, either based on an international treaty to which China is a party or in accordance with the principle of reciprocity. Judgments will not be recognized where they are found to violate public security, state sovereignty, public interests, or basic principles of PRC law. China is not yet a signatory to the *Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters*; thus, the recognition and enforcement of foreign judgements by the PRC courts remains relatively difficult and depends on reciprocal enforcement arrangements between China and the home country.

Currently, China has entered into agreements on bilateral judicial assistance on judgment recognition and enforcement with around 30 countries, including France, Spain, Russia, and certain other developing countries, but it has not yet entered into agreements with major economies such as the United States, Japan, Germany, the United Kingdom, or Australia. Absent an express agreement, PRC courts are unlikely to grant reciprocity to foreign court judgments unless there exists precedent whereby a court in the foreign jurisdiction has recognized and enforced the judgment of a PRC court (i.e., de facto reciprocity). In 2017, a local court in Wuhan, Hubei province recognized and enforced for the first time a judgment of the Los Angeles Superior Court in California on the grounds that a PRC judgment had previously been accepted in the United States. China is expected to take a more liberal approach toward reciprocity, for example, with countries along the "Belt and Road" initiative where precedent is not

required and reciprocity can be presumed to exist if the foreign country has no prior instances of failing to recognize a PRC court judgment.

China is a signatory to the *United Nations 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards* (the "**New York Convention**") and generally a foreign arbitral award rendered in a signatory country can be recognized and enforced by the intermediate court of the place of domicile of the award debtor or the place where the debtor's property is located.

The Supreme People's Court has entered reciprocal arrangements with Hong Kong and Macao for the recognition and enforcement of judgments and arbitral awards, and has also issued provisions to similar effect for judgments and awards rendered in Taiwan.

CHAPTER 2 FOREIGN INVESTMENT LEGAL REGIME

I. Evolution of the Legal Regime

China is among the world's top countries for inbound foreign investment. The country's economic reforms have seen its policies and laws toward foreign investment evolve from restrictive, constrained liberalization to active promotion.

i. Old FIE Laws and Approval System

At the beginning of China's opening to the West in 1978, there was no corporate law, commercial law, or contract law. The *Law on Chinese-foreign Equity Joint Ventures* (the "**EJV Law**") was adopted in 1979 and was the first PRC corporate law. The EJV Law was a cornerstone in the opening up of China and its adoption marked the beginning of a legal regime which allowed foreign investors to conduct business on Chinese soil. In 1986, the NPC adopted the *Law on Foreign-capital Enterprises* (the "**WFOE Law**"), which permitted foreign investors to establish and operate wholly foreign-owned companies in China. In 1988, the NPC adopted the *Law on Sino-Foreign Contractual Joint Ventures* (the "**CJV Law**", together with the EJV Law and the WFOE Law, the "**Old FIE Laws**") under which foreign investors could invest in so-called "contractual joint ventures."

The Old FIE Laws, supplemented by a body of subordinate legislation, established a relatively comprehensive examination and approval system for foreign investment. In addition to anti-monopoly review, national security review, industry regulatory approval, and business registration, which are customary in other economies, the Old FIE Laws imposed additional general approval requirements targeting only foreign investments, i.e., project-based approval from the National Development and Reform Commission or its local counterparts ("**NDRC**") and an enterprise-type approval from the Ministry of Commerce or its local counterparts ("**MOFCOM**"). These approvals were both critical and time-consuming; without them, a foreign investor would not be allowed to establish a presence in China and the regulators had to first satisfy themselves of the creditworthiness of the foreign investor, the legitimacy of its

proposed investment, and, in case of a joint venture, the fairness of the agreement for the Chinese parties. The investor would also need to obtain approval on an ongoing basis for any amendments to material aspects of the investment, such as investment size, business scope, investor(s), directors, and termination, as well as major corporate transactions such as mergers and acquisitions.

ii. Approval/Record-filing System

The Old FIE Laws played an institutional role for decades and oversaw a surge of foreign investment into China. However, due to their vagueness and lack of transparency and consistency in implementation, the old regime was often criticized for failing to provide foreign investors with an effective and fair mechanism for investing into China.

MOFCOM began efforts to reform foreign investment governance, first in 2013 by introducing the "pre-access national treatment plus negative list" system on a trial basis in the Shanghai Pilot Free Trade Zone, and later in 2016 on a nationwide basis. This hybrid system consists of both the decades-old approval element and a new record-filing system. As its name implies, the system references a so-called "negative list," which determines how certain types of investments are to be regulated. The negative list was originally derived from the restricted and prohibited categories of the *Catalogue for the Guidance of Industries for Foreign Investment* ("**Foreign Investment Catalogue**"). Foreign investments which fall under the negative list continue to be subject to the close scrutiny of MOFCOM. For those areas outside the negative list, a more standardized and convenient record-filing process has been adopted. Under this system, foreign investors disclose only limited information rather than submitting definitive documents, such as articles of association, joint venture contracts, or equity transfer agreements, and MOFCOM will conduct a non-substantive examination focusing mainly on compliance with form requirements.

In 2014, NDRC followed MOFCOM's practice and also implemented a similar system for its review of foreign investment projects, requiring approval for negative-listed projects and providing a record-filing process for non-negative-listed projects.

II. New Regulatory Regime under the Foreign Investment Law

i. Foreign Investment Law and National Treatment

Foreign investment regulation saw continued reforms in response to the evolving economic environment in the 2010s, although these measures were patchwork in nature and increasingly seen as having shortcomings. In response, the NPC adopted on March 15, 2019, the *Foreign Investment Law of the People's Republic of China* (the "**Foreign Investment Law**"), which became effective on January 1, 2020. On December 26, 2019, the State Council promulgated the *Regulations for the Implementation of the Foreign Investment Law of the People's Republic of China*, which took effect concurrently with the Foreign Investment Law. The Foreign Investment Law is essentially an investment promotion law applicable to all direct and indirect foreign investment activities in China, unlike the Old FIE Laws which were corporate laws. The Foreign Investment Law mandates a broad structural reform of the foreign investment regulatory system.

Throughout the Foreign Investment Law, China pledges a "national treatment" regime whereby foreign investors and domestic investors are treated equally, subject only to exceptions as provided in special administrative measures, e.g., the negative list. Further, the Old FIE Laws were repealed under the Foreign Investment Law. There is no longer a separate category of FIEs and all FIEs are now equally subject to the provisions of the *Company Law of the People's Republic of China* (the "**Company Law**", revised in 2023) and the *Partnership Enterprise Law of the People's Republic of China* (the "**Partnership Enterprise Law**"). Terminology such as equity joint venture (EJV), contractual joint venture (CJV), and wholly foreign-owned enterprise (WFOE) arising from the Old FIE Laws are being phased out.

ii. Negative List and Encouraged List

It is essential when planning to invest in China to first verify whether the proposed business or operation is open to foreign investment.

Previously, the definitive authority on this issue was the Foreign Investment Catalogue. The Foreign Investment Catalogue classified investment industries as encouraged, restricted, or prohibited, with all unspecified industries being regarded as permitted to foreign investment. As the regulatory approach changed beginning in 2018, the Foreign Investment Catalogue was replaced by the *Special Administrative Measures (Negative List) for the Access of Foreign Investment* to define areas in which foreign investors could invest and, if so, on what conditions. The negative list divides listed industries into two categories – restricted (e.g., telecommunications, education, healthcare, etc.) and prohibited (e.g., broadcasting and publishing, etc.). Foreign investors may not invest in prohibited industries and their investments in restricted industries are subject to special administrative measures and enhanced regulatory scrutiny. Aside from these two categories, foreign investors are now treated equally to their domestic counterparts for market access in all other industries.

Special administrative measures usually include shareholding limitations or a nationality requirement for the legal representative or senior executives. Currently, there are several negative lists: the free trade zone ("**FTZ**") version (updated in 2021), which applies in the 21 FTZs in China, the Hainan Free Trade Port version (updated in 2020), which applies in the Hainan Free Trade Port, and the national version (updated in 2020), which applies in all other areas. The lists are generally of the same content and form except that the FTZ and Hainan Free Trade Port versions are relatively more liberal, allowing for additional foreign investment in certain industries.

At the same time, China has adopted a "positive list" for industries in which foreign investment is encouraged, the *Catalogue for the Encouragement of Foreign Investment Industries*. The latest catalogue was updated in 2022 and consists of two categories – one applies nationally and has 519 items, and the other is applicable to 22 provinces in China's central, western, and northeastern regions and has 955 items. Encouraged areas include advanced manufacturing, high and new technology, and modern service industries. It is notable that there are overlapping items in the negative lists and the positive lists (such as construction of nuclear power stations and public air transportation), showing the Chinese government recognizes the strategic need for such investment while also seeking to retain a level of control.

FIEs in encouraged industries can receive discounted land prices and tax benefits. All eligible FIEs nationwide can be exempted from import duties for goods imported within the total investment amount and eligible FIEs in the central, western, and northeastern regions can further enjoy a preferential corporate income tax rate of 15% versus the standard 25%. Local governments may also provide support policies in line with the central government's policies.

iii. Regulatory Review and Approval

The Foreign Investment Law establishes a new framework for opening-up and marks the beginning of a new era for foreign investment. Realizing many of the principles and requirements depends on more detailed regulations which are yet to be issued, including further legislation clarifying the review criteria and procedures for access approval for investments on the negative lists or with national security implications, streamlining between registration with the State Administration for Market Regulation and its local counterparts ("**SAMR**") and industry regulatory approvals, and the manner of administering non-equity investment projects.

Notwithstanding the above, the regulatory regime for foreign investment market access under the Foreign Investment Law is summarized as below, which is subject to further change pending further developments.

Type of approval	Authorities	Notes
Anti-monopoly review	SAMR	• Applicable to cross-border acquisitions resulting in a change of control or, in certain cases, the establishment of a joint venture that exceeds certain financial thresholds. • The review should be completed before the closing of the investment.
National security review	A working mechanism office for the security review of foreign investment jointly led by NDRC and MOFCOM	• Applicable to foreign investments with national security implications. • The review should be completed before the closing of the investment and is usually a pre-requisite for other

Type of approval	Authorities	Notes
	(“**Working Mechanism Office**”)	approvals if the review is triggered.
Foreign investment project approval or record-filing	NDRC or its local counterpart	• Applicable to foreign investment projects involving fixed asset investments. • The approval or filing should be obtained before the commencement of the project.
Foreign investment information reporting	MOFCOM	• Applicable to all foreign investments. • The reporting will be conducted concurrently with SAMR registration.
Industry-specific permits (as applicable)	Relevant industry regulator	• Applicable if certain business or activities require industry approval under industry-specific regulations. • Timing of the permit depends on specific industry regulations – either a pre-requisite for registration with SAMR or after the issuance of the business license.
Business registration	SAMR or its local counterpart	• Applicable to all foreign investments.

a. SAMR Anti-trust Review

Inbound acquisitions that result in a change of control are subject to anti-trust review. Greenfield investment generally does not fall under the purview of anti-trust review, except for newly established joint ventures which at least two parties jointly control. The prior fiscal year financial thresholds to trigger a mandatory pre-transaction notification and review are:

- the combined worldwide turnover of all parties involved exceeds RMB 12 billion (approximately US$ 1.71 billion), and the turnover in China of each of at least two parties exceeds RMB 800 million (approximately US$ 114.29 million); or
- the combined turnover in China of all parties involved exceeds RMB 4 billion (approximately US$ 571.43 million), and the turnover in China of each of at least two parties exceeds RMB 800 million (approximately US$ 114.29 million).

SAMR has been responsible for anti-trust enforcement since a government reorganization in 2018. Under PRC law, transactions involving a concentration of undertakings are prohibited unless the parties prove either that the advantages of the concentration would outweigh the disadvantages or that the concentration is in the public interest.

Anti-trust reviews may take up to 180 days and consist of an initial review of 30 days, an extended review of up to another 90 days, and a third extension of up to 60 days. A "fast-track" is available for cases not giving rise to significant competition concerns, which usually can be concluded within 30 days. Other than issuing an approval or blocking the deal entirely, SAMR can also impose conditions as part of its approval to address competition concerns, such as divestitures and restrictions on certain types of activities. The review must be completed prior to the completion of the investment, i.e., the completion of an acquisition transaction and issuance of the business license for a joint venture. Otherwise, SAMR may impose penalties including penalty fines and an order to cease the deal, dispose of acquired shares or assets, as well as other measures to restore the parties to the status quo ante.

b. National Security Review

Since 2011, China has required national security reviews of foreign investments which raise national security implications. On December 19, 2020, NDRC and MOFCOM jointly issued the *Measures for the Security Review of Foreign Investment* ("**Security Review Measures**"), which became effective on January 18, 2021. The Security Review Measures apply to both direct and indirect foreign investment in China, including investments for constructing new projects or establishing enterprises in China, acquiring the equity or assets of any enterprise in China, and investments by other means. The Working Mechanism Office, which is established under NDRC and jointly led by NDRC and MOFCOM, organizes, coordinates and guides the national security review process.

Foreign investors must apply for a national security review in instances where a planned investment involves: (i) a sector which relates to national defense and security, such as the arms industry or a sector that supply the arms industry, or locations near military facilities or arms industry facilities; or (ii) acquiring actual control over an enterprise

that relates to any important agricultural product, important energy and resources, major equipment manufacturing, critical infrastructure, important transportation services, important cultural products and services, important information technologies and internet products and services, important financial services, key technologies, or any other important field that concerns national security.

After receiving an application, the Working Mechanism Office has 15 working days to determine whether to commence a security review of the subject investment. National security reviews include two phases: general reviews and special reviews. Once the Working Mechanism Office determines a security review is required for the investment, it has 30 working days to complete the general review. Following the general review, the investment will be permitted to proceed if no national security concerns are found. However, if concerns are identified, a special review will be initiated, which can take up to 60 working days and may be extended if circumstances so require. Where a subject investment is found to have national security implications, the Working Mechanism Office may either prohibit it outright or impose conditions as part of its approval.

c. *MOFCOM Information Reporting*

Prior to January 1, 2020, all foreign investments were subject to scrutiny by MOFCOM, either approval for negative-listed investments or record-filing for non-negative-listed business entities. The Foreign Investment Law entirely repeals the previous approval/record-filing system and MOFCOM now assumes a monitoring role by receiving foreign investment information through a reporting system, rather than directly supervising foreign investment.

During the FIE investment lifecycle, foreign investors and their FIEs should submit reporting information to the *Enterprise Registration System* or the *National Enterprise Credit Information Publicity System*. These reports are made for initial establishment, subsequent changes of initial information, annual operation, and de-registration. Note that information disclosures include a look-through to the foreign shareholder's ultimate controlling person, which could be of concern for investors with complex holding structures. The ultimate controller of the biggest shareholder is regarded as an FIE's ultimate controlling person. Any subsequent change of the FIE's ultimate

controlling person (even without a change of record shareholder) should be reported through the information reporting system.

Except for random post-reporting inspections, MOFCOM will generally not substantively examine the information submitted, nor will it issue an approval or denial in relation to the reporting. Failure to file a report or falsifying information, however, will be shared among governmental departments and be recorded as a demerit in the national enterprise credit reporting system.

d. NDRC Project Approval and Record-filing

NDRC is responsible for reviewing all project-based foreign investments. In practice, NDRC reviews only investments entailing fixed asset investment, such as manufacturing, transportation, energy, and natural resources. Investment in sectors such as services, or adopting an asset-light model, generally is not subject to NDRC review.

Since 2014, NDRC has streamlined its approval process by introducing a record-filing system for all projects except for those under a negative list. It should be noted, however, that NDRC approval is also required for projects under the *Catalogue of Investment Projects Subject to Verification by the Government (2016 Version),* regardless of whether they are negative listed.

Under the approval system, an applicant should submit extensive project-related information, including the project's basic parameters, an environmental impact assessment, natural resources exploitation, and economic and social effects. Depending on the size and nature of the project, this approval can be issued by NDRC at the local or national level. NDRC will issue its approval after verifying that the proposed project conforms to the law, the relevant negative list, industrial and foreign exchange policies, and, if applicable, whether the project explores for and extracts natural resources in a reasonable manner and causes no harm to national security or public interests. Under the record-filing system, relatively limited information is required about the project and investor. The filing will be accepted if the project conforms to the law, industrial and development policies, and market access standards. Procedures similar to those described above apply where a substantial change to an existing project is being

implemented. Expansion of capacity, together with changes involving shareholders, often occurs when introducing foreign investment to an existing project in China.

NDRC should decide whether to approve the project within 30 days (not including time for consultation with outside experts) after the application is received. For record-filing, the filing is considered valid and accepted unless NDRC makes a negative filing decision within seven days.

The NDRC review should be completed prior to commencement of the project. In practice, however, NDRC reviews have created considerable confusion because there are no explicit rules on when they should be completed in relation to business registration, especially where approval is required. Practices therefore may also vary among different regions and industries, and foreign investors are advised to verify with the relevant authorities before making investment plans.

e. Industry Regulatory Permits

Previously, permits required under industry-specific regulations were considered a layer of market access restrictions in addition to the general MOFCOM and NDRC foreign investment approvals. Under the new regulatory regime, industry regulators should, in addition to their regular approval practices, also verify whether proposed investments comply with the special administrative measures provided in the negative list in terms of shareholding limitations, nationality for senior management, etc. Industry regulators will generally not issue permits prior to confirmation of compliance with the special administrative measures.

Notably, existing industry regulations and rules impose a number of requirements for foreign investment, such as investor qualifications, track record, and technological capabilities, etc. which are broader than those provided in the negative list. In practice, these provisions may continue to be effective pending further legislative updates to implement the national treatment requirement. In this regard, foreign investors investing in regulated industries are advised to closely follow the legal developments in their industries.

The timing of the permits depends on specific industry regulations, and in most cases they can be obtained after an FIE has obtained its business license.

f. Business Registration with SAMR

SAMR is the official registry for both PRC-registered entities and non-equity investments, such as representative offices and certain permitted operations. Once SAMR has verified an FIE's proposed name and registration application documents, it will issue a business license, unless industry regulatory pre-approval is required, such as permits for education, hazardous chemicals, banking permits, etc. SAMR will also verify the FIE's compliance with the special administrative measures before issuing the business license if either the FIE intends to operate in a negative-listed industry and no regulatory pre-approval is required or the relevant permit may be applied for on a post-registration basis.

Local SAMR counterparts provide detailed registration application checklists on their websites which cover the identity of the investor and particulars of the proposed FIE, such as business scope, registered capital, senior management, and the company's articles of association. In particular, foreign investors should provide notarized and authenticated identification certificates, which usually takes weeks to procure. The content of these detailed checklists may vary by region. Applicants apply through an online enterprise registration system administrated by SAMR, followed by an onsite application submission. It normally takes 5 to 15 days for SAMR to issue a business license to an FIE upon receipt of the onsite application submission if it satisfies SAMR's requirements.

After the FIE is registered with SAMR and obtains a business license, it will be considered a legal entity in China and may contract on its own behalf. Commencement of certain business activities by the FIE may, however, be subject to specific conditions, such as obtaining industry-specific permits and post-establishment registrations.

iv. Transitional Period

Under the Old FIE Laws, FIEs were divided into three distinct types – EJVs, CJVs, and WFOEs – with each being subject to special provisions regulating formation and operation. For EJVs and CJVs, in particular, the statutory provisions differed from

those under the Company Law with respect to governance structures, rules of order, voting procedures, equity transfers, and profit distributions.

Existing FIEs, including unincorporated FIEs, must reconcile inconsistencies with the Company Law or the Partnership Enterprise Law. To allow flexibility, the Foreign Investment Law provides legacy FIEs with a five-year transition period to effect the necessary changes, i.e. before January 1, 2025. As these changes will likely require re-distribution of controlling rights among shareholders and new documentation to reflect the changes, foreign investors are advised to start planning and discussions in advance to avoid possible delays and business interruptions due to disagreements. Existing agreements between shareholders on issues such as profit distributions and asset allocations upon dissolution, however, will continue to be valid notwithstanding the change in organizational structure.

v. Re-investment by FIEs

In the past, domestic re-investments made by non-investment oriented FIEs may have been regulated either as purely domestic or foreign investments, and practices varied by industry. In this regard, the Foreign Investment Law defines foreign investment to include investment activities carried out directly or indirectly by foreign investors in China and explicitly provides that its provisions govern domestic re-investments. As a result, going forward, re-investment by FIEs will be subject to the foreign investment regulatory regime and such investees will be regulated as FIEs. Note that there is no shareholding threshold or control element in determining FIE status based on re-investment, and thus the regime applies to all FIE re-investments regardless of the FIE's shareholding structure or the amount of the re-investment.

Given this change, multi-layer structures, even with joint participation from Chinese investors, may prove to be problematic if foreign investors engage in business in restricted or prohibited areas, and foreign investors currently using such structures are advised to consider alternative plans in advance of any further changes in regulatory practice.

CHAPTER 3 FORM OF INVESTMENT VEHICLE

Foreign investment in China can be accomplished with or without a presence in China, and with or without local partners. This chapter summarizes general background advice concerning forms of doing business in China; in particular, by providing an overview of the available investment vehicles if foreign investors wish to set up a permanent presence in China.

I. Joint Ventures

Under the Old FIE Laws, a "joint venture" referred to an equity joint venture (EJV) or a contractual joint venture (CJV) established between foreign and Chinese investors pursuant to the EJV Law or the CJV Law. Nevertheless, EJVs and CJVs are similar to limited liability companies under the Company Law (although under the CJV Law, an unincorporated CJV was permitted), and the Company Law applies to all joint ventures in addition to the EJV Law and the CJV Law. In the case of conflict between the Company Law and specific provisions governing such an enterprise, then the specific provisions will prevail. As a result, EJVs and CJVs are, in many respects, different from Chinese domestic companies incorporated under the Company Law, such as governance structure, rules of order, voting procedures, equity transfers, and profit distributions.

As discussed above, the Foreign Investment Law repealed the Old FIE Laws and all FIEs and Chinese domestic companies are now equally subject to the Company Law. Joint ventures newly established on or after January 1, 2020, must follow the same rules as their domestic counterparts. Legacy FIEs are granted a five-year grace period to amend their corporate structures, by January 1, 2025. The following summarizes the major changes brought by the Foreign Investment Law vis-à-vis the Old FIE Laws.

- *Chinese individual co-investors*. Previously, foreign investors could only partner with Chinese companies when setting up a joint venture. Chinese individuals were excluded, except by way of acquisition where the target company was owned by Chinese individuals or in certain areas where explicit local policies gave permission, such as in Shanghai Pudong. This restriction caused foreign investors

to find it difficult to enter direct contractual relationships with individuals they regarded vital to their investments. The Foreign Investment Law explicitly permits Chinese individuals to co-invest with foreign investors, thereby offering more flexibility in choosing business partners and structuring joint ventures.

- *No substantive document reviews*. Foreign investors previously spent substantial time and effort drafting the joint venture contract, not only for negotiations with counterparties but also back-and-forth discussions with the approval authority. There were strict requirements for business legal documents, both in content and form. The Company Law, however, has no such requirements. While investors are advised to put a shareholder agreement in place to secure contractual protections over covenants around joint ventures, the contract itself is no longer subject to legal constraints nor is it generally reviewable by authorities. This change confers greater flexibility and certainty over arrangements concerning the joint venture.
- *Revised corporate governance structures*. Joint venture shareholders sometimes found themselves at a loss when trying to control their joint ventures. While the shareholders could claim control through their appointees on the board, the burdensome unanimous voting requirements or run-away management have caused numerous issues. Under the Foreign Investment Law, joint ventures can now set up more sound corporate governance structures in accordance with the Company Law, such that both a board of shareholders and a board of directors is to be set up, and shareholders can exercise direct control rather than by proxy through appointees.
- *Liberalized equity transfers*. Joint venture interests suffered from illiquidity concerns because the law required that interest transfers be approved by the other venture parties. Under the Company Law, shareholders can formulate rules for the transfer of interests in the venture's articles of association. In the absence of agreement, the Company Law does not have the statutory approval requirement for equity transfers to third parties, but the transfer is subject to the right of first refusal of other shareholders unless otherwise provided in the articles of association.

There are two basic forms for corporate organization under the Company Law: the limited liability company and the company limited by shares. Limited liability companies, which in some respects resemble LLCs under U.S. law (other than taxation), may have up to 50 shareholders. Set forth below is a summary of the characteristics of joint venture limited liability companies.

- A joint venture is a Chinese limited liability company with an independent legal personality. Investors have no liability for the debts and obligations of the joint venture.
- A joint venture is the only viable mechanism for investors who wish to invest in a negative-listed industry subject to a shareholding limit.
- A joint venture does not issue shares but has "registered capital" equal to the total amount of the equity contributions committed by shareholders upon formation. Investors hold "equity interests" which are expressed as a percentage of the registered capital.
- The "preferred share" concept is not applicable to joint ventures, and all "equity interests" rank *pari passu*. Shareholders can agree on varied rights through a shareholder's agreement; note, such variations are personal to the shareholder and are not deemed attached to the underlying equity interests.
- No statutory unanimity is required, either at shareholder or board level (except for written shareholder resolutions in lieu of a meeting), thereby reducing the previous likelihood of deadlocks.
- Shareholder voting rights are distributed in proportion to their equity contributions, though all shareholders can agree otherwise in the articles of association.
- Dividends and pre-emptive rights to capital increases are distributed in proportion to the paid-in equity contributions, though all shareholders can agree otherwise in the articles of association.
- Equity transfers are subject to the other shareholders' pre-emptive rights, though all shareholders can agree otherwise in the articles of association.

II. Wholly Foreign-owned Enterprises

An alternative to the Chinese-foreign joint venture is the wholly foreign-owned enterprise ("**WFOE**"). A WFOE is a limited liability company with only foreign shareholders, it can be a sole-shareholder company or a joint venture among foreign shareholders.

A WFOE, especially a sole-shareholder company, offers the advantages of a straightforward management structure without the involvement of a local partner, which confers the consistent execution of group policies and better protection of intellectual property. There is also no need to take over the existing operations of a local partner and the liabilities and obligations that may come with it. Formerly, a key disadvantage of the WFOE was that, without a local partner, the foreign investor lacked proper access to the resources and markets in China's planned economy. However, this concern has been greatly reduced as China's economy has liberalized and resources and markets have become more freely accessible.

Previously, WFOEs were formed and operated pursuant to both the WFOE Law and the Company Law, with the former prevailing in case of conflict. Given the WFOE Law was generally compatible with the Company Law, the repeal of the WFOE Law by the Foreign Investment Law does not materially change practices for WFOEs.

While the WFOE is not feasible for restricted businesses subject to shareholding limitations as provided in the negative list, WFOEs share most of the major characteristics of joint ventures as summarized above, including capitalization and corporate governance, although WFOEs with only one shareholder need not be concerned with sharing management and profits. Further, unlike a joint venture which involves a Chinese partner, a WFOE can take advantage of an offshore holding structure to avoid domestic requirements and procedures.

III. Foreign-Invested Company Limited by Shares

Another form provided under the Company Law is the company limited by shares, or joint stock company, which is similar to the corporate form under U.S. state laws. Previously, a foreign-invested company limited by shares ("**FICLS**") was subject to the

Interim Provisions Governing Establishment of Joint Stock Companies Using Foreign Investment, issued by MOFCOM in 1995, which created a mechanism for setting up such companies. MOFCOM repealed these interim provisions in 2019 prior to the effectiveness of the Foreign Investment Law. As a result, the FICLS is now free of requirements specific to foreign investment and is subject to all applicable provisions of the Company Law.

Foreign investors can form an FICLS either by creating a new Chinese entity through the "promotion" method or by converting an existing FIE, such as a joint venture, through the "transformation" method. Where an FICLS is created by way of promotion, there must be between 1 and 200 promoters, of which more than half must be domiciled in China. The major distinctions between an LLC and an FICLS under the Company Law are summarized below:

#	LLC	FICLS
Number of Shareholders	1~50 shareholders	1~200 promoters
Capital contribution Requirement	Pursuant to the articles of association, but no later than five (5) years from the date of establishment.	Fully paid for the subscribed shares by promoters before the date of establishment.
Transparency of shareholding structure to the public	Compulsory filing: An LLC must file the name(s) of its shareholder(s) with SAMR, which will be available to the public via the National Enterprise Credit Information Publicity System (which is an online platform run by SAMR to publicize the information of Chinese enterprises). Compulsory disclosure: An LLC is required to disclose: (i) the amount of capital contributions subscribed for and actually paid by the shareholders; (ii) the method and date of capital contributions; (iii) the information on equity changes to the public via the National Enterprise	Essentially the same as the LLCs, except that: • An FICLS is only required to file the name(s) of its promoters with SAMR and is not required to file name(s) of subsequent shareholder(s) with the SAMR; the company needs to maintain a complete and updated register of shareholders internally, which is not required to be disclosed to the public. • An FICLS is required to disclose (i) the number of shares subscribed for by the promoters; and (ii) the information on changes in

#	LLC	FICLS
	Credit Information Publicity System.	shares held by the founding shareholders via the National Enterprise Credit Information Publicity System.
Issuance of Shares	N.A., but in practice, an LLC may utilize a shareholder agreement to assign preferential rights to certain shareholders, such as veto rights on certain reserved matters, dividend/liquidation preference, etc.	An FICLS may: • issue shares with or without par value; • issue classified shares (i.e., shares with weighted voting rights, preference over distribution etc.); • authorize the board of directors to, within three years, issue not more than 50% of the issued shares. However, if the capital contributions are to be made using non-cash property, they shall be subject to a resolution made by the shareholders' meeting.
Equity/Share Transfer	Unless otherwise provided in the company's articles of association: • A shareholder may freely transfer its equity interests to other shareholder(s); • A shareholder may transfer its equity interests to third parties, while the other shareholders are entitled to the right of first refusal.	By default, a shareholder may freely transfer its shares to other parties unless otherwise provided in the company's articles of association.
Corporate Governance	• Board of Directors: shall have no less than three members, but an LLC of small scale or with a small number of shareholders may have only one director (who may serve concurrently as the manager of the company). • Board of Supervisors: shall	• Essentially the same as LLCs under the Company Law, except that an FICLS of small scale or with a small number of shareholders cannot forgo establishing a supervisory position, even with unanimous shareholder consent (but, same as an LLC, an FICLS may have

#	LLC	FICLS
	have no less than three members, but an LLC of small scale or with a small number of shareholders may have only one supervisor or opt to forgo any supervisory position with unanimous shareholder consent. • An LLC may set up an audit committee composed of directors in the board of directors, which exercises the functions and powers of the board of supervisors as prescribed by the Company Law, with no board of supervisors or supervisors established.	only one supervisor or an audit committee in lieu of the board of supervisors or supervisors(s)). • However, an FICLS still has relatively little flexibility in formulating its own rules on meetings and voting proceedings, which are subject to the provisions of the Company Law, e.g., mandatory annual meetings of the board of shareholders, and the board of directors to convene at least two meetings annually.
Public Financing	N.A., but as a practical matter, an LLC may receive various forms of non-public financings.	• An FICLS may issue convertible bonds. • A company must be in the form of an FICLS to seek a listing on the Chinese stock exchanges or to be quoted through the National Equities Exchange and Quotations.

In practice, very few FIEs were formed as FICLSs or converted into FICLSs under the previous Company Law, partly because: (i) a sole shareholder may not form an FICLS due to the minimum number of shareholders required; (ii) there is little flexibility in organizing a streamlined corporate governance structure; and (iii) FICLSs are generally considered to be structured for large-scale companies or companies with a substantial number of shareholders, which are positioned to publicly issue shares in Chinese capital markets. Now, the Revised Company Law has made FICLSs more flexible as an investment vehicle. It is likely that the FICLS form will become more popular in the future due to a number of advantages, such as the flexibility of issuing classified shares

and convertible bonds, and the possibility of issuing shares to the public to provide a realistic exit strategy for foreign investors.

IV. Foreign-invested Partnership

Starting from 2010, foreign investors were provided with a new alternative structure to invest in China, i.e. the foreign-invested partnership ("**FIP**"), which allows foreign firms to follow the more common practice of establishing partnerships, rather than companies, for certain types of joint ventures. An FIP can either be newly established or established by one or more foreign investors contributing to or accepting equity interests in an existing domestic partnership, thereby converting it into an FIP.

An FIP can take the form of either a "general partnership" where all partners bear unlimited liability or a "limited partnership" where there is at least one general partner and at least one limited partner with liability limited to its capital contributions. To be eligible for limited liability, a limited partner is required not to participate in the management of the partnership. In practice, an FIP with a limited partner structure is commonly used as a vehicle for investment funds as well as other businesses which have passive financial investors.

The major characteristics of FIPs are summarized below:

- FIPs are not allowed to engage in businesses subject to shareholding limitations as provided in the negative list.
- FIPs have a more flexible capitalization regime under which contributions can include services (except for limited partners), in addition to cash and in-kind contributions. The valuation of in-kind contributions and services can be agreed among the shareholders rather than by an appraiser.
- FIPs enjoy more flexibility over profit distributions and loss allocations, which can be freely agreed in the partnership agreement without reference to the proportion of equity contributions.

- FIPs have considerable autonomy in structuring management and governance through the partnership agreement, though partners should retain basic investigation and information rights.
- FIPs are subject to pass-through taxation, income taxes are assessed at the partner level.

Practical experience with FIPs is currently limited, but the FIP form allows foreign private equity funds to manage money in China through limited partnerships. In addition, FIPs provide several scenarios where the partnership form might be utilized, as opposed to the more traditional joint venture form, such as for construction-related joint ventures, which are frequently accomplished through general partnerships outside China; and also offer a steppingstone to form locally organized and funded investment funds that would be structurally similar to private equity funds in Western countries.

V. Investment-oriented Companies

FIEs structured as holding and investment-oriented companies ("**Holding Companies**") are subject to separate regulations and are distinct from other FIEs because current legislation takes an umbrella approach in permitting multinationals to organize all their functional business activities under one organization, including sales, human resources, legal and compliance, distribution and finance, etc. Holding Companies are subject to the Company Law, the same as limited liability companies, but are also subject to the *Provisions on Establishment of Investment-oriented Companies by Foreign Investors,* adopted in 2003 and amended several times, in 2004, 2006, and 2015.

To be eligible to establish a Holding Company, the foreign investor should meet either of the following requirements with respect to its financial strength and a proven investment track record:

- the foreign investor is in good financial standing and must have a total asset value of no less than US$ 400 million in the preceding year, and must have previously established FIE(s) in China, with the investor's paid-up capital contributions totaling more than US$ 10 million; or

- the foreign investor is in good financial standing and must have established in China ten or more FIEs, with the investor's paid-up capital contributions totaling more than US$ 30 million.

If there is to be a Chinese partner in the Holding Company (which has to date been relatively uncommon), the Chinese partner must have at least RMB 100 million in assets.

The minimum registered capital requirement for Holding Companies was removed in 2015, but it is still necessary for Holding Companies to have at least US$ 30 million of its registered capital available to fund investments in China, either as greenfield investments or acquisitions of existing domestic companies.

The major characteristics of Holding Companies are summarized below:

- As the name implies, Holding Companies should engage in activities centered around investing and holding operations, including related services to investee-companies and affiliates, and is explicitly prohibited from engaging in production or manufacturing operations;
- Holding Companies are regulated as foreign investors and, when investing in China, they are required to follow rules applicable to foreign investment and their investee companies are classified as FIEs; and
- Holding Companies enjoy a higher offshore debt quota, they can borrow up to four times their paid-in registered capital, or up to six times if paid-in capital exceeds US$ 100 million.

The Holding Company has a derivative form – the regional headquarters ("**RHQ**"). To encourage multinationals to move their regional operations into China from other countries in Asia, the Chinese government has formulated rules whereby existing or new Holding Companies can be recognized as RHQs to provide regional services to entities in one or more jurisdictions and enjoy more preferential benefits provided by the government. Further, local governments in different cities (such as Shanghai) follow the national approach to localize their own standards on recognition of RHQs (or quasi-RHQs) and incentive policies. RHQs are more flexible than regular Holding

Companies in providing inter-company capital management, financial support, service outsourcing, logistics services, and foreign exchange allocation.

Notably, until recently, only Holding Companies and certain qualifying entities subject to special administration were permitted to utilize their capital funds to make equity investments in China. Previously, non-investment-oriented FIEs could invest only by utilizing their retained earnings generated through operations. Starting from November 2019, all other FIEs can now use foreign capital to fund their domestic investments, subject to the general requirements of "truthfulness" and "reasonableness." While there remains uncertainty in practice whether non-investment-oriented FIEs may only invest in industries related to their core businesses, the liberalizing of capital use challenges the popularity of the Holding Company form. It is expected that the PRC government may introduce further reforms, such as lowering threshold requirements, expanding permitted business scopes, or providing additional policy incentives to retain the appeal of the Holding Company form among foreign investors.

VI. Representative Offices

A representative office ("**RO**") is an attractive method for establishing a foothold in China, as it enables a foreign company to legally appoint its own representatives to reside in China without the need for a full-fledged operation or capital commitment. Structurally, an RO is an extension of the home office and has no separate legal status.

ROs have the advantage of being relatively easy to set up and maintain and are not subject to a capitalization requirement. Except for certain regulated industries such as legal, banking, and securities, the foreign company can directly apply with SAMR for business registration. Along with its operations, an RO must comply with the same information reporting requirements as other FIEs. Once established, an RO can be used as a local base to reach customers, receive inquiries, conduct market research, and develop contacts with Chinese partners and government officials. The main disadvantage is that the RO may not directly engage in revenue-generating activities, such as signing contracts and invoicing, either on its own behalf or on behalf of its foreign home office. Because the RO is not an independent legal person under PRC

law, all legal consequences for the activities of the office in China are eventually borne by the foreign home office.

ROs must have a chief representative appointed by the home office and may also be staffed by foreign and/or local Chinese employees. Local Chinese employees cannot be hired directly by an RO but must be hired through a qualified staffing agency where the RO is located. The RO will then sign a labor service contract for the services of the local employees with the staffing agency, which is the legal employer of the local employees.

VII. Variable Interest Entity Structures

Many offshore companies adopt variable interest entity ("**VIE**") structures to engage in industries that are restricted or prohibited to foreign investment in China. The structure utilizes a set of VIE control documents between a WFOE set up by an offshore holding company and a pure domestic operating company, i.e., an OPCO. The OPCO and/or its subsidiaries, each being a PRC domestic company, will conduct foreign-restricted or -prohibited business activities and hold licenses that are prohibited to foreign investment or are difficult to obtain in practice. WFOEs under the VIE structure are deemed to exert "control" over OPCOs for consolidation purposes under U.S. GAAP and IFRS.

In contrast to direct ownership, the VIE structure circumvents certain foreign investment restrictions while retaining control and avoids burdensome approvals connected with the foreign operation of certain domestic businesses. Companies have widely employed the VIE structure in restricted or prohibited industries, such as telecommunications and education, for the purpose of public offerings in the United States, Hong Kong, and other securities exchanges which recognize the structure.

Note that breach of contract risk exists throughout the effectiveness of the VIE documents, which could threaten investor control and economic benefits. Also, while each of the VIE documents, legally speaking, does not violate PRC law, the risk exists that such documents, taken as whole, may be deemed an intentional circumvention of statutory restrictions on foreign investment. The Foreign Investment Law remains

silent on the VIE structure, including its legality and whether it is to be regulated as a type of foreign investment. But, with the apparently broad definition of "foreign investment" under the Foreign Investment Law, it is possible that, in the future, the law will be interpreted to include as "foreign investment" indirect means of control, such as by contract or trust. In that case, the structure could be deemed illegal if the relevant industry were not yet open to foreign investment or the investment failed to meet the relevant special administrative measures.

VIII. Other Forms of Investment and Doing Business

It may not be necessary to establish a presence in China if the same objectives can be achieved through trade, a processing and assembly contract, technology transfer, etc.

Foreign investors may cooperate with Chinese partners to exploit certain natural resources as a joint development, such as petroleum or coal. In this form of investment, the foreign party bears all exploration costs and risks, and both parties then share the expenses incurred in the development and production phases. The foreign party does not own any of the natural resources extracted but is entitled to payment in kind as compensation for its investment of capital together with accrued interest, plus a negotiated profit share.

Foreign companies may also consider a form of doing business in China that falls somewhere between pure export-import trade and equity investment and is referred to as "compensation trade", which covers a variety of short-term arrangements basically enabling the Chinese party to pay for capital imports with goods rather than foreign exchange funds. Compensation trade may take the form of a processing arrangement, whereby the foreign party supplies raw materials, and sometimes equipment or packaging and trademarks that are used to process goods for export by the Chinese party according to specification at a competitive fee. In some cases, the Chinese party may also supply raw materials. Alternatively, the foreign party may supply all or some of the component parts to be assembled by the Chinese party into a finished product. The foreign partner is entitled to all the output in return for an assembly fee and sometimes a percentage of the sales profits. Other forms of compensation trade include the foreign party's sale to the Chinese party of one product in return for a different Chinese product

or raw materials (counter trade or barter trade), and arrangements involving the exchange of foreign equipment and technology for a percentage of the output generated by its use over a period of time. The resulting product output may be free of charge or sold to the foreign supplier at an agreed discount.

It should, however, be noted that few of these forms are free from some sort of government regulation in China. Technology transfer contracts, for example, are subject to government filing or approval; international contractors must be registered and may bid only for certain types of contracts in China. In addition, in many cases, the supervision of contracts of this kind may not be less than the active role of foreign investors in a direct investment – unstable quality standards and weak enforcement of intellectual property rights mean that a foreign licensor can generally not afford to limit its involvement in Chinese operations being carried out on its behalf. It is, however, necessary to consider the various options vis-à-vis the illiquidity of many of the other forms of doing business.

CHAPTER 4 MERGERS AND ACQUISITIONS

Greenfield investment was the traditional form of foreign investment in China when there were few viable Chinese targets on the market, and it remains popular in circumstances where an investor seeks an organic growth strategy. On the other hand, many foreign investors also desire to build up their business in China through acquisitions where the targets hold valuable assets, channels or other business resources. Thus, acquiring an existing business in China as opposed to greenfield investment is also a popular way to enter the Chinese market. This chapter provides some of the highlights on private acquisitions in China and, particularly differences between acquisition structures in China and those with which international investors may be more familiar.

It should be noted that while the term "mergers and acquisitions" has been consistently used to describe the consolidation of companies or assets through various types of transactions, in the context of inbound foreign investment, it predominately takes the form of acquisitions. A merger between a foreign firm and a domestic one whereby a new company is created is not feasible under PRC law, though a foreign investor may effect an indirect merger between an FIE under its ownership and a Chinese company. Therefore, in this chapter, we will focus on acquisitions where a foreign investor acquires equity or assets of a Chinese domestic company or by subscription of new share capital. As a result, the target company is converted into an FIE or a new FIE is established from the assets acquired.

I. Government Approvals

Inbound acquisitions are regulated as foreign investments, and enterprises so acquired are converted into FIEs. Thus, approvals and reviews discussed in Chapter 3 also apply to acquisitions in this chapter. MOFCOM approval at the central level is required under the negative list for related-party acquisitions where an offshore acquirer is set up or controlled by domestic entities or individuals and the domestic target is affiliated with those domestic persons. To date, however, this provision has not been publicly

exercised in any actual transactions, partly because of the difficulty of obtaining approval.

Notably, there also remain legacy rules on cross-border acquisitions which contain various substantive restrictions on pricing, cashless transactions, timeframe for payment, documentation as well as procedures requiring MOFCOM approval, the *Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors* (effective June 22, 2009) (the "**M&A Provisions**"). These requirements are in conflict with the Foreign Investment Law and also fall short of the current regulatory practices. It is likely that China will soon take actions to update the rules on acquisition to align with the new regulatory regime under the principle of national treatment.

II. Structuring an Acquisition

i. Onshore versus Offshore Transactions

A direct transfer of assets or equity in a Chinese domestic company is subject to the approvals and reviews discussed in Chapter 3, while an indirect investment through a transfer of shares in an offshore entity holding equity in the Chinese domestic company generally would not require domestic approval.

International investors often invest in China through special purpose vehicles established in jurisdictions such as the Cayman Islands, the British Virgin Islands, and Mauritius. In addition to tax concerns, investors should also consider whether investments will be subject to approval through such vehicles in these jurisdictions when investing in particular industries in China, as well as whether the structure would facilitate a subsequent exit through the sale or listing of the offshore entity.

ii. Asset versus Equity Acquisitions

Equity acquisitions are currently much more common than asset acquisitions in China, despite asset acquisitions allowing foreign investors to strategically select assets and forgo historical liabilities. Equity acquisitions are more common for the following reasons:

- Foreign investors may not be able to freely commence operations in China simply by purchasing assets and may need to set up a new vehicle to operate the assets;
- Sale of core assets or a business by a Chinese domestic company to a foreign investor also requires Chinese governmental approval under the M&A Provisions;
- The procedures for an asset acquisition from a Chinese domestic company are generally more complicated than those for an equity acquisition as there is an additional requirement under the M&A Provisions to notify and obtain confirmation from the seller's creditors that they do not object to the deal; and
- The tax burden in relation to an asset acquisition is generally more onerous than that of an equity acquisition.

iii. State-owned versus Private Enterprises

Private capital is a relatively new phenomenon in China. Most privately owned businesses lack the scale and reach of their state-owned counterparts; however, the regulatory and political processes involved in investing in a private enterprise are comparatively easier than those for investing in a state-owned enterprise.

Because of concerns over the undervaluing of transfers of state-owned assets, a transaction involving equity or assets to be transferred by a state-owned entity to a foreign- or privately-owned entity requires approval by and filing or notification to the competent state-owned assets authority, which may be the State-owned Assets Supervision and Administration Commission ("**SASAC**") or the Ministry of Finance ("**MOF**") (the latter is in charge of the administration of state-owned assets for financial institutions), or any group-level SOE authorized by SASAC or MOF. This procedure requires the subject matter of the transaction to be appraised by a qualified PRC appraisal firm in order to ensure that the price to be paid fairly reflects the value of the assets being transferred.

Where the equity or assets are state-owned, the process will be subject to specific requirements overseen by SASAC as set out in the *Interim Measures for Administration of Appraisal of State-owned Assets of Enterprises* (effective 1 September 2005) and *Measures for Administration of the Appraisal of State-owned Assets* (revised in 2020).

A state-approved appraiser must be appointed, only certain valuation methodologies may be used, and the price must be no less than 90% of the appraised value unless special approval is granted. The valuation must also be filed with SASAC. Where the target is listed and the price exceeds the book value of the assets to be sold, a state-owned assets valuation is not required though state-owned assets approval procedures would still apply. Equity or assets of state-owned financial institutions are subject to oversight by MOF and the relevant MOF rules and regulations.

To transfer state-owned assets, a transferor is generally required to undertake the transfer through a legally established property trading institution in line with *the Measures for Supervision and Administration of Transactions of State-owned Assets of Enterprises* (effective June 24, 2016) and relevant regulations.

III. Purchase Price and Payment Flows

PRC government authorities have historically preferred fixed-price transactions involving a fixed amount of foreign currency to be paid into China within a specified time. Foreign investors must consider the impact of these requirements in any transaction which involves complex closing mechanisms or multi-directional payment flows in and out of China. Also, PRC law limits the scope and amount of any non-cash elements which can be used by a foreign investor to pay for its investments. The issue is complicated further by the M&A Provisions, which require that where a foreign investor acquires equity in a Chinese domestic company, thus converting it into an FIE, the entire purchase price be paid within a maximum of one year after completion. In practice, however, either under the previous record-filing system and now the information reporting system, MOFCOM no longer actively supervises compliance with this requirement.

Whilst escrow or retention arrangements are relatively common for M&A transactions in China, their usefulness as a price adjustment mechanism is limited due to the impact of foreign exchange controls and provisions which require the purchase price to be paid to the vendor within a specified time.

It is worth noting that, for the first time, the M&A Provisions explicitly permit the use of equity of a foreign company to be used to acquire the equity of a Chinese domestic company. In the past, there was no specific statutory guidance on using equity for acquisitions in China, but applications to do so were generally rejected. The use of stock is now permitted subject to certain requirements, such as the equity to be used must be shares listed on recognized securities exchanges, trading prices must have been stable in the most recent year, and so on.

CHAPTER 5 ESTABLISHMENT AND OPERATION OF FIES

This chapter summarizes the key steps and general rules and issues relating to the establishment and operation of FIEs in China pursuant to the most updated laws and practices. As introduced above, following the effectiveness of the Foreign Investment Law, all FIEs are now to be formed as limited liability companies, companies limited by shares pursuant to the Company Law, or partnerships pursuant to the Partnership Enterprise Law, among which the limited liability company is the most common form. As such, the primary focus of this chapter concerns foreign-invested limited liability companies, although the rules described here also generally apply to other types of direct investments and transactions.

I. Approvals and Registrations

Establishment of an FIE is now much more straightforward and simpler than before if no regulatory permit or approval is required. In most cases, for a non-negative-listed FIE in an unrelated industry, only a one-stop registration with SAMR is needed.

i. Enterprise Name Declaration

An applicant intending to establish an FIE needs to submit to SAMR a self-declared enterprise name in parallel with the application for establishment. In practice, whether a chosen name can be used for formal registration is subject to verification by the local SAMR. A name that is the same or similar to existing companies in the same industries and registered in the same administrative area cannot be used. To improve the chance of success, the applicant may conduct a preliminary check for the availability of desired names through the enterprise name databases or online application systems maintained by the local SAMR.

An FIE's enterprise name usually consists of the following components: (i) administrative area such as the province, city, or county where the FIE is located; (ii) a trade name consisting of two or more Chinese characters; (iii) industry or business

features; and (iv) the form of business organization. Names cannot be used which are the same as or similar to existing companies in the same industries and registered in the same administrative area. Many FIEs use a Chinese translation of their foreign investor's trade name in their enterprise names. While FIEs can adopt a foreign language name, such names will not be accepted for registration with SAMR.

ii. Registration of Establishment with SAMR

SAMR is the official registry for PRC-registered entities and enterprise information such as shareholders, share capital, and the names of directors. Following SAMR's verification of the FIE's proposed name and registration application documents, SAMR will mark the formal establishment of the FIE by issuing a business license, unless industry regulatory pre-approval is required, such as permits for education, hazardous chemicals, banking permits, etc.

For negative-listed FIEs which require no regulatory pre-approval or post-registration permits, SAMR will, before issuance of the business license, verify compliance with the special administrative measures in terms of shareholding limitations, nationality of the legal representative or key person-in-charge, etc.

Local SAMR counterparts provide detailed registration application checklists on their websites, which include or require: (i) a standard application form formulated by the local SAMR; (ii) the FIE's articles of association; (iii) appointment letters of the FIE's director(s) and supervisor(s); (iv) a letter engaging the FIE's manager; (v) photocopies of executed lease agreements and certificate of premises ownership of the proposed registered address; (vi) notarized and authenticated foreign shareholder's identification certificate; (vii) shareholder's board resolutions or power of attorney regarding the appointment of an authorized representative to execute the application documents, etc. The content of these detailed checklists may vary by region. It normally takes 5 to 15 days for SAMR to issue a business license to the FIE.

After the FIE is registered with SAMR and obtains a business license, it will be considered a legal entity in China and may contract on its own behalf. Commencement

of specific business activities by the FIE may, however, be subject to specific conditions, such as obtaining industry-specific permits and post-establishment registrations.

iii. Post-establishment Registrations

After obtaining its business license, the FIE would typically handle certain formalities and obtain licenses necessary for its day-to-day operations, including with the tax authority and the State Administration of Foreign Exchange ("**SAFE**"), opening bank accounts, and recording of the company seal with the public security bureau. In certain regions, such as Shanghai, an FIE may choose to proceed with the tax authority and seal recordation formalities in parallel with the application for establishment.

iv. MOFCOM Information Reporting

Following repeal of the Old FIE Laws, MOFCOM approval for FIEs no longer plays an active role in foreign investment administration. The initial establishment of an FIE and any subsequent changes in the FIE's initial reporting will only need to be reported online with MOFCOM through the SAMR registration system, as opposed to being separately recorded or approved. This change tremendously speeds up the establishment process for foreign investment in China. Note that such information reporting systems also apply to foreign acquisitions of Chinese domestic companies and to the resultant FIEs on a going-forward basis.

v. NDRC Approval/Record-filing

NDRC approval or record-filing is the first stage in obtaining government approval to initiate a new project involving foreign investment in fixed assets, such as construction or production. The record-filing system applies to all projects except for those under the negative list or the *Catalogue of Investment Projects Subject to Verification by the Government (2016 Version)*.

Under the NDRC approval system, applicants should submit extensive project-related information, including the basic parameters, and impact assessments on the environment, natural resources exploitation, and economic and social effects.

Depending on the size and nature of the project, this approval can be issued at one of various levels of NDRC. NDRC will issue approval after verifying that the proposed project conforms to the law, the negative list, and industrial and foreign exchange policies, and whether the project will explore for and extract natural resources in a reasonable manner and causes no harm to national security or public interests. Under the record-filing system, relatively limited information about the project and investor is required. The filing will be accepted if the project conforms to the law, industry and development policies, and market access standards. Procedures similar to those described above apply where a substantial change to an existing project is being implemented. Expansion of capacity together with a change or addition of shareholders often occur when introducing foreign investment into an existing project in China.

II. Scope of Business

In China, a business entity may only engage in activities specified in its business license. An entity cannot freely engage in any activity which it chooses, contrary to common practices in other jurisdictions. Accordingly, many investors apply for a business scope which is as broad as possible in order to maintain flexibility for future development without seeking further government approvals. In practice, however, there may be cases where foreign investors may actually prefer that an FIE has a narrow business scope. For example, if an investor anticipates that it will establish multiple ventures in China with different partners, it may wish to limit the scope of each venture so that one will not be able to compete with the investor's other Chinese ventures.

A company which acts outside its approved scope of business may be subject to penalties, extending, in extreme cases, to revocation of the business license. It is thus important to engage only in activities specified in the business scope, since the business license is a basic credential for doing business in China.

The proposed business scope of an FIE is required to be described by using the standard expressions in accordance with the *Industrial Classification for National Economic Activities* and the business scope databases maintained by the local SAMR and included in the application documents submitted to the government at the time of its establishment and may have to be modified per SAMR's requirements as a condition

for registration. Likewise, government approval or registration is required to modify a company's business scope at any time after its establishment.

III. Capitalization and Financing

China previously required specific ratios of registered capital to total investment to avoid undercapitalized FIEs. "Total investment" is defined as the total amount of funds required to establish an FIE's production/business scale, consisting of both equity investment and debt financing. The gap between total investment and registered capital served as the FIE's offshore debt financing ceiling. Shareholders now generally have sole discretion in deciding the timeframe for capital contributions, subject to a statutory deadline of five years as of the date of establishment or a subsequent capital increase, unless it is otherwise provided for by other specific regulations or rules (e.g., the registered capital of foreign-invested banks is required to be fully paid up before establishment).

i. Registered Capital

"Registered capital" is the equity capital subscribed for by its shareholder(s) and represents initial funds of the company until it is able to fund itself through operations. The capital may be contributed by the shareholders to the FIE either in a lump sum or in instalments at any time during its term. The permitted forms of capital contribution include cash, in-kind, intellectual property rights, equity interests in an existing company, creditor's rights, land use rights, and other forms of assignable non-cash assets, such as shares or equity interests in companies in China.

Reductions of capital, although possible, are likely to be time-consuming. Once the investor in an FIE makes a contribution to registered capital, the registered capital in practice is generally difficult to withdraw until the entity is dissolved and liquidated.

ii. Share Transfers

Equity interests in FIEs are transferrable. Previously, the Company Law did not require approval of equity transfers between shareholders unless so provided in the company's

articles of association, while transfers to third parties required the approval of 50% of the other shareholders. Where a shareholder voted against the transfer, the shareholder needed to exercise its right of first refusal to purchase such equity interests; otherwise, it would have been deemed to have consented to the sale. The Revised Company Law removes the statutory approval requirement for equity transfers to third parties, but the transfer is still subject to the right of first refusal of other shareholders unless otherwise provided in the articles of association. Note that any changes to the FIE's shareholders and their equity interests must be registered with SAMR.

iii. Debt Financing

FIEs can borrow from both Chinese and offshore lenders. Domestic borrowings are market-oriented, and no government procedures are involved, but offshore borrowings have always been tightly controlled by the competent authorities. As mentioned above, in the past, FIEs could only borrow offshore funds within the gap of total investment and registered capital. Since 2014, China began to introduce a more flexible and sophisticated approach to regulating cross-border borrowings, the "macro-prudential management system," which is applicable to both FIEs and Chinese domestic companies. Under the new approach, the upper limit for cross-border borrowing for a non-financial enterprise is the product of its net assets, a cross-border financing leverage ratio, and a macro-prudential adjustment factor. The leverage ratio and the macro-prudential adjustment ratio are determined and published periodically by China's central bank, the People's Bank of China, and currently are set at 2:1 for the leverage ratio and 1.25 for the macro-prudential adjustment factor. FIEs can now choose between the two approaches for cross-border borrowings, though the total investment-registered capital approach will likely be phased out along with further foreign investment reforms.

To tighten the supervision of medium and long-term foreign debt (i.e., debts with a tenor more than one year), NDRC adopted the *Measures for Administration of Examination and Registration of Medium- and Long-Term Foreign Debt of Enterprises* (effective February 10, 2023), which requires in-scope borrowers to register their foreign debts with NDRC prior to registering with SAFE.

IV. Duration

FIEs can now exist perpetually unless otherwise provided under industry-specific regulations. In practice, most FIEs still specify a term based on business need; for example, industrial enterprises generally set terms lasting as long as 30 or 50 years. The shareholders may dissolve an FIE during its term or apply for an extension upon expiration.

V. Organizational Structure

FIEs, in particular Chinese-foreign joint ventures, previously had an organizational structure different from domestic companies established under the Company Law. Under the Foreign Investment Law, however, the organizational structures and corporate governance of all companies in China, including FIEs, are unified pursuant to the Company Law or other laws governing a specific type of enterprise type.

FIEs, in the form of a limited lability company, are legally required to have corporate governance structures which include the following elements:

- Board of shareholders or sole shareholder;
- Board of directors or sole director;
- Board of supervisors or supervisor(s)[1]; and
- Legal representative.

i. Board of Shareholders

The board of shareholders consists of all shareholders of the FIE. It is the highest corporate governance body and has authority over: (a) matters of structural importance to the company, such as articles of association, capitalization, merger, division,

[1] Per the Revised Company Law, it is optional to appoint a board of supervisors or supervisor(s). In the alternative, a company may: (i) set up an audit committee composed of directors in the board of directors, which will exercise the functions and powers of the board of supervisors; or (ii) if the company is relatively small or has a limited number of shareholders, to opt to not set up a supervisory position at all, with the unanimous consent from all shareholders.

dissolution, liquation; (b) the establishment of other governance organs; (c) approval of profit distribution plans prepared by the board of directors.

The powers of the board of shareholders are provided in the FIE's articles of association, which include both the statutory powers provided under the Company Law and other matters agreed by all shareholders that are considered significant, such as litigation, technology transfer, or lending.

The shareholders' powers are exercised at the shareholders' regular and interim meetings. In case no meeting is convened, it is required under law that the motion will be considered passed only after all shareholders have approved in writing. The shareholders' regular meeting must be convened according to the provisions of the articles of association. Interim meetings may be called at any time at the request of shareholders representing one-tenth or more of the company's voting rights, at least one-third of directors, the board of supervisors, or as otherwise stipulated by the articles of association.

The Company Law allows the company to formulate its own voting rules and, in practice, most FIEs will provide in their articles of association rules on the quorum for the meeting and voting requirements over certain matters. Note, however, that PRC law requires approval of at least two-thirds of an FIE's voting rights to amend the articles of association, increase or reduce registered capital, effect a merger, division or dissolution of the company, or effect a conversion of the company form.

ii. Board of Directors

Under the Old FIE Laws, the board of directors of an FIE was the highest decision-making authority and exercised powers which would normally be reserved for shareholders in other jurisdictions. Since the effectiveness of the Foreign Investment Law, however, the board of directors should report to the board of shareholders and be responsible for implementing the shareholders' decisions and exercising powers for overall management of the company, including matters such as operational strategy, business and investment plans, internal management systems, as well as formulating profit distributions plan for shareholder approval.

The board is composed of at least three (3) members, and a sole director may be appointed, rather than a board, for FIEs with fewer shareholders or of a smaller scale. All directors must be natural persons. Under the Company Law, directors are elected by shareholders, which may result in a majority shareholder choosing all the directors. In practice, shareholders often agree on the allocation of nomination rights to ensure the board is not under sole control of a particular shareholder. The term of office for directors is no more than three years and directors may serve consecutive terms if re-elected.

The Company Law provides that each director is entitled to one vote and, in practice, most FIEs provide in their articles of association rules on the quorum for the meeting and voting requirements over certain matters for board resolutions.

Additionally, if the board has three (3) or more members, it may include an employees' representative. As for medium-large size companies with 300 or more employees, they will be subject to a mandatory requirement of including employees' representative(s) either on the board of supervisors or the board of directors. The employees' representatives on the board of directors are democratically elected by the employees through the employees' representative congress, employees' congress, or by other means.

iii. Board of Supervisors

Under the Revised Company Law, it is now optional for a limited liability company to establish a board of supervisors or supervisor(s). In the alternative, a limited liability company may (i) set up an audit committee composed of directors in the board of directors, which will exercise the functions and powers of the board of supervisors; or (ii) if the company is relatively small or has a limited number of shareholders, opt to not set up a supervisory position at all with unanimous consent from all shareholders.

Supervisors must be natural persons and should include representatives for both shareholders and staff, and at least one-third of supervisors on the board of supervisors must be employee representatives democratically elected by the workforce. The term

of office for supervisors is three years and supervisors may serve consecutive terms if reappointed or re-elected.

Directors and senior officers of the company cannot concurrently serve as supervisors.

iv. Legal Representative

The Company Law requires a unique statutory position for companies – legal representative. By definition, a legal representative is the "person responsible for engaging in civil acts on behalf of a legal person in accordance with law or the legal person's articles of association." The legal representative must be a natural person, and a director or manager who represents a company to manage corporate affairs can be the legal representative.

The legal representative of a company must be registered with SAMR and has the power to legally represent and bind the company in all material aspects in accordance with the law or the articles of association of the company, such as entering into contracts and participating in various civil activities on behalf of the company. A contract executed by the legal representative is binding on the company, even where made *ultra vires* (i.e., beyond the authorized scope), unless the counterparty knew, or should have known, that the legal representative was exceeding his or her powers when entering into the contract.

The legal representative bears obligations of diligence and loyalty to the company, failure to observe these obligations may result in certain civil, administrative, and even criminal liabilities. In this context, civil liability primarily means compensation to the company if the legal representative's failure to perform his obligations causes a loss to the company. Administrative liability includes fines and administrative punishment if the legal representative's company engages in certain activities in violation of laws. While uncommon, the legal representative could bear criminal liable if he participates in and plays a major role in crimes committed by the company he serves and is determined to be in charge of or responsible for such activities. Notwithstanding, legal representatives face generally low personal legal risk so long as they are diligent and loyal to the company and ensure the company operates as permitted by law. In practice,

some companies will enter an indemnification agreement to provide contractual protection to the legal representative, except for the legal representative's acts of gross negligence and willful misconduct.

Given the potential personal liabilities attached to the role of legal representative, the Company Law also provides for a mechanism to resolve a potential deadlock that the legal representative may be permanently fixed to the position if no successor is available. If a director or the general manager who serves as a legal representative resigns from his or her position as a director or manager, he or she shall be deemed to have also resigned as the legal representative simultaneously and the company must appoint a new legal representative within 30 days from the date of resignation.

v. Duties and Liabilities

(1) Duty to be compliant. Directors, supervisors, and senior officers (collectively, "**Senior Managers**") must abide by laws, administrative regulations, and the company's Articles.

(2) Duty of loyalty and duty of diligence. Senior Managers undertake a duty of loyalty (i.e., they must take measures to avoid conflicts of interest and may not seek improper interests by taking advantage of their powers) and the duty of diligence (i.e., when performing their duties, they must act with reasonable care and in the best interests of the company) to the company. Article 181 throughout Article 185 of the Company Law further establish certain restrictive rules based on the duty of loyalty and duty of diligence.

(3) Liabilities:

- <u>Liability for damages to the company or shareholders</u>: Under Article 188 of the Company Law, Senior Managers may be held liable in the performance of their duties for damages caused to the company that result from violations of any law, administrative regulation, or the Articles. A company's supervisors (or the board of supervisors) may initiate actions against the directors and/or senior officers who are liable under Article 188 for such damages. Additionally, a shareholder can file suit directly against any director or senior officer who, in performing their duties,

harms the interests of the shareholder in violation of any law, regulation, or the Articles.

- Return of illegal income: Further, any income obtained by a Senior Manager arising from a breach of the duty of loyalty or the duty of care belongs to the company.

- Potential liabilities to a third party: Per the Company Law, where any director or senior officer (not including supervisors) causes any damage to any other person in the performance of their duties, the company may be liable for compensation. A director or senior officer may also be liable for compensation if they are found to have acted intentionally or with gross negligence.

- Potential liabilities of the controlling shareholder and/or the actual controller: Other than the Senior Managers, the Company Law also subjects the controlling shareholder and/or the actual controller ("**Controller**") to a duty of loyalty and duty of diligence when the Controller acts as a "de facto director", i.e., the Controller in fact manages the affairs of the company even though they are not a director. Further, a Controller may bear joint and several liability with a director or senior officer in instances where the Controller instructs such person to carry out an act which damages the interests of the company or the shareholders, i.e., acting as a "shadow" director or senior officer.

- Potential criminal liabilities: In serious cases where the company suffers heavy losses, Senior Managers may be subject to criminal liabilities per the *Criminal Law of the People's Republic of China (2023 Amendment)*.

VI. Labor Matters

The foundational law governing labor in China is the *Labor Law of the People's Republic of China*, which came into effect on January 1, 1995, and for the first time laid out a law applicable to all employers within China. Another law that has a significant impact on the employer-employee relationship is the *Labor Contract Law of the People's Republic of China* (the "**Labor Contract Law**"), which came into effect on January 1, 2008. In addition to these two laws, it is important for FIEs to become

familiar with laws applicable specifically to FIEs and local and provincial regulations, as well as to establish a positive relationship with the local labor bureau which deals with labor issues on a day-to-day basis. Notwithstanding the freedom to contract, the local labor bureaus have considerable authority over the terms and conditions set forth in labor contracts and a company's internal labor rules, as well as the ability to approve matters such as the institution of a non-fixed hours system (that is, a workweek which is not limited to a fixed 40 hours) for employees undertaking certain types of work.

i. Labor Contracts

All Chinese companies are required to enter into individual labor contracts with their employees. A labor contract must be in writing in accordance with general Chinese legal principles, which do not recognize the validity of an oral contract (except for part-time labor). If an employer fails to sign a contract with an employee within one month after the employee starts work, the employee is entitled to receive double his or her normal wages until a contract is signed.

Labor contracts are required to include material provisions such as the parties, term of the contract, the job description and place of work, the working hours, rest and leave, labor compensation, social insurance, labor protection, working conditions and protection against occupational hazards, etc. Local regulations may also require the inclusion of additional provisions in some localities. In addition, some localities attempt to require the use of model contracts prepared by the labor bureau.

Chinese companies are also generally well-advised to include in the contract provisions relating to the confidentiality of information. In addition, the Labor Contract Law restricts liquidated damages provisions to two circumstances: (i) in the case of key employees, it is also becoming standard to include non-competition provisions extending for a period beyond termination; under the Labor Contract Law, the non-competition period will not exceed two years after the termination of the labor contract; (ii) if the employee breaches the labor contract after receiving special training from the employer and committing to serve the employer for a specified term, he or she would be required to pay liquidated damages to the employer as agreed; however, in the event

of breach, the liquidated damages may not exceed the portion of the training expenses allocable to the unperformed portion of the term of service.

Importantly, employers and employees do not have absolute autonomy in the labor contract to determine conditions of employment. PRC law sets the hours of employment (40 hours per week), regulates the permissible amount of overtime and the amount of compensation or compensatory rest that must be provided for overtime, and also specifies the amounts that must be paid into welfare and pension funds for and on behalf of each employee. Each locality also specifies a minimum wage. Labor contracts cannot be negotiated on terms which would contradict or fail to comply with any of these legal requirements.

ii. Collective Agreements

PRC law allows for employees to enter into collective agreements with their employers. It is currently strongly encouraged for employees, generally through their trade union, to enter into a collective agreement with employers setting out matters of general application to all employees, such as remuneration, working hours, rest days, holidays, work safety and health, insurance, welfare, etc. In fact, with the exception of wages, most of these matters are dealt with in applicable laws, and collective agreements often largely repeat these relevant provisions. In general, collective agreements will be negotiated by the company's trade union on behalf of the employees. The collective agreement legislation contemplates an exercise of negotiation and settlement by agreement. Disputes, if they arise, may be handled through mechanisms set forth in the *Law of the People's Republic of China on Labor-dispute Mediation and Arbitration* (the "**Employment Dispute Law**"), which is currently the primary legal authority that addresses the handling of employment disputes - not by unilateral employer or employee action.

iii. Term and Termination

A labor contract may have a fixed term, an indefinite term, or a term which is based on the completion of a particular task. Employees who have worked for the same employer

for more than ten years may require the employer to sign a contract with an indefinite term, which in effect means that the employee can only be terminated for cause.

There are a number of ways in which a labor contract can be terminated (other than by expiration at the end of its term):

- Mutual agreement by the parties.
- Unilateral termination by an employer is strictly limited and is only permitted pursuant to a legal basis clearly set out in the law and by observing certain procedural requirements. Otherwise, the termination is wrongful and the employee is entitled to twice the severance pay or reinstatement of employment with back pay. In the case of unilateral termination by the employer on a legal basis, a prior notice of not less than 30 days (or payment of one month's salary in lieu of notice) must be served to the employee.
- Summary dismissal (i.e., termination without notice and without severance pay) is permitted for what are considered to be flagrant breaches by an employee, such as an employee's severe violation of company rules, employees under probation, the employee being prosecuted for criminal liability, etc.
- Collective dismissals (terminations of 20 or more employees or over ten percent of an employer's total workforce) are allowed in instances where the objective economic circumstances taken as the basis for conclusion of the labor contracts have materially changed so that the labor contract can no longer be performed, such as the employer's reorganization due to bankruptcy, encountering serious operational and management difficulties, switching methods of production, introducing a major technological innovation, or adjusting business models, etc.
- The employee may terminate his employment without notice if the employer forces the employee to work under threat of violence or coercion or fails to pay labor remuneration or to provide the agreed working conditions.
- In addition, the employee can terminate his employment at any time with 30 days' written notice or with three days' written notice during the probationary period.

Except in the case of dismissal by the employer without notice for cause as described above, certain employees are protected from dismissal, e.g., employees who are pregnant, or on maternity leave and nursing, employees who are severely disabled as a result of occupational disease or work-related injury, or employees who have worked continuously for the employer for 15 years and have fewer than five years remaining before the statutory age of retirement.

iv. Severance Pay

On termination, except in the case of a summary dismissal or where an employee resigns voluntarily without cause, the employer must pay severance roughly equivalent to one month's pay for each year of service. If the employee's monthly salary is more than three times the local average monthly salary in the preceding year, the base severance is capped at three times the local average monthly salary. For mutual termination or unilateral termination on a legal basis, the above standard severance plus one month's salary is a common practice. In addition, there may be an entitlement to medical benefits of some kind. Under the Labor Contract Law, it is clear that severance pay must also be paid if the employer declines to renew a contract upon its termination, unless the employee does not agree to renew the contract, even though the conditions offered by the employer are the same as or better than those stipulated in the current contract.

v. Labor Disputes

The Labor Law and the Employment Dispute Law contemplate labor dispute resolution methods such as mediation or arbitration, litigation before a court, and negotiation for settlement. Under these laws, once conciliation has failed, the first step is mediation before the labor dispute mediation commission. Alternatively, the matter may proceed directly to arbitration. Mutual consultation and mediation are strongly encouraged but not required. Labor arbitration, however, is mandatory, and occurs before a labor dispute arbitration commission. The mediation committee is usually composed of representatives of the company, the employees, and the trade union, and is chaired by the trade union representative. In the event that mediation fails, or arbitration is initiated

as a first step, the action may proceed to a city- or county-level arbitration committee composed of representatives of the employer, the local labor administration authorities, and the trade union (superior to the employer's own union). If a party remains dissatisfied with the outcome, the matter can be taken to court.

In practice, the local labor bureau may act as an arbiter if a dispute is brought to it by a disgruntled employee and, notwithstanding the provisions set forth above, many employers will comply with an order from the local labor bureau in order to settle relatively minor disputes.

VII. Intellectual Property

China has a rather extensive set of laws on the protection of intellectual property rights. In addition to the *Trademark Law of the People's Republic of China* (the "**Trademark Law**"), China's principal laws protecting intellectual property include the *Civil Code of the People's Republic of China*, the *Patent Law of the People's Republic of China* (the "**Patent Law**"), the *Copyright Law of the People's Republic of China* (the "**Copyright Law**"), the *Law of the People's Republic of China Against Unfair Competition,* and the *Regulations on Computer Software Protection*. China is also a signatory to most of the key international intellectual property agreements and treaties, such as the *Paris Convention on the Protection of Industrial Property*, the *Madrid Agreement on International Registration of Trademarks,* the *Berne Convention for the Protection of Literary and Artistic Works*, the *Universal Copyright Convention*, and the *Agreement on Trade-Related Aspects of Intellectual Property Rights.* The China National Intellectual Property Administration ("**CNIPA**") is the principal government agency for the registration, administrative review, and invalidation of trademarks, patents and layout designs of integrated circuits.

Nevertheless, China has had considerable problems in the last two decades with foreign criticism of its intellectual property rights enforcement system. This foreign criticism, the entry into the World Trade Organization, and the recent China-US trade negotiations have led to substantial changes in China's intellectual property protection regime and China is making an effort to ensure consistency in its protection of intellectual property rights with the relevant international treaties and norms.

i. Trademarks

The PRC regulatory framework regarding trademarks principally comprises the Trademark Law and its implementing rules. The primary government agency involved in the registration and review of trademarks is the CNIPA Trademark Office.

Registering a trademark is necessary because the mere use of a trademark in China does not create a protectable right, as is the case in some foreign jurisdictions. China adopts the "first-to-file" system for trademark registration. Foreign applicants are advised to apply for trademarks with information in both foreign and Chinese languages and to ensure the Chinese characters reasonably correspond or relate to the foreign counterpart. Normally, it takes about one year to register a trademark in China, i.e. nine months for the Trademark Office to examine the application and three months for public objections. The Trademark Office will issue the trademark registration certificate to the applicant if there is not a third-party infringement claim or objection to the published trademark. A trademark registration is normally valid for a period of ten years and can be renewed.

Foreign investors may often wish to license trademarks to their FIEs. Other than the precondition of registering the trademarks in China, once a license agreement is signed, it should be filed for record with the appropriate trademark authorities. Foreign investors are permitted to charge a royalty for use of their trademarks and to extend the royalty period for the entire term of the FIE.

PRC law prohibits bad-faith trademark registrations and permits preliminary injunctions, to protect the trademark owner's exclusive rights and improve the enforcement of trademark rights. In addition, PRC law provides not only for civil and criminal penalties, but also provides for administrative punishment of trademark infringers. The amount of compensation paid by the infringer to the trademark owner in an infringement suit should be either the owner's losses or the infringer's profits derived from the infringement, plus reasonable costs paid by the owner to stop the infringement. If it is difficult to determine the amount, a court may grant a statutory fixed amount of up to RMB 5 million (approximately US$ 743,400) for each infringement.

ii. Patents

China promulgated the Patent Law and its implementing regulations in the 1980s and has amended them several times to conform more closely to international intellectual property practices. The latest amendment of the Patent Law became effective on June 1, 2021. Compared to its previous version promulgated in 2008, the amendment: (i) increases statutory damages, introduces punitive damages and a preliminary evidence disclosure obligation where the judge can now order the defendant to disclose damage-related evidence; (ii) enables the CNIPA to determine patent infringement disputes of significant national impact; (iii) expands the scope of protection over design patents (particularly on subject matter) and extends their term of protection; (iv) allows disclosure under a national emergency or an extraordinary state of affairs that is not novelty-destroying; and (v) allows patentees to file a declaration to implement open license.

The law provides for the granting of patent rights to individuals and economic entities with respect to inventions, utility models, and industrial designs. It also provides for deferred examination, opposition proceedings, assignment and licensing of patent rights, and recognition of priority of foreign patents in certain circumstances. The CNIPA Patent Office is designated as the agency for the acceptance, publication, and examination of patent applications and the granting of patent rights. The Patent Office also reconsiders rejected patent applications and granted patent invalidation requests.

Similar to trademarks, China recognizes the "first-to-file" principle for patent registration. Foreign applicants that do not have a domicile or place of business in China are to entrust a PRC patent agent with handling their applications. Foreign applications are accepted in accordance with any relevant bilateral governmental agreement or international treaty, or the principle of reciprocity. China joined the World Intellectual Property Organization (WIPO) in 1980 and became a party to the multilateral Paris Convention on the Protection of Industrial Property Rights in 1984.

Invention patents are valid for 20 years, utility model patents are valid for 10 years, and design patents are valid for 15 years. Invention patentees may now request protection period compensation for unreasonable delays during the examination process. Specifically, an invention patentee may request CNIPA to grant protection period

compensation if an invention patent is granted at least four years from the filing date and at least three years from the date of the substantive examination request, except where such delays are caused by the patentee. Patentees not only have the exclusive right to sell patented goods in China but also have the exclusive right to import patented goods into the country. Unauthorized importation constitutes an infringement, and the patentee may either sue in a PRC court or request the PRC customs authorities to impound the goods. Meanwhile, patentees are required to practice their patents by manufacturing patented products or processes or by granting licenses to other persons to do so, otherwise entities possessing the means to practice the patent may apply to CNIPA for a compulsory license upon payment to the patentee of a reasonable fee.

Cases of infringement may be handled by the patent administration authorities or the courts and infringers may be imposed with criminal, civil, and administrative penalties. As with patents, preliminary injunctions to prevent counterfeiting may be granted before the commencement of the infringement action itself. Also, damages are the losses to the patentees or the gain to the infringing party with statutory penalties ranging from RMB 30,000 (approximate US$ 4460) to RMB 5 million (approximately US$ 743,400) in case it is difficult to prove actual damages or illegal gains.

iii. Copyrights

Under the Copyright Law and its implementing regulations, PRC citizens enjoy copyrights to their literary, artistic and scientific works regardless of whether such works are published. The works of non-PRC citizens are also protected whether or not the works are first published in China. Furthermore, stateless authors who publish in China or another convention country are protected. PRC copyright law has also followed the development of technology and regulations on copyright protection and licensing have been extended to digital reproductions. The latest amendment to the Copyright Law became effective on June 1, 2021. Compared to the previous version adopted in 2010, the amendment: (i) clearly defines the definition of works; (ii) adds audio-visual works as a new type of works; and (iii) increases statutory damages and introduces punitive damages and a preliminary evidence disclosure obligation by which the judge can now order the defendant to disclose damage-related evidence.

On enforcement, preliminary injunctions are permissible as well as the preservation of evidence for use at trial. Infringing parties must compensate the copyright owner for losses which are the higher of the infringer's gain or the owner's loss, with statutory compensation ranging from RMB 500 (approximately US$ 74) to RMB 5 million (approximately US$ 743,400) where it is difficult to prove damages.

iv. Technology Licenses

In nearly all FIE projects, the transfer of technology remains a key element of the transaction. In part, this is due to the heavy emphasis in official PRC investment policy to improve China's economy through obtaining "new high technology" from developed countries. The primary rules governing the licensing of such technology is the *Regulations of the People's Republic of China on Administration of Technology Import and Export.* These regulations apply to transactions between Chinese and foreign organizations, including technology licensing, technical assistance, and certain types of equipment sales contracts, and cover patent technology, industrial property rights, technical services and know-how relating to production processes, formulae, quality control, product design, and management.

Technology import regulations impose certain limitations, such as government approval of certain "restricted" technologies. However, for unrestricted technologies, the regulations only require an online filing for the contract in order to facilitate the foreign exchange payment. Other key requirements include that the foreign provider of the technology guarantees that the technology provided is complete, correct, effective, and capable of accomplishing the technical targets specified in the contract. To soften this requirement, the foreign party should insist that such a guarantee remains subject to proper implementation of the technology by the local licensee.

In terms of technology fees, the foreign provider of technology is permitted to charge an upfront transfer fee and/or a running royalty based, for example, upon units sold. The foreign party may also charge fees for the services of technical experts who periodically travel to China to assist in implementing the technology.

The foreign licensor can and should require the FIE or licensee to sign a separate trademark agreement covering the products produced with the technology. At a more basic level, foreign providers of technology may also need to consider whether it is appropriate to bring certain leading technologies to China at all, due to the underlying difficulty of maintaining the confidentiality of technology in China.

v. Customs Recordals

An intellectual property owner may file a recordal of its ownership interest with the General Administration of Customs at various ports in China. This includes PRC trademarks, patents, and copyrights. The export or import of products that infringe the registered interest will be stopped if detected by customs authorities. As customs authorities inspect all inbound and outbound shipments, this recordal procedure has proven to be particularly effective.

vi. Tips for Protection of Intellectual Property Rights in China

In practice, challenges remain in protecting intellectual rights in China. It is therefore advisable for foreign investors to adopt a rigorous approach to protecting their intellectual property rights. In this regard, useful best practices include:

- ensuring that all intellectual property rights belonging to the foreign investor are accurately and promptly registered with the relevant PRC authorities;
- incorporating anti-counterfeiting technologies (such as inks, labels, and foils on the external packaging of products);
- developing a corporate intellectual property protection strategy; and
- conducting regular training sessions to raise employees' awareness of the importance of protecting the foreign investor's intellectual property rights.

Notably, an FIE has rights to all intellectual property developed by its full-time employees that is developed under the FIE's specific instructions and during the course of employment with the FIE. Furthermore, all intellectual property rights which are developed based on intellectual property rights licensed by a foreign investor to the FIE

will not necessarily vest in the FIE, but rather in whomever so agreed by the licensor and licensee.

VIII. Data Protection

i. Overview

China has adopted a series of laws in recent years governing data protection, beginning in 2016 with the *Cybersecurity Law of the People's Republic of China* (the "**CSL**"), which provides framework provisions for certain protected classes of data, namely personal information and "important data." After the adoption of the CSL, relevant administrative departments issued draft rules and voluntary standards to begin implementing these provisions, most notably the Personal Information Security Specification. These administrative pronouncements were made in advance of further legislation governing data protection adopted in 2021: the *Data Security Law of the People's Republic of China* (the "**DSL**") and the *Personal Information Protection Law of the People's Republic of China* (the "**PIPL**"). Together with the CSL, these three laws are commonly regarded as the "three pillars" of China's data protection regime.

In addition to the CSL, the DSL, and the PIPL, certain sensitive industries and matters are subject to separate legal provisions. Such industries include connected vehicles, telecommunications, banking, healthcare, e-commerce, postal services, cloud services, online payments, mapping, and ridesharing, among others. Other matters subject to protection include: (i) personal privacy, which is protected by legal provisions found in the Criminal Law and the Civil Code; and (ii) state secrets, which are subject to the *Law of the People's Republic of China on Guarding State Secrets* and other laws.

Based on the laws adopted to date, China's data classification scheme includes the following data types. Note these classifications are presumed not to be mutually exclusive, e.g., certain types of personal information could also be regulated as a type of sensitive data.

- State secrets.
- Sensitive data comprising:

  - National core data;
  - Important data; and
  - Specified industrial, healthcare, and other data (e.g., digital mapping, human genetic resources).
- Personal information comprising:
  - Sensitive personal information; and
  - Personal information.

Foreign investors who operate in industries where protected forms of data are processed should develop robust data compliance policies before operating in China, particularly large-scale, integrated multinationals that tend to centralize their data and processing functions. Below, we provide a brief overview of two of these data types: important data and personal information.

ii. Important Data

Important data is loosely defined as data which could harm national security, economic function, social stability, and public health and safety if it were altered, damaged, disclosed, or illegally obtained. The DSL delegates authority to each industry regulator to publish catalogues which provide the scope of important data in industries under its supervision. To date, however, many regulators have yet to publish these catalogues and current administrative rules rarely provide specific examples of important data. Thus, foreign investors in China are often advised to conduct data mapping of their operations, determine the forms of data collected and generated, and consult with legal counsel or the applicable regulator for guidance.

iii. Personal Information

Personal information under PRC law is defined as "various information related to an identified or identifiable natural person recorded electronically or by other means, but does not include anonymized information," which is generally analogous to personal data under the EU General Data Protection Regulation ("**GDPR**"). Sensitive personal

information is "personal information that, once leaked or illegally used, may lead to the infringement of the personal dignity of a natural person or may endanger his personal safety or property, including information such as biometrics, religious belief, specific identity, medical health status, financial accounts, and the person's whereabouts, and the personal information of a minor under the age of 14."

Similar to GDPR, personal information subjects in China have rights to their personal information, including the right to be informed about how their personal information is processed, to obtain a copy of their personal information, to portability, and to correct errors or inaccuracies, among others. Foreign investors accustomed to operating in the European Union will be familiar many of these rights and the compliance measures around them; however, it often remains necessary to localize internal policies and procedures to comply with the PIPL and related rules.

iv. Entity Classification Scheme

The data protection framework described above overlays a related entity classification scheme that includes two primary categories: (i) critical information infrastructure ("**CII**") operator; and (ii) large personal information handler. In general, these entities are imposed with more stringent data protection obligations, as they are considered important to the nation and the public.

The CSL defines CII operators as entities that operate information infrastructures and important information systems either: (i) in important industries and fields such as public telecommunications and information systems, energy, transportation, water resources, finance, public services, e-government, and national defense science and technology; or (ii) which, if damaged, disrupted, or subject to a data leak, may seriously threaten national security, people's livelihood, or the public interest. To date, industry regulators have been reticent about determining which entities they consider to be CII operators, which often leaves domestic companies to seek an ad hoc determination or to voluntarily comply with CII operator requirements.

Under the PIPL, large personal information handlers are considered those entities which process personal information that includes 1 million or more individuals in China.

These large handlers are required to localize their personal information in China, the same as CII operators.

v. Data Localization and Outbound Data Transfers

Data localization refers to the local storage of certain types of data collected or generated in China and the prohibition or restriction on their outbound transfer or "export", which is based on the sensitivity of the data and the status of the transferor. The most sensitive types of data that remain exportable may generally only be exported upon approval by China's cyberspace authority, the Cyberspace Administration of China (the "**CAC**"). CAC approval is required, for example, where large personal information handlers and CII operators intend to export personal information outside China.[2]

In other instances, personal information collected or generated in China can be exported by adopting one of the three statutory safeguards, which are: (i) CAC approval; (ii) certification by a professional organization; or (iii) execution of standard contractual clauses with the offshore receiver. The third safeguard, standard contractual clauses, is analogous to the standard contractual clauses under GDPR in that the two contracting parties agree to abide by PRC law in the handling of the personal information being transferred.

The CAC has publicly issued its first approvals to entities who intend to export sensitive data outside China. The approval process, much like the rules themselves, is new and without precedent. It is thus necessary to continue monitoring regulatory developments to see how the CAC and other regulators intend to supervise outbound data transfers.

IX. Real Property Issues

Land in China is either state-owned or collectively owned. All companies in China can only hold land use rights rather than own land. An FIE may acquire land use rights in one of the following ways.

[2] Note that other approvals may be required for specified forms of data, such as human genetic resources.

i. Allocation of Land Use Rights

Land is generally only allocated to state-owned enterprises for industrial or public use, though it might be possible for land to be allocated to private enterprises in some localities. Land may be allocated to FIEs for construction in certain sectors, principally for large infrastructure projects. There are certain restrictions on the use of allocated land; for example, the land may not be used as collateral and disposal is not permitted without prior government consent.

ii. Grant of Land Use Rights

Grants involve obtaining land use rights from the central government or a local land authority by entering into a land grant contract. Upon payment of a grant premium and completing the registration procedures, a land use right certificate will be issued. The land user is required to pay an annual fee. Granted land use rights may be mortgaged and are transferable.

iii. Purchase from Existing Land Users

Granted land use rights can be purchased from existing holders of such rights. A contract for the assignment of land use rights must be entered into to effect the assignment of rights and then registered with the local land authority. Conditions attaching to the original grant are transferred to the assignee. Allocated land use rights cannot generally be assigned unless they have been converted into granted land use rights.

iv. Lease

An FIE can also enter into a lease with a holder of granted land use rights, under which the FIE pays rent to the land use rights holder. Allocated land cannot be leased.

v. Contribution by Chinese Investor to an FIE

In many FIEs, land use rights are often the main, if not the sole, asset that the Chinese investor may inject into an FIE as a capital contribution. Granted land use rights can be contributed to an FIE. However, it is unclear whether allocated land use rights can, in practice, be contributed to an FIE without first being converted into granted land use rights. As noted above, practices may vary from one locality to another.

X. Foreign Exchange

China has a comprehensive series of regulations governing the management of foreign exchange. The policy behind these regulations is one of centralized control and unified management. SAFE, under the supervision of the People's Bank of China, is the principal regulatory authority for exchange controls and administers and supervises foreign exchange transactions within China. SAFE also administers China's foreign exchange control regime, which applies to individuals as well as to legal persons. As part of this function, SAFE is responsible for administering the registration of all offshore debts, whether directly incurred abroad or lent from domestic entities, so as to ensure the State's macro-control over the amount and composition of offshore debts.

Control over FIEs is realized by requiring each FIE, before opening a foreign exchange bank account and applying for other services, to submit a "Registration of Basic Information of Foreign Investment Enterprise."

Save for limited exceptions, all foreign exchange revenue generated by entities in China (including FIEs) must be repatriated to China and either sold to designated foreign exchange banks or placed into foreign currency accounts at such banks. Depending on the type of transaction, the foreign currency accounts may be a general account for "current account items" or a special purpose account for "capital account items", and there are detailed provisions regarding the establishment and maintenance of such accounts. "Current account items" are defined as ordinary transaction items within the context of international receipts and payments, including balance of payments from trade, labor services, unilateral transfers, etc. "Capital account items" are defined as items that increase or decrease debt and equity due to inflows or outflows of capital

within the context of international receipts and payments, including direct investment, all forms of loans, investments in securities, etc. Some of the most common current and capital account transactions are listed in the tables below:

Payments	Receipts
Current Account Items:	
Import of goods	Export of goods
Royalties	Receipts from transfer of intangibles
Expatriate wages and benefits	Service revenues
Repayment of loan interest	
Capital Account Items:	
Repayment of loan principal	Capital contributions
Capital equipment imports	Foreign currency loans
Reductions in capital	Increases in capital

Notably, SAFE has been relaxing control over the foreign exchange management for foreign investment over the past several years. In the past, SAFE's pre-approval was required before an FIE could apply for most foreign exchange services (including opening a foreign exchange bank account). Nowadays, SAFE's pre-approval has been cancelled and the process is streamlined. Besides this, SAFE has also delegated administrative authority to banks, so an FIE can directly apply for foreign exchange registrations and services with banks.

XI. Tax Issues

i. Corporate Income Tax

Companies residing in China are subject to Corporate Income Tax on their taxable profits at a unified tax rate of 25%. There is no special tax holiday for FIEs, but various favorable tax treatments are applicable on a regional/industry/project basis. For example, if an FIE qualifies for high and new technology enterprise status, it could enjoy a reduced tax rate of 15%. In addition, companies within the encouraged

categories in the central, western, and northeastern regions also enjoy a 15% reduced tax rate.

From January 1, 2022, to December 31, 2024, small thin-profit enterprises are subject to a reduced 20% CIT rate on only 12.5% of their annual taxable income up to RMB 1 million (i.e., the effective CIT rate is 2.5%). For the portion of annual taxable income between RMB 1 million and RMB 3 million, only 25% of the income is taxable at the reduced 20% rate (i.e., the effective CIT rate is 5%).

In terms of tax losses, there is a five-year limit for loss carryforwards. No loss carry-back regime is available.

Profits of FIEs distributed as dividends are subject to withholding tax at a rate of 10% (this rate may be reduced under a tax treaty or arrangement) when the dividends are actually paid. Effective January 1, 2017, if a foreign investor makes an investment directly with the profits that it obtains from a Chinese resident enterprise in an investment project in one of the designated encouraged industries, the withholding tax deferral policy applies, provided that certain requirements are fulfilled.

Passive income derived from China by a non-resident company, e.g. capital gains, royalty income, interest income, etc. are subject to withholding tax at a rate of 10% (this rate may be reduced under a tax treaty or arrangement).

In terms of related party transactions, China has introduced transfer-pricing rules under which all amounts paid or charged in business transactions between related parties must be determined based on an arm's-length standard. If the parties fail to meet this requirement, the tax bureau may make reasonable adjustments.

ii. Value Added Tax

Value added tax ("**VAT**") applies to the provision of goods or taxable services for consideration in China by a taxable person in the course or furtherance of any business and to the importation of goods into China.

Sales of goods and the provision of processing, repair, or replacement services are generally subject to 13% VAT. Certain goods are subject to a reduced rate of 9%. VAT

pilot services are subject to the following rates: 6%, 9%, 13%, depending on the nature of the services. The 3% rate applies to provisions covered by the simplified VAT calculation methods or provisions made by small-scale VAT taxpayers (small businesses).

General VAT taxpayers whose sales exceed certain thresholds are required to pay VAT on the difference between the "Output VAT" for the current period and "Input VAT" for the current period. Output VAT is calculated as the sales revenue for the period multiplied by the applicable VAT rate, while "Input VAT" is the VAT paid by the taxpayer with respect to its purchases of taxable goods and services. In order to offset Input VAT against Output VAT, a VAT taxpayer must obtain and keep the special receipts for the purchased taxable goods and services, which should indicate the amount of VAT paid.

VAT on imported products is generally imposed on the customs value (i.e., the C.I.F. value) plus the customs duties and consumption tax (where applicable) imposed on imported goods. Hence, VAT payable upon imports is generally the C.I.F. value of the imported item increased by any customs duties and consumption tax paid multiplied by the applicable VAT rate. The liability for VAT on the import of goods into China is on the importer and is collected by the PRC General Administration of Customs (the State Administration of Taxation is responsible for VAT collection in all other contexts).

As in the case of customs duties, certain exemptions or preferential treatment for VAT are accorded where materials or semi-finished products are imported, processed in China, and then exported.

The latest draft of the *Value Added Tax Law* was issued by the NPC on December 27, 2022. The draft aims to consolidate the pre-existing rules and regulations on VAT into a single substantive VAT law. Notably, the draft does contain some important changes to the current VAT rules and regulations in areas of simplified taxation, deemed sales, non-taxable transactions, non-creditable input taxes, and mixed sales.

iii. Customs Duties

The importation of goods is subject to customs duties, unless exempted, either at the minimum tariff rate (for goods imported into China from countries with which PRC has concluded a trade agreement) or the general tariff rate. These two tariff rate schedules are then subdivided into various categories of goods with different rates applicable to different categories.

An importer generally is the party responsible for paying customs duties. Thus, in the context of construction projects, if the Chinese general contractor directly imports equipment and/or parts and components, the Chinese general contractor would be required to follow all import procedures and pay duties as appropriate.

iv. Individual Income Tax

Chinese tax residents are generally subject to tax on their China-source and non-China-source income. Nonresidents are subject to tax on their China-source income only. Effective from January 1, 2019, Chinese tax residents include the following persons:

- Individuals who have their domicile in China; and
- Individuals who do not have their domicile in China but who reside in China for 183 days or more in a tax year.

For employment income, non-China-domiciled individuals who are Chinese tax residents for no more than six consecutive years are subject to Chinese individual income tax (IIT) on income earned from services rendered in China and on income earned from services rendered outside China but paid or borne by the individual's employer in China.

Tax rates for employment income range from 3% to 45%.

XII. Environmental Issues

The PRC government has been taking steps to strengthen environmental controls and sanctions. All manufacturing projects including their expansions are required to pass the environmental impact assessment, regardless of whether they are invested by

Chinese or foreign companies. In polluting industries, projects must obtain various permits and licenses, such as discharge permits, before production and operation. In general, FIEs are held to a higher standard of environmentally sound practices than are Chinese domestic companies.

In the case of a joint venture project where the Chinese party contributes real property or an acquisition project where manufacturing facilities are involved, it is advisable to include in all contracts concerning land use rights and other real property at least minimal representations and warranties concerning environmental liability. Among other things, the Chinese party should warrant that the property or the facilities are not affected by any pollution and are in full compliance with all PRC environmental legislations. Whatever the contractual protections, in practice it may be difficult to obtain indemnification from a Chinese party for environmental liability given the generally poor financial condition of many Chinese enterprises and the less attention they traditionally give to environmental issues.

XIII. Repatriation of Profits

A foreign investor may remit out of China legitimate income and funds distributed in accordance with relevant foreign exchange regulations. Profits distributed to the foreign investor can be remitted out of China in foreign exchange upon proper documentation submitted to the banks after the board has made a resolution to distribute profits and relevant taxes have been paid.

Previously, profits could only be freely repatriated once the FIE's registered capital had been fully contributed; otherwise, the amount allowed to be repatriated would be reduced in proportion to the percentage of actual paid-in-capital. This restriction has now been relaxed, and profits can be repatriated regardless of whether the foreign investor has fully contributed its subscribed registered capital.

XIV. Dispute Resolution

As noted in Section 1.2, China has a well-organized judicial system for dispute resolution, and three alternative methods are available for foreign investors and their FIEs to resolve disputes in China: mediation, arbitration, and litigation.

i. Mediation

Mediation is conducted between the parties in dispute on a voluntary basis and in general has no legal binding effect. However, mediation by a court is legally binding on the parties and is enforceable by the court.

ii. Arbitration

Compared with mediation, arbitration is more time-consuming and complex, but it is also an effective dispute settlement mechanism compared to litigation. Parties to a contract have many options if they choose arbitration to resolve their disputes. They may choose the arbitrators, which is not the case with judges in litigation. They may choose the language of arbitration, while there is no choice of language in court proceedings. Foreign investors may also have their disputes arbitrated either in China or abroad. Even in China, foreign investors may choose the arbitral tribunal, while they cannot choose the court if the disputes are resolved through litigation in China. Most importantly, unlike litigation, arbitral awards are final and binding on the parties.

In case of arbitration, the contract must stipulate that disputes will be resolved through arbitration, unless the parties can agree on arbitration after the dispute has arisen (this is often difficult). Arbitral tribunals in China will not hear a dispute in the absence of an arbitration clause or an agreement to arbitrate. Moreover, the arbitral institution must be clearly specified in the contract; otherwise, a covenant that disputes are to be resolved through arbitration will be unenforceable under PRC law.

There are two PRC government-sponsored arbitration tribunals for handling cases involving at least one foreign party – the China International Economic and Trade Arbitration Commission ("**CIETAC**") and, for maritime disputes, the China Maritime Arbitration Commission ("**CMAC**"). Contracts involving foreign elements often

provide for CIETAC arbitration if the parties prefer to have the disputes resolved through arbitration in China. CIETAC, which has an approved list of arbitrators that includes a number of foreign nationals, has a reasonably good reputation and is currently one of the busiest arbitration centers in the world due to the complexity of China's judicial system. In recent years, some regional arbitration centers have been viewed positively by foreign parties in resolving disputes in China, such as the Beijing Arbitration Commission, the Shanghai International Arbitration Center, and the Shenzhen Court of International Arbitration.

As stated above, the contracting parties can also have their disputes arbitrated outside of China. As an alternative to a Chinese arbitration tribunal, the contracting parties can also specify an arbitration institution outside of China, such as in Singapore, Stockholm, Geneva, or Hong Kong, or some other business centers. The arbitral awards made by an arbitral tribunal in these locations can be recognized and enforced in China.

iii. Litigation

A final way to resolve commercial disputes in China is through litigation in PRC courts. Compared with negotiation and arbitration, litigation is the strongest dispute settlement mechanism. The injured party can obtain a strong remedy through litigation. However, compared with arbitration, as above mentioned in Section 1.2, China adopts a two-tier final appeal court system and the judgment court rulings are subject to appeal, which means litigation may continue for years. The litigation procedures are complex, and the results of a judgment tend to be quite unpredictable.

Foreign individuals and companies have the same ability to bring an action in court as Chinese citizens and companies. PRC courts have jurisdiction over the cases when a Chinese entity or individual is a party to the case. In other words, when the foreign party sues or is sued by its Chinese partners, a PRC court will have jurisdiction over the case. For most disputes, PRC law adopts a three-year statute of limitations calculated from the date when the plaintiff knew or should have known his rights had been infringed. However, a one-year statute of limitations will also apply to product quality or rent-related disputes, while even a four-year limitation applies to international trade disputes.

Unless an extension is approved, generally, the court will enter a judgment within six months after docketing for the first instance and within three months after an appeal is accepted for the second instance. However, these time limits are not applicable to cases involving foreign elements. The law does not specify an exact time limit for making a judgment for these foreign-related cases; however, in practice, courts will enter a judgment within one year and six months after accepting cases of the first and second instances, respectively.

The choice of foreign laws as the governing law is permitted even where the dispute is resolved through PRC court litigation if the dispute contains any foreign elements. The foreign parties may also institute litigation against their Chinese partners in their home countries. However, as China has not yet acceded to the *Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters*, recognition and enforcement by PRC courts is relatively difficult and depends on reciprocal enforcement arrangements between China and the home country.

CHAPTER 6 EXITING THE CHINESE MARKET

Where an FIE does not succeed, what can the foreign investor do to exit the Chinese market? PRC law provides several options for foreign investors to consider.

I. Sale of Shares

The easiest way to exit is to transfer the shares of an FIE to its existing shareholders or a third party. As mentioned above, under the previous Company Law, equity transfers between shareholders did not inherently require approval unless otherwise provided in the company's articles of association, and transfers to third parties still required the approval of 50% of the other shareholders. Where a shareholder voted against the transfer, such shareholder must exercise its right of first refusal to purchase such equity interests; otherwise, it would be deemed to have consented to the sale. The Revised Company Law removes the statutory approval requirement for equity transfers to third parties, but the transfer is still subject to the right of first refusal of other shareholders unless otherwise provided in the articles of association.

Under the Revised Company Law, an equity transfer is deemed completed after the updating of the register of shareholders. The transferring shareholder is obligated to request the company to update the register of shareholders and to file the shareholder change with SAMR. If the company refuses to do so or fails to reply within a reasonable time limit, the transferee and the transferor may file a lawsuit against the company.

II. Dissolution and Liquidation

An FIE may be dissolved upon the expiry of its operating term, or if it suffers serious losses and damages, experiences serious difficulties in its business, or is ordered to cease operations. Upon the occurrence of a cause of dissolution, the directors are the liquidation obligors of the company and are required to establish a liquidation committee which, by default, is composed of the directors unless it is otherwise provided for in the company's articles of association or it is otherwise elected by the shareholders. The liquidation obligors are liable for compensation if they fail to fulfill their liquidation obligations in a timely manner which causes any loss to the company

or the creditors. If, however, the FIE fails to establish a liquidation committee, its creditors or shareholders may apply for compulsory liquidation where the members of a court-appointed liquidation committee will dominate the dissolution process.

The liquidation committee will take over the day-to-day management of the FIE and notify known creditors through notices and unknown creditors publicly in newspapers or via the National Enterprise Credit Information Publicity System so that the creditors can declare their claims and the liquidation committee can register and verify such claims. The liquidation committee also handles labor and employment-related matters, settles claims and debts, disposes of unsettled company assets, and prepares a balance sheet and list of assets for the FIE. All litigation in a dissolution liquidation must be settled before the dissolution is concluded. During the liquidation period, the FIE cannot undertake any business activities except for purposes of liquidation.

The liquidation committee will dispose of company assets and prepare a balance sheet and list of assets and then formulate a liquidation plan and report it to the FIE or the court for confirmation. Once the liquidation plan is confirmed, expenses, wages, and taxes must be paid out of the FIE's assets in the order of priority and any remaining assets will be distributed to shareholders in proportion to their respective capital contributions. Thereafter, the liquidation committee will prepare a liquidation report for shareholder confirmation and approval and deregister the FIE with various competent authorities, including the tax authority, SAFE, customs, SAMR, banks, etc. If, during the course of liquidation, it is discovered that the FIE's assets are inadequate to pay all of its debts, the liquidation committee will apply to the court to terminate the dissolution and declare bankruptcy as discussed below.

The Company Law subjects the liquidation committee to fiduciary duties: (i) any member who neglects to fulfill his/her liquidation duties, thus causing any loss to the company, may be liable for compensation; and (ii) any member who causes any loss to a creditor, whether intentionally or due to gross negligence, may be liable for compensation.

III. Bankruptcy

The *Enterprise Bankruptcy Law of the People's Republic of China* (the "**Bankruptcy Law**"), which is effective as of June 1, 2007, unifies the fundamental bankruptcy rules

and procedures for both foreign- and domestic-invested companies. The law provides for three kinds of procedures in a bankruptcy proceeding, i.e. liquidation, reorganization, and settlement, but not every bankruptcy case necessarily involves all three procedures. In general, a bankruptcy proceeding is time-consuming, taking one to two years from the constitution of the liquidation committee until its conclusion.

Note that experience with bankruptcy in China is still relatively limited, as PRC government authorities have traditionally been very reluctant to force a company into bankruptcy with the consequent loss of jobs. The number of bankruptcies has, however, been rapidly increasing and it can be expected that they will continue to do so, as the government withdraws its support from unsustainable companies.

i. General Bankruptcy Proceedings

The inability to pay bills when due is the benchmark for measuring whether a company is insolvent. As discussed above, a company may enter voluntary liquidation or be forced into compulsory liquidation. However, the company will be forced into bankruptcy if, during the liquidation, the liquidation committee determines that the company is unable to pay all of its debts from available assets.

Proceedings relating to the property of the debtor and other actions must, however, be stayed or cease from the date on which the court accepts the case. Creditors must register their claims with the court within a period of at least 30 days and a maximum of three months after the court's publication of its acceptance of the case, determined by the court. Unsecured assets of a bankrupt enterprise, even in the hands of other persons, are available for distribution to general creditors in a bankruptcy proceeding. If the bankrupt company controls other legal persons, then its interests in those legal persons are available for distribution among its creditors. Assets involved in certain actions, e.g. fraudulent conveyances and preferences granted within one year prior to the acceptance of the bankruptcy case, may be recovered within a period extending to two years after the close of the bankruptcy case.

Before a court declares a company bankrupt, the company's affairs are managed and controlled by the administrator, which can be an individual or, more typically, a professional organization such as a law firm or accounting firm. Once the declaration

is made, the administrator will, in a timely manner, draft a plan for selling the property in bankruptcy and a plan for the distribution of the property in bankruptcy and submit the same to the creditors' meeting for discussion. The administrator will implement the bankruptcy plan once the court has ruled to approve the distribution of the property in bankruptcy adopted by the creditors' meeting.

Assets subject to distribution in a bankruptcy proceeding are distributed in the following order: (i) secured creditors; (ii) bankruptcy expenses and debts of common interest; (iii) wages, medical, and disability subsidies and support owed to staff and workers and their families by the bankrupt, the basic pension and basic medical insurance premiums payable into the individual accounts of the staff and workers and owed by the bankrupt, and the compensation payable to the staff and workers in accordance with laws and administrative regulations; (iv) taxes and other social security premiums the bankrupt owes; and (v) claims by general creditors. Claims of the same priority are distributed pro rata if the assets are insufficient to satisfy all claims of that rank.

Following the final distribution of the bankruptcy assets, the administrator will apply for the conclusion of the bankruptcy proceeding with the court and deregister the FIE.

ii. Bankruptcy Reorganization

One alternative to bankruptcy liquidation is to carry out a reorganization to save the debtor while sacrificing the ownership and/or control of the original shareholder(s). In extreme cases, shareholders may even fully divest from a company.

Reorganization under the Bankruptcy Law is effected by the entry into a reorganization agreement between a debtor and its creditors that is endorsed by at least half of the unsecured creditors who are present at the creditors' meeting, which becomes effective on the issue of a public notice by the court. A company can, under the supervision of the administrator, continue to operate during the reorganization. However, the company will be declared bankrupt if it is found that it has failed to act in accordance with the reorganization plan, the financial condition of the debtor continues to deteriorate, or the company commits any prohibited acts such as fraudulent conveyance and preferences. If, on expiration of the term of reorganization, the company goes into bankruptcy, all

the unsatisfied claims can be asserted against the assets of the bankrupt in a liquidation process.

The reorganization plan, subject to approval and supervision by the court, should contain provisions for the adjustment or establishment of a management group and the activities of the debtor. The Bankruptcy Law does not contemplate a reorganization which would result in a lender controlling the bankrupt enterprise. Further, it is not clear whether a lender can insist on taking control of and become a mortgagee in possession of an insolvent business or assets since a lender cannot take the mortgaged assets in satisfaction of its debts. Many security agreements do, however, provide for the concept of a receiver, although the scope of the receiver's potential rights and liabilities under PRC law is not clear.

iii. Bankruptcy Settlement

Another alternative to bankruptcy liquidation is to save the debtor by entering into a settlement agreement between the debtor and its creditors. In comparison with bankruptcy reorganization proceedings, a court-approved settlement agreement is only binding on unsecured creditors, while a reorganization agreement approved by a court is binding on all creditors. In addition, the settlement agreement does not involve the admission of new investors and, in general, does not involve conversions of debt to equity - the current shareholders are thus often able to retain substantial control of the debtor.

During bankruptcy settlement proceedings, a settlement agreement will be reached through negotiation between the debtor and its creditors and approved by the court. It is common for creditors to compromise on the amount and maturity of claims. The resolution on the settlement agreement concluded at the creditors' meeting is required to be adopted by over half of the creditors with voting rights present at the creditors' meeting and the amount of their claims must comprise more than two-thirds of the total amount of unsecured claims.

[END]

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