The Wholly Foreign-Owned Enterprise Law: Defining the Legislative History and Interpreting the Statute

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The incorporation in a foreign jurisdiction of a wholly owned subsidiary is a typical investment decision for corporations that conduct business abroad. A significant advantage to this type of foreign investment is the ability to control the internal affairs of the subsidiary, yet retain flexibility by separating its operations from those of the parent. However, until recently, there existed no statutory authority for the formation and operation of wholly foreign owned enterprises (WFOEs) in China. Only the regulations pertaining to Special Economic Zones (SEZs) in Guangdong province permitted foreign investors "to open up factories with their own investments."[1] This legislative void was filled when the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises (the WFOE Law) was adopted on April 22, 1986, by the Fourth Session of the Sixth National People's Congress (NPC).[2]

This law deals with the legal status and legal protection, supervision, establishment and operation of WFOEs. It provides a new channel for foreign investment and marks an important step in the development of China's economic legislation. However, the text of the WFOE Law is relatively brief, consisting only of twenty-four arti-

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1. The Regulations on Special Economic Zones in Guangdong Province (Guangdong-sheng Jingji Tequ Tiaoli) art. 1 (adopted Aug. 26, 1980) *trans. in* 1 CHINA'S FOREIGN ECONOMIC LEGISLATION 193-200 (1983) [hereinafter CFEL:1]. The other articles cover in very general terms the scope of investment, registration, labor management, preferential treatment and other operational matters.

2. Zhonghua Renmin Gongheguo Waizi Qiye Fa (The Law of the People's Republic of China Concerning Wholly Foreign-Owned Enterprises) [hereinafter WFOE Law], Renmin Ribao [hereinafter RMRB], Apr. 18, 1986, at 2; for a translation of this law, see CHINA BUS. REV., July-Aug. 1986, at 52-53.

cles stated in broad language. Although the wording is vague, a more precise understanding of the statute can be gained by examining the legislative history of the WFOE Law. The term "legislative history" does not refer to the legislative and administrative records of the law-making process, as it does in the U.S., since such records are treated as internal documents (*neibu wenjian*) and are not available to the public.[3] Instead, in this article, legislative history refers to the historical, economic, political and legal context in which the law was passed.

Examining the context of a statute is particularly important in China due to the way in which legislation is applied to dispute resolution. Chinese statutes are not likely to be interpreted formalistically by the courts; they are, instead, applied as a guide to mediated and negotiated dispute settlement. In this informal setting, the background and policy of a law are considered in close conjunction with the actual text.

This article first identifies certain elements of the legislative history of the WFOE Law, then, in light of this analysis, interprets fundamental provisions of the WFOE Law.

I. ELEMENTS OF THE LEGISLATIVE HISTORY

A. *The Economic Rationale for WFOEs*

The principal motivation behind China's adoption of the WFOE Law was the perceived need to increase the number of legal channels for foreign investment in China.[4] Initially, China encouraged foreign investors to establish joint ventures (JVs), in the belief that they were the most appropriate way for China to absorb advanced technology, learn Western managerial skills and help Chinese companies earn foreign exchange. Except for cooperative agreements for the exploration of natural resources, joint venture agreements are the only form of foreign investment regulated by a comprehensive set of statutes. These include the enabling statute itself,[5] implementation regulations and other provisions covering registration, labor management and

3. The discussion on the legislative history of the WFOE Law is based generally upon Mr. Fang's recollection of his review of prior drafts and participation in discussions relating to those drafts.

4. Zheng Tuobin (Minister of Foreign Economic Relations and Trade), Report on the WFOE Law (Draft), on April 2, 1986, at the Fourth Session of the Sixth National People's Congress of the People's Republic of China, *Guanyu Zhonghua Renmin Gongheguo Waizi Qiye Fa Caoan de Shuoming*, RMRB, Apr. 18, 1986, at 2.

5. The Law of the People's Republic of China on Chinese-Foreign Joint Ventures (Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Fa) (promulgated July 1, 1979) *trans. in* CFEL:1, *supra* note 1 at 1 [hereinafter JV Law]. The JV Law was the first foreign economic legislation passed in China since the adoption of its "Open Door Policy."

taxation.[6] Despite high expectations and the relatively sophisticated statutory scheme, the operation of joint ventures has not been without difficulty.[7]

At the outset, the selection of an appropriate Chinese JV partner has proven problematic, due to the lack of both a well-developed information network and an effective consulting system in the PRC. This problem is compounded by China's centrally planned economic system, under which a prospective Chinese partner is identified locally on the basis of its potential contribution to the national or local development program, rather than on the basis of its economic and technological capability. Moreover, when partners have been matched together, the differences in managerial style, cultural tradition and ideology have caused operational complications.[8] In addition, China's limited governmental financing and the lack of qualified managers serve to dampen the enthusiasm of foreign investors and frustrate China's ambitious goal of economic development.[9]

The need for legislation governing WFOEs became apparent shortly after the promulgation of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures (the JV Law) in 1979. The failure of the JV Law to provide a limit on the proportion of the foreign capital investment[10] in a joint venture enterprise gave rise to a problem of interpretation: should foreign investors be permitted to establish JV enterprises in which they would own a 100% share and thereby operate their own business in China?[11] Officials concerned with this issue promoted the adoption of a separate law to regulate WFOE operations.[12] The need for a separate WFOE Law was also advanced by several foreign firms, including the Minnesota Mining &

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6. For the list of these regulations, see *infra* note 29.

7. *See* Gelatt, *Legal and Extra-legal Issues in Joint Venture Negotiations*, 1 J. CHINESE L. 217 (1987).

8. *Id.*

9. The State Council has promulgated an important set of provisions to try to remedy any sentiments of disenchantment. Guowuyuan Guanyu Guli Waishang Touzi de Guiding (Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment) art. 2 (promulgated Oct. 11, 1986), RMRB, Oct. 11, 1986, at 1 [hereinafter 22 Articles]; for the official translation, see China Daily, Oct. 13, 1986, at 1. For background on the 22 Articles, see *infra* note 45; *see also* Cohen & Valentine, *Foreign Direct Investment in the PRC: Progress, Problems and Proposals*, 1 J. CHINESE L. 161 (1987).

10. JV Law, *supra* note 5, art. 4, requires that the foreign party hold not less than twenty-five percent of the registered capital of a joint venture.

11. *See* CHU BAOTAI, ZHONGWAI HEZI JINGYING QIYE FA JIQI SHISHI JINGYAN QIANTAN (A Brief Introduction to the Experience in Implementing the Joint Venture Law) 57-58 (1983). Mr. Chu currently serves as Deputy Director of the Department of Foreign Investment Administration of the Ministry of Foreign Economic Relations and Trade (MOFERT).

12. *Id.* at 58.

Manufacturing Co. (3M). As early as 1979, 3M had expressed a desire to establish operations in the PRC, but would only do so if it could maintain a consistent pattern of overseas operations by establishing a wholly owned subsidiary in China. After three years of negotiations with the Chinese central authorities, 3M obtained approval to begin negotiations with the Shanghai Investment and Trust Corporation for the establishment of the first WFOE outside the SEZs.[13]

In addition to the difficulties with JVs, considerations of reciprocity also played a role in the decision to permit the operation of WFOEs in China. The integration of China into the international business community and the establishment of Chinese enterprises overseas have been major aspects of the "Open Door Policy." Although the last decade has witnessed a dynamic growth in China's overseas commercial operations,[14] Chinese efforts have frequently been frustrated because host countries were reluctant to accommodate the presence of Chinese companies until an equal opportunity was afforded their own nationals by the Chinese government.[15] Allowing WFOEs to operate in the PRC will, therefore, likely increase opportunities for Chinese companies to invest abroad.

B. Overcoming Political Obstacles

The significance of the WFOE Law can best be appreciated in an ideological context. Several ideological concerns confronted the drafters of the WFOE Law, the main issue being the inherent contradiction between Western capitalism and China's socialist system of ownership. Under the orthodox Marxist view, the means of production cannot be privately owned, which would theoretically preclude the operation of foreign corporations on Chinese soil. However, eight

13. *See China Ponders Venture Owned Totally by 3M*, Asian Wall St. J. Weekly, Mar. 2, 1983, at 1, col. 3.

14. There are more than 200 enterprises in over 50 foreign countries and areas, which are operated by Chinese enterprises. Some of these enterprises are in the form of wholly-owned enterprises; others are joint ventures with foreign companies. These enterprises are involved in the areas of processing, manufacturing, forestry, fishery, shipping, construction contracting, hotel, restaurant and technological consulting. *See Wozai Haiwaiban Qiye Yu Erbai Jia*, RMRB, July 18, 1987, at 1; *Dui Waikaifang Zhengce Jieshuoguo*, RMRB, Jan. 2, 1987, at 1.

15. As revealed in an article, the Italian government once set as a prerequisite for the incorporation of a Chinese subsidiary the condition that China allow Italian venturers to open a restaurant in Beijing. *See* Jiang Enci, *Guanyu Waizi Qiye Lifa de Jige Lilun Wenti*, 9 SHANGHAI SHEHUI KEXUE 34 (1986); Remarks by Mr. Xu Daquan (Director, Shanghai International Economic and Trade Law Firm of the China Council for Promotion of International Trade (CCPIT) Shanghai Sub-Council) on the 1985 draft of the WFOE Law at a legislative meeting held by the Standing Committee of the People's Congress of Shanghai, August 1985, *supra* note 3.

years ago China rejected the orthodox view when it enacted the JV Law, believing that socialist control could be maintained in a joint venture enterprise by subjecting the enterprise to direct government supervision.[16]

Although the new interpretation could justify joint venture operations as co-ownership with socialist dominance, WFOEs are in more direct contradiction with the principle of public ownership. To rėsolve this ideological dilemma, the Communist Party of China (CPC) has announced a more flexible and pragmatic approach to the question of ownership. This view was put forward in a blueprint for urban economic reform entitled "Decision on Reform of the Urban Economic System."[17] Article 8 of the Decision on Reform notes that state-owned enterprises "constitute the leading force in China's socialist economy," while the private sector is "a necessary and valuable adjunct to the socialist economy." The document encourages both collective and individual enterprises and states that China "should try to remove obstacles in the way of the collective economy and individual economy in cities and rural towns, create conditions for their development and give them the protection of the law."[18] This is part of a major drive on the part of the CPC leadership towards fundamental economic reform. The reforms sharply curtail direct governmental control over industrial and commercial activity and encourage individual entrepreneurial activities; indeed, they promote the creation of a genuine and vigorous socialist market economy. This policy has favorable implications for foreign investment in China, in that it endorses a greater role for private business, both domestic and foreign.

16. Joint venture operations can be regarded as analogous to the previously existing "joint state-private owned enterprises", *gongsi heying qiye*, an element of the "state capitalist sector" welcomed by Mao Zedong after the foundation of the People's Republic of China. In the late 1950s and early 1960s, the joint state-private owned enterprises were a main component of China's economy. Such arrangements allow private capitalists to continue to own equity in an enterprise and receive a fixed return on their equity. By this means, China gradually shifted private ownership into state ownership. *See* CHU BAOTAI, *supra* note 11, at 2-3, 17-19 (1983).

The works of Lenin have also been cited to justify the existence of JVs. *See* Wang Jafu & Su Qin, *Zhongwai Hezi Qiye Fa Chutan* 3 FAXUE YANJIU 21 (1979); CHU BAOTAI, *supra* note 11, at 12-17; WANG YIHE & XU ER, ZHONGWAI HEZI JINGYING QIYE (Sino-Foreign Joint Ventures) 10 (1982).

17. The Decision on Reform of the Urban Economic System was adopted by the Third Plenum of the Twelfth Central Committee of the Chinese Communist Party on October 20, 1984. *See Zhonggong Zhongyang Guanyu Jingji Tizhi Gaige de Jueding*, RMRB, Oct. 21, 1984, at 1 [hereinafter Decision on Reform]. For a detailed discussion of the Decision on Reform and the emergence of private enterprises in China, see Chao & Yang, *Private Enterprises in China, The Development Law of Collective Enterprises*, 19 INT'L LAW. 1215 (1985).

18. Decision on Reform, *supra* note 17, art. 8.

Ideological concerns also surfaced regarding the WFOE's potential infringement upon China's sovereignty and national economy. As a nation which has experienced unwelcome foreign incursions before, China's attitude towards foreign investment was characterized by reluctance and even, at times, hostility. Until the late 1970s, foreign investment was regarded as an instrument of imperialist economic invasion and was considered exploitive.

After the adoption of the JV Law, the intrusiveness of WFOEs was cautiously tested by allowing them to operate within the SEZs as an experiment. After examining the advantages and disadvantages of WFOE operations,[19] it was concluded that the establishment of WFOEs on a broader scale would provide a beneficial form of investment capable of increasing the flow of foreign technology and capital to China on equitable terms.[20] However, the WFOE Law also establishes procedures that maintain close administrative supervision over WFOEs, in order to take into account China's continuing fear of abusive behavior by foreign investors. As indicated by the Minister of Foreign Economic Relations and Trade, the WFOE Law was created with the dual purpose of providing a legal basis for WFOEs and regulating their activities through strict supervision and procedure.[21]

C. *The Drafting Process*

Plans to adopt a WFOE Law were implied by article 18 of the 1982 PRC Constitution, which allows "foreign enterprises, other foreign economic organizations and individual foreigners to invest in China."[22] The drafting of the WFOE Law itself began in early 1983,[23] simultaneously with China's announcement that the 3M WFOE should serve as a model for foreign investors.[24] When the

19. The Chinese government addresses a number of issues in deciding whether to allow WFOEs to operate outside the SEZs, such as (1) whether China should allow WFOEs to operate at all; (2) what would be the potential benefits and losses to China's socialist modernization; (3) which law should be followed; and (4) what should be the procedure for the establishment of a WFOE. *See* CHU BAOTAI, *supra* note 11, at 57-58.

20. The WFOE Law benefits not only the foreign investor, but also the development of China's economy by providing (1) extra income to the Chinese government from taxes, land use fee and administration fees without imposing any business risk on the Chinese side; (2) labor training to local employees; and (3) import substitutes. *See* Zhao Yanshi, *Jianxi Waishang Touzi Qiye Sanzhong Xingshi*, 4 ZHENGFA LUNTAN 32 (1986); Jiang, *supra* note 15.

21. *See* Zheng, *supra* note 4.

22. THE CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA, art. 18 (1982) [hereinafter PRC CONST.].

23. Zheng Tuobin introduced the Wholly Foreign-Owned Enterprise Law to the Standing Committee. *See Chanpin Wei Woguo Duanque huo Chukou Waimao Qiye Bixu Jishu Xianjin*, RMRB HB, Jan. 14, 1986, at 1.

24. *See supra* note 13.

drafting of the law began, it was undertaken at both central and local government levels.[25] The responsibility for drafting the WFOE Law was given to the Ministry of Foreign Economic Relations and Trade (MOFERT), which acted as a special drafting agency for the State Council. Once the drafting was completed, the prospective legislation was submitted to the State Council, the Standing Committee of the NPC and the NPC itself,[26] and became law when all three bodies gave their approval.

At the end of 1983, the first draft of the WFOE Law was released and was discussed by legal scholars and practitioners at a special seminar held in Beijing under the auspices of MOFERT.[27] In June 1985, a revised draft of the WFOE Law was distributed nationally. This was followed by the visit of a legislative delegation, led by the Vice-Chairman of the Legal Committee of the Standing Committee of the NPC, to coastal cities and SEZs such as Shanghai and Shenzhen. The delegation solicited comments and suggestions on the draft law from local government officials, businesspeople, lawyers and scholars. On December 18, a new draft, incorporating the comments received, was submitted to the State Council. Three articles were deleted from the earlier draft and some structural rearrangements were made to pro-

25. At the end of 1983, the Draft Regulations of Shanghai on WFOEs, drafted under the direction of the Shanghai Municipal Committee of Foreign Economic Relations and Trade, were released. This draft was later adopted as part of the Shanghaishi Guanyu Kaiban Zhongwai Hezi Jingying Qiye he Jieshou Waishang Touzi Kaishe Ziying Qiye de Qiatan Gongzuo he Shenpi Chengxu Guiding (Shixing de Shishi Banfa) (Implementing Measures for the Regulations of Shanghai Municipality on Discussion and Examination and Approval Procedures Concerning the Establishment of Sino-Foreign Equity Joint Ventures and the Acceptance of Self-operated Enterprises Invested in and Established by Foreign Businesses (Trial Implementation) (issued Oct. 8, 1984) *trans. in* CHINA LAWS FOR FOREIGN BUSINESS (CCH Australia Ltd.), ¶95-891 [hereinafter CHINA L. FOR. BUS.].

26. In China, legislative power is allocated among the National People's Congress (NPC), the Standing Committee of the NPC and the State Council. The NPC is empowered to promulgate statutes which are seen as the basic building blocks of the Chinese legal system, *e.g.*, the Economic Contract Law. *See* PRC CONST., *supra* note 22, art. 62(3). The Standing Committee of the NPC is empowered to enact some special laws. *See* PRC CONST., *supra*, art. 67(2).

On April 10, 1985, the third session of the Sixth NPC adopted a decision that delegates to the State Council the power to draft and promulgate interim rules and regulations relating to the reform of the economic system and the implementation of the "Open Policy." *See Luojie Quanguo Renda Sanci Huiyi Guanyu Shouquan Guowuyuan Zai Jingji Tizhi Gaige he Duiwai Kaifang Fangmian Keyi Zhize Zhanxin de Guiding Houzhe Tiaoli de Jueding*, RMRB, Apr. 11, 1985, at 2.

The Legal Committee of the Standing Committee serves as the drafter for both the NPC and its Standing Committee and has the responsibility of drafting, reviewing and recommending laws to the NPC. The Economic Law Center concentrates on performing similar tasks for regulations enacted by the State Council, by supervising and coordinating the legislative activities and drafting work of various ministries.

27. *See supra* note 3.

duce the final version of the WFOE Law. The effect of these revisions was (1) to stress the legal protection afforded foreign investors; (2) to confer discretionary power upon the governmental agencies regarding the approval and duration of WFOEs; (3) to offer incentives to foreign investors; and (4) to create a favorable climate for WFOEs. Approximately one month later, the State Council approved the draft and sent it to the Standing Committee of the NPC for review and approval.[28] The process culminated in the adoption of the WFOE Law by the NPC in April 1986.

Just as the JV Law was followed by implementing regulations, a package of WFOE regulations, as provided in the WFOE Law,[29] can

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28. *See* Zheng, *supra* note 23.

29. In order to implement the laws, the State Council (including its subordinate ministries) is authorized to promulgate administrative rules and regulations.

For such an authorization under the WFOE Law, see WFOE Law, *supra* note 2, art. 23. With regard to joint venture operations, after the Joint Venture Law was adopted by the NPC in 1979, the State Council promulgated the following regulations: Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Fa Shishi Tiaoli, in ZHONGGUO SHEWAI JINGJI FAGUI HUIBIAN, 1949-85, at 853 [hereinafter ZSJFH] (Regulation for the Implementation of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures) (promulgated Sept. 20, 1983) *trans. in* 3 CHINA'S FOREIGN ECONOMIC LEGISLATION 1 [hereinafter JV Regulations]; Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Laodong Guanli Guiding, in ZSJFH, *supra*, at 877 (Provisions of the People's Republic of China for Labor Management in Chinese-Foreign Joint Ventures) (promulgated July 26, 1980) *trans. in* CFEL:1, *supra* note 1, at 20; Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Dengji Guanli Banfa, in ZSJFH, *supra*, at 855 (Procedures of the People's Republic of China for the Registration and Administration of Chinese-Foreign Joint Ventures) (promulgated July 26, 1980) *trans. in* CFEL:1, *supra* note 1, at 13 [hereinafter Registration and Administration Procedures]; Guowuyuan Guanyu Zhongwai Hezi Jingying Qiye Waihui Shouzhi Pingheng Wenti de Guiding, in Guowuyuan Gongbao 66 (1986) (Provisions of the State Council on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Chinese-Foreign Joint Ventures) (promulgated Jan. 15, 1986) *trans. in* E. ASIAN EXEC. REP., Feb. 1986, at 26 [hereinafter JV Balancing Provisions]. The State Council also approves rules and regulations made by various ministries such as Zhongwai Hezi Jingying Qiye Laodong Guanli Guiding Shishi Banfa, in ZSJFH, *supra*, at 880 (Provisions for the Implementation of the Regulations on Labor Management of Joint Ventures Using Chinese and Foreign Investment) (adopted and promulgated Jan. 19, 1984) *trans. in* CHINA ECON. NEWS, Mar. 12, 1984, at 2; Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Suodeshui Fa Shishi Xize, in ZSJFH, *supra*, at 622 (Rules for the Implementation of the Income Tax Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures) (approved Dec. 10, 1980, promulgated Dec. 14, 1980) *trans. in* CFEL:1, *supra* note 1, at 45; Zhongguo Yinhang Banli Zhongwai Hezi Jingying Qiye Daikuan Zanxing Banfa, in ZSJF, *supra*, at 751 (Interim Procedures for the Handling of Loans by the Bank of China to Chinese-Foreign Joint Ventures) (approved by the State Council, Mar. 13, 1981, promulgated by the Bank of China, Mar. 13,1980) [hereinafter 1981 Loan Procedures]. This Interim Procedure was repealed by Zhongguo Yinhang Dui Waishang Touzi Qiye Daikuan Banfa (Procedures of the Bank of China for Loans to Enterprises with Foreign Investment), in GUOWUYUAN GONGBAO 359 (1987) (adopted Apr. 24, 1987) *trans. in* E. ASIAN EXEC. REP., Sept. 1987, at 24 [hereinafter 1987 Loan Procedures]; Zhonghua Renmin Gongheguo Gongshang Xingzheng Guanli Zongju Guanyu Zhongwai Hezi Jingying Qiye Jiaona Dengji Feibiao Zhunde Zanxing Guiding (Provisional Regulations of the General Bureau of Industrial and Commercial Administration of the People's Republic be expected in the near future.[30]

D. The Place of the WFOE Law in the Legislative Scheme

The WFOE Law does not directly address such issues as taxation, profit remittance or management. The tax status of WFOEs provides an illustration: instead of specifying detailed tax rates and incentives, the WFOE Law merely refers to the "relevant tax laws."[31] As interpreted by Chinese officials, the relevant tax law is the Income Tax Law Concerning Foreign Enterprises (FEITL).[32] However, application of the FEITL reveals an inconsistency in China's tax laws. Technically, the FEITL should not apply to WFOEs since they are Chinese legal persons. Furthermore, the primary purpose of the FEITL is the taxation of contractual joint ventures and parties engaged in the cooperative exploitation of natural resources. The FEITL explicitly removes the foreign subsidiary from the scope of its "establishment"[33] requirement that serves as the basis for levying taxes on foreign enterprises. In order to address this inconsistency, a WFOE tax law is expected in the near future.

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of China on the Standards of Registration Fees to Be Paid by Joint Ventures Using Chinese and Foreign Investment) (promulgated Feb. 2, 1982) *trans. in* CHINA L. FOR. BUS. *supra* note 25, at ¶6-540; Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Kuaiji Zhidu, in ZSJF, *supra*, at 902 (The Accounting Regulations of the People's Republic of China for Joint Ventures Using Chinese and Foreign Investment) (promulgated Mar. 4, 1985) *trans. in* CHINA L. FOR. BUS, *supra* note 25, at ¶35-500; Guanyu Zhongwai Hezi Jingying Qiye Zhuce Ziben Yu Touzi Zonge Bili de Zanxing Guiding, in *Guowuyuan Gongbao* 215 (1987) (Interim Provisions Concerning the Ratio Between Registered Capital and Total Amount of Investment of Chinese-Foreign Equity Joint Ventures) (promulgated Mar. 1, 1987) *trans. in* E. ASIAN EXEC. REP., Mar. 1987, at 22; and Zhongwai Hezi Jingying Qiye Heying Gefang Chuzi de Ruogan Guiding (Certain Regulations on the Subscription of Capital by the Parties to Sino-Foreign Joint Equity Enterprises) (adopted Dec. 30, 1987) *trans. in* CHINA L. FOR. BUS, *supra* note 25, at ¶6-556.

30. As informed by Zheng Tuobin in his introductory report, MOFERT is drafting the implementing regulations to complement the WFOE Law. *See* Zheng, *supra* note 4.

31. WFOE Law, *supra* note 2, art. 17.

32. Zheng, *supra*, note 4. Zhonghua Renmin Gongheguo Waiguo Qiye Suodeshui Fa (The Foreign Enterprise Income Tax Law of the People's Republic of China) (adopted Dec. 13, 1981) CFEL:1, *supra* note 1 at 64 [hereinafter FEITL]. Article 3 of the FEITL spells out the progressive rates for foreign enterprise income tax: (1) less than $250,000 of annual income, 20%; $250,001 to 500,000, 25%; $500,001 to 750,000, 30%; $750,001 to 1,000,000, 35%; above $1,000,000, 40%. Article 4 of the FEITL provides for an additional ten percent local surtax on annual income.

33. Zhonghua Renmin Gongheguo Waiguo Qiye Suodeshui Fa Shixing Xize (Detailed Rules and Regulations for Implementation of the Foreign Enterprise Income Tax Law of the People's Republic of China) (approved Feb. 17, 1982) *trans. in* CHINA L. FOR. BUS, supra note 25, at ¶32-510. Article 2 of these regulations defines places and business agents established within China by the foreign enterprises for production and business, to include management offices, branches, representative offices, factories and places for exploitation of natural resources, construction, assembly and exploration operations.

The statutory contradiction does not concern Chinese tax authorities as much as expected, however, since almost all of the WFOEs established so far are located within the SEZs and the fourteen coastal cities. In the SEZs and coastal cities, there is no difference in tax treatment between the Joint Venture Income Tax Law and the FEITL.[34] Tax incentives are offered to WFOEs operating in the SEZs and the fourteen coastal cities by specific tax laws, which cover all forms of foreign investment including equity joint ventures, contractual joint ventures and WFOEs.[35] The Provisions of the State Council of the PRC for the Encouragement of Foreign Investment (22 Articles) provide for an extension of the tax reduction period for export-oriented and technologically advanced enterprises.[36] The WFOE Law also encourages reinvestment in China by providing for a refund of taxes already paid by any investor that contributes after-tax profits to the establishment or expansion of a business within China.[37]

The WFOE Law addresses the issue of profit remittance in a general way. It requires the WFOE, upon obtaining a license from the government, to open a foreign exchange account with the Bank of China or one of the banks designated by the state foreign exchange control authorities. The WFOE must use this bank account to balance its foreign exchange income and disbursements and cannot remit foreign exchange unless there is a surplus of foreign exchange proceeds over disbursements.[38] Although various alternative forms of

34. Guanyu Jingji Tequ he Yanhai Shisige Chengshi Jianzheng Mianzheng Qiye Suodeshui he Gongshang Tongyishui de Zanxing Guiding (Provisional Regulations on Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Consolidated Tax for the 14 Coastal Cities and the Special Economic Zones) *trans. in* CHINA L. FOR. BUS., supra note 25, at ¶70-845 [hereinafter Tax Reduction and Exemption Regulations].

35. Under the Tax Reduction and Exemption Provisions, *id.* pt. II, § 1, a 15% preferential tax rate will be granted to any equity joint venture, contractual joint venture or WFOE located in the SEZs, or Economic and Technological Development Zones (ETDZs). This rate also applies to those enterprises located in the old city areas of the 14 coastal cities with more than $30 million in foreign investment and which possess the approval of the Ministry of Finance. *Id.* pt. III, § 3. The old city area enterprises that do not qualify, but are industries of some importance, such as electronics, metallurgy, chemicals and building materials, are offered a 20% discount off the existing rate. *Id.* pt. III § 1.

36. For example, after the expiration of the income tax reduction period, foreign investment enterprises, whose value of export product in that year amounts to 70% or more of the total value of their production for that year, may pay income tax at one-half the rate of the present tax. *See* 22 Articles, *supra* note 9, art. 8. Also, technologically advanced enterprises may enjoy a continuous one-half tax reduction for three more years after the expiration of the reduction period. *Id.* art. 9.

37. WFOE Law, *supra* note 2, art. 17.

38. *Id.* art. 18; Dui Qiaozi Qiye, Waizi Qiye, Zhongwai Hezi Jingji Qiye Waihui Guanli Shixing Xize (Rules for the Implementation of Foreign Exchange Controls Relating Overseas Chinese Enterprises, Foreign Enterprises and Chinese-Foreign Joint Ventures) art. 13

profit remittance are provided for in the Provisions of the State Council on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Chinese-Foreign Joint Ventures,[39] such alternatives do not apply to WFOEs. However, the experience of 3M suggests that alternatives available to joint ventures may also be applicable to WFOEs.[40] This has been confirmed by the replacement of certain regulations, which initially were applicable only to JVs, with updated regulations applicable to all forms of foreign enterprises in the PRC.[41]

In order to interpret the WFOE Law, the role of Party policy in the formulation of rules and regulations should also be borne in mind. The WFOE Law was promulgated as part of the Chinese government's effort to improve the climate for foreign investment. Since the inauguration of the "Open Door Policy" in 1978 and the promulgation of the JV Law in 1979, the Chinese government has received complaints from foreign investors about the poor investment cli-

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(approved July 19, 1983) *trans. in* 2 CHINA'S FOREIGN ECONOMIC LEGISLATION 230 (1983) [hereinafter CFEL:2].

39. JV Balancing Provisions, *supra* note 29, provide for the following alternatives: (1) article 3 makes the approving authorities responsible for currency conversion, meaning that the foreign exchange account of joint ventures, which are approved and established under the Chinese law, shall be re-adjusted, where needed, by the original approving authorities at various levels as the case may be; (2) article 5 allows import-substitution, i.e., joint ventures, under the approval of the Chinese government, are permitted to sell their products in China if these products would otherwise need to be imported for a long period of time or are urgently needed by the domestic market; (3) article 10 allows the foreign investor to reinvest in renminbi, which means that with the approval of governmental agencies, foreign investors running into exchange deficits are allowed to reinvest their share of Chinese currency into enterprises that produce goods for export; (4) article 9 allows foreign investors who have established two or more joint ventures to pool the foreign exchange earnings of their establishments together so as to be able to offset foreign exchange deficits of one venture with the surplus of another; (5) article 6 allows countertrade, i.e., foreign partners in joint ventures, subject to approval, are permitted to purchase some domestic products through a "comprehensive compensation arrangement," and resell them in the international market.

40. For the purpose of countertrade, 3M has specifically formed a Hong Kong trading company (3M-Shamash) which deals in silk and other products such as tablecloths, artificial flowers, candles, glassware and nails. For details, see Stein, *Wholly Foreign Owned Ventures in China: A Comparison of 3M China Ltd., Grace China Ltd. and the New Foreign Enterprise Law*, 4 CHINA L. REP. 21-3 (1987). It was reported by the Chinese newspaper that 3M purchased more than one million renminbi of domestic products for export. *See also*, *Shanghai Yunyong Duozhong Linghuo Cuoshi Jiejue Hezi Qiye Waihui Pingheng*, RMRB, July 14, 1986, at 1; Duiwai Jingji Maoyibu Guanyu Waishang Touzi Qiye Goumai Guonei Chanpin Chukou Jiejue Waihui Shouzhi Pingheng de Banfa, in *Guowuyuan Gongbao* 118 (1987) (Measures of the Ministry of Foreign Economic Relations and Trade for Enterprises with Foreign Investment to Solve the Balance of Foreign Exchange Receipts and Expenditures by Purchasing Domestic Products for Export) (promulgated Jan. 20, 1987) *trans. in* E. ASIAN EXEC. REP., Feb. 1987, at 24. Article 1 elaborates detailed procedures for countertrade that apply to three kinds of foreign ventures.

41. For example, the promulgation of the 1987 Loan Procedures, supra note 29, art. 27, repealed the previous 1981 Loan Procedures, *supra* note 29.

mate.[42] The time-consuming bureaucratic coordination procedure combined with limited access to local supplies have frustrated many foreign investors. Higher than expected costs of rent, services and labor have significantly reduced the expected profits of foreign investments in the PRC.[43] In response to such complaints, the government promulgated a series of regulations, beginning in early 1986. The first of these was the Provisions of the State Council on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Chinese-Foreign Joint Ventures,[44] which attempted to resolve the profit remittance problem of JVs. In October 1986, the 22 Articles were promulgated[45] and in the next six months a mass of legislation was enacted by the national and local governments as well as by various governmental agencies to implement the 22 Articles.[46] This effort

42. *See* Cohen & Valentine, *supra* note 9, at 161.

43. Sterba, *U.S. Firms Urge China to Make Changes or Risk the Loss of Foreign Investment*, Wall St. J., June 6, 1986, at 28, col. 2; Lubman & Randt, *The Frustrations of Investing in China*, Asian Wall St. J. Weekly, May 19, 1986, at 14, col. 2.

44. JV Balancing Provisions, *supra* note 29.

45. On October 11, 1986, the State Council, the highest executive body in China, promulgated the 22 Articles, *supra* note 9. "Its promulgation was purported," according to Zhu Rongji, the Vice-Minister of the State Economic Commission, to "improve China's economic climate to the point where it can compete with the economies of South Korea, Singapore, Taiwan and other Asian countries and regions." *See Woguo Zhengfu Jiangong Shigaishan Touzi Huanjing Waishang Xingban Chanpin Chukou he Xianjin Qiye Shuishou Feiyong Deng Geiyu Tebie Fuhui Daiyu*, RMRB, Oct. 11, 1986, at 1. These provisions offer qualifying foreign enterprises lower taxes, reduced labor and land use fees, more managerial autonomy and the right to appeal for any overcharge to Chinese authorities.

46. Timothy Gelatt provides a comprehensive list of the rules and regulations that have followed the 22 Articles:

> As of December, 1987, eleven implementing regulations have been issued under the 22 Articles, with more expected: Guanyu Waishang Touzi Qiye Yongren Zizhuquan he Zhigong Gongzi, Baoxian Fuli Feiyong de Guiding, in STATE COUNCIL GAZETTE 959 (1986) (Provisions Concerning the Right of Autonomy of Enterprises with Foreign Investment in Hiring Personnel and the Wages, Insurance and Welfare Costs of Staff and Workers) (promulgated Nov. 10, 1986) *trans. in* E. ASIAN EXEC. REP., Jan. 1987, at 25 [hereinafter 1986 Labor Provisions]; Zhonghua Renmin Gongheguo Haiguan dui Waishang Touzi Qiye Luxing Chanpin Chukou Hetong Suoxu Jinkou Liao Jian Guanli Banfa, in STATE COUNCIL GAZETTE 960 (1986) (Procedures of the Customs of the People's Republic of China for the Administration of Materials and Parts that Enterprises with Foreign Investment Need to Import in order to Carry Out Product Export Contracts) (promulgated Nov. 24, 1986) *trans. in* E. ASIAN EXEC. REP., Jan. 1987, at 23; Zhongguo Renmin Yinhang Guanyu Waishang Touzi Qiye Waihui Diya Renminbi Daikuan Zanxing Banfa, STATE COUNCIL GAZETTE 25 (1987) (Interim Procedures Concerning Renminbi Loans to Enterprises with Foreign Investment Secured by Foreign Exchange) (promulgated Dec., 12, 1986) *trans. in* E. ASIAN EXEC. REP., Jan. 1987, at 25; Caizhengbu Guanche Guowuyuan Guanyu Guli Waishang Touzi de Guiding Zhong Shuishou Youhui Tiaokuan de Shishi Banfa, in STATE COUNCIL GAZETTE 93 (1987) (Implementing Measures of the Ministry of Finance to Implement the Tax Preference Articles of the Provisions of the State Council for the Encouragement of Foreign Investment) (promulgated Jan. 31,

strongly suggests that the WFOE Law was drafted and should be interpreted in light of the policy to create a more favorable climate for foreign investors.

In addition to improving the climate for foreign businesses, China has attempted to increase the variety of investment channels. This goal can be traced back to the issuance of the Tax Reduction and Exemption Provisions of 1984.[47] Two years later, the 22 Articles set forth additional criteria upon which preferential tax treatment would be accorded. Under the present rules and regulations, the focus of the

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1987) *trans. in* E. ASIAN EXEC. REP., Feb. 1987, at 25; Duiwai Jingji Maoyi Bu Guanyu Waishang Touzi Qiye Goumai Guonei Chanpin Chukou Jiejue Waihui Shouzhi Pingheng de Banfa, in STATE COUNCIL GAZETTE 118 (1987) (Measures of the Ministry of Foreign Economic Relations and Trade for Enterprise with Foreign Investment to Solve the Balance of Foreign Exchange Receipts and Expenditures by Purchasing Domestic Products for Export) (promulgated Jan 20, 1987) *trans. in* E. ASIAN EXEC. REP., Feb. 1987, at 24 [hereinafter Product Export Measures]; Duiwai Jingji Maoyi Bu Guanyu Waishang Touzi Qiye Shenqing Jinchukou Xukezheng de Shishi Banfa, in STATE COUNCIL GAZETTE 119 (1987) (Implementing Measures on the Application by Enterprises with Foreign Investment for Import and Export Licenses) (promulgated Jan. 24, 1987) *trans. in* E. ASIAN EXEC. REP., Feb. 1987, at 24; Duiwai Jingji Maoyi Bu Guanyu Queren he Kaohe Waishang Touzi de Chanpin Chukou Qiye he Xianjin Jishu Qiye de Shishi Banfa, in STATE COUNCIL GAZETTE (1987) 120 (Implementing Measures of the Ministry of Foreign Economic Relations and Trade for the Confirmation and Examination of Export Enterprises and Technologically Advanced Enterprises with Foreign Investment) (promulgated Jan. 27, 1987) *trans. in* E. ASIAN EXEC. REP., Feb. 1987, at 26; Debt-Equity Ratio Provisions; BOC Loan Procedures; Jingnei Jigou Tigong Waihui Danbao de Zanxing Guanli Banfa, in STATE COUNCIL GAZETTE 157 (1987) (Interim Measures for the Administration of the Provision of Foreign Exchange Guaranties by Domestic Institutions) (promulgated Feb. 20, 1987) *trans. in* E. ASIAN EXEC. REP., March 1987, at 21; Guanyu Zhongwai Hezi Hezuo Jingying Qiye Chanpin Yi Chan Ding Jin Banfa (Measures Concerning the Use of Products of Chinese-foreign Equity and Cooperative Joint Ventures for Import Substitution) (promulgated Oct. 19, 1987) *trans. in* Ta Kung Pao, Nov. 5, 1987 [hereinafter Import Substitution Measures]. For examples of local regulations implementing the 22 Articles, see Shanghai Shi Guanyu Guli Waishang Touzi de Ruogan Guiding (Provisions of Shanghai Municipality for the Encouragement of Foreign Investment) (effective Nov. 1, 1986) trans. in ELIASOPH, LAW AND BUSINESS PRACTICE IN SHANGHAI 6 (1987) [hereinafter Shanghai Provisions]; Beijingshi Renmin Zhengfu Guanyu Shishi Guowuyuan Guanyu Guli Waishang Touzi de Guiding de Ruogan Guiding (Certain Provisions of the Beijing Municipal People's Government Concerning the Implementation of the Provisions of the State Council for the Encouragement of Foreign Investment) (promulgated Oct. 11, 1986) [hereinafter Beijing Provisions]; Guangzhou Shi Guli Waishang Touzi de Shishi Banfa (Provisions of the Municipal Government of Guangzhou for the Encouragement of Foreign Investment); Guangzhou Jingji Jishu Kaifaqu Guli Waishang Touzi de Shishi Banfa (Implementing Measures of the Guangzhou Economic and Technological Development Zone for the Encouragement of Foreign Investment) (promulgated Dec. 15, 1986).

Gelatt, *supra* note 7, at 220 n.19. *See also* Han, *New PRC and Shanghai Regulations for the Encouragement of Foreign Investment*, 10 HASTINGS INT'L COMP. L. REV. 557 (1987).

47. *See* Tax Reduction and Exemption Regulation, *supra* note 34, preamble.

preferential treatment accorded to foreign investment has shifted from the form of the enterprise to its nature. In other words, to qualify for preferential treatment it is not necessary that the enterprise be an equity JV, a contractual JV or a WFOE, but in all cases it is important that it be either export-oriented or technologically advanced.[48]

II. Interpreting Fundamental Provisions of the WFOE Law

A. *Legal Personality*

The concept of legal personality represents a willingness on the part of the Chinese government to promote economic reform based on the idea of independent responsibility.[49] The WFOE Law allows a WFOE to qualify as a Chinese legal person. Article 8 states: "[t]he wholly foreign owned enterprise, if qualified as a legal person under Chinese law, shall obtain the status of legal person."[50] The qualifications for legal personality are stated in the General Principles of Civil Law (the General Principles). The General Principles provide that organizations which are accorded legal rights and obligations, are competent to perform civil acts and are able to assume civil duties independently, qualify to become legal persons.[51] To qualify as a legal person, an organization must: (1) be established in accordance with the law; (2) possess the necessary property or funds; (3) have its own name, organizational structure and premises; and (4) be able to assume civil obligations independently.[52] The General Principles specifically provide that a WFOE may acquire the status of a Chinese legal person after it has been registered with and approved by the local branch of the State Administration for Industry and Commerce (SAIC).[53]

Article 8 of the WFOE Law did not actually appear until the final draft was submitted to the NPC for approval.[54] The delay in including this provision was caused by a failure to differentiate clearly

48. *See* 22 Articles, *supra* note 9 and accompanying text.

49. *See* Decision on Reform, *supra* note 17, art. 2, which states, "the enterprise should be truly made a relatively independent economic entity and should become a producer and operator of socialist commodity production that is independent and responsible for its own profits and losses and capable of transforming and developing itself . . ."

50. WFOE Law, *supra* note 2, art. 8.

51. Zhonghua Renmin Gongheguo Minfa Tongze (General Principles of Civil Law of the People's Republic of China) [hereinafter General Principles], art. 36, in RMRB, Apr. 14, 1986, at 2-3; English translation by Gray & Zheng, 34 AM. J. COMP. L. 722 (1986).

52. *Id.* art. 37.

53. *Id.* arts. 41(2), 36(2).

54. Unlike article 8 of the final version, no legal status was given to WFOEs by the June 1985 draft of the WFOE Law, *supra* note 3.

between the terms "WFOE" and "branch." A WFOE is incorporated under the law of the host country, rather than that of a foreign country, whereas a branch has its principal business office in the corporation's country of origin. In the early drafts of the WFOE Law this distinction was blurred[55] and the question of whether to exclude branches from the scope of the WFOE Law remained an unresolved issue.[56] For example, in the June 1985 draft, a WFOE was defined as an entity established in accordance with Chinese law and owned exclusively by foreign investors,[57] a definition which is broad enough to include both branches and subsidiaries.[58] The WFOE Law resolved this problem by explicitly excluding branches from its coverage.[59] Branches will instead be covered by the prospective Company Law.

Under the generally accepted conflict of laws rule, corporate governance is a matter for either the law of the place of incorporation[60] or the law of the jurisdiction in which the corporation is located.[61] Either of these rules would result in the application of substantive Chinese corporations law to WFOEs. Yet, neither the WFOE Law nor the General Principles provide any corporations law. The June 1985 draft attempted to confer autonomy to individual WFOEs in the area of corporate governance.[62] This attempt was rejected and the article relating to corporate governance was excised from the text of

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55. The earlier Shanghai local legislation, for example, attempted to regulate foreign presence in Shanghai in accordance with the same rules without differentiating among the representative offices, branches and subsidiaries.

56. The comments on the June 1985 draft of the WFOE Law identified the status of branches as one of the controversial issues to be further discussed and researched. *See supra* note 3.

57. Article 1 of the June 1985 draft reads "In order to expand international economic cooperation and technological exchange, the People's Republic of China permits foreign enterprises and other economic entities or individuals to establish within China enterprises whose capital is exclusively owned by the foreign investors." *See supra* note 3.

58. This interpretation appeared in the comments on the 1985 draft of the WFOE Law. *See supra* note 3.

59. WFOE Law, *supra* note 2, art. 2.

60. This is the conflict rule adopted in the RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 302-9 (1971); RESTATEMENT (FIRST) OF CONFLICT OF LAWS, § 152-61 (1934).

61. For example, according to long-standing German court practice, companies and all other organizations are governed by the law of their principal place of business U. DROBNIG, AMERICAN-GERMAN PRIVATE INTERNATIONAL LAW 265 (1972). The law applicable to the internal affairs of companies remains controversial in Japan; some scholars favor the law of the place of incorporation, some favor the law of the principal place of business. *See* A. EHRENZWEIG, S. IKEHARA & N. JENSEN, AMERICAN-JAPANESE PRIVATE INTERNATIONAL LAW 184 (1964).

62. Article 11 of the June 1985 draft reads: "The management office and its responsibility and rights are to be determined by the enterprise itself. In any event, the enterprise shall designate a statutory representative within the territory of China to represent the enterprise." *See supra* note 3.

the final law. This suggests that corporate governance will be provided for either in the WFOE implementing regulations, or in the prospective Company Law. In the absence of substantive corporate law, uncertainty exists over whether a WFOE may elect to be governed by the substantive corporations law of the parent company's home country. If the use of foreign law is allowed, it is uncertain how inconsistencies or conflicts between those corporate governance provisions and the requirements of future Chinese law or regulations would be resolved.

Another issue relating to the legal status of a WFOE is the choice of law governing the various contractual arrangements between WFOEs and other enterprises, either domestic or foreign. In China, there is a bifurcated contract system: one part deals with domestic economic contracts and is governed by the Economic Contract Law (ECL) and the other deals with foreign economic contracts and is governed by the Foreign Economic Contract Law (FECL). Contracts signed by WFOEs and foreign corporations are governed by the FECL,[63] and the parties are free to choose either foreign or Chinese law to be the governing law of the contract.[64] This freedom to choose the governing law is characteristic of the FECL's adherence to the principle of freedom of contract.

However, if a WFOE qualifies as a Chinese legal person, contracts signed between the WFOE and Chinese domestic enterprises will be governed by the ECL. The June 1985 draft of the WFOE Law supported this application of the ECL.[65] This practice may prove unacceptable to foreign investors due to the fact that the underlying principle of the ECL is the priority of the state plan.[66] Any contract which violates the state plan is deemed null and void.[67] Furthermore, any deviations from the state plan constitute a legitimate basis for discharging or revising the contract.[68] In contrast to a domestic enterprise, a WFOE, as an independent organization, needs a "micro-

63. Foreign Economic Contract Law of the People's Republic of China (Zhongguo Renmin Gongheguo Shewai Jingji Hetong Fa) (adopted Mar. 21, 1985) *trans. in* CHINA BUS. REV., July-Aug. 1985, at 54-55 [hereinafter FECL]. Article 2 provides that "[t]he scope of application of this law is economic contracts concluded between enterprises or other economic organizations of the People's Republic of China and foreign enterprises and other economic organizations or individuals . . ."

64. FECL, *id.* art. 5.

65. Article 25 of the June 1985 draft of WFOE Law. See *supra* note 3.

66. Zheng, *A Comparative Analysis of the Foreign Economic Contract Law of the People's Republic of China*, 3 CHINA L. REP. 235 (1986).

67. Economic Contract Law of the People's Republic of China (Zhonghua Renmin Gongheguo Jingji Hetong Fa) (adopted Dec. 13, 1981) *trans. in* CHINA L. FOR. BUS, *supra* note 25, at ¶5-500.

68. *Id.* art. 27.

cosmic atmosphere,"[69] so that it can operate within the norms of prevailing international commercial practice and can remain autonomous and flexible in its operations. Any provision that subjects WFOEs to the state plan may restrict their ability to conduct business. It was this consideration that led the drafters of the WFOE Law to eliminate language mandating the use of the ECL from the June 1985 draft. As a result, a contract between a WFOE and another Chinese legal person may choose to be governed by the FECL.[70]

B. Extent of Liability

The WFOE Law does not define WFOEs as limited liability corporations, which gives rise to the question of whether or not the foreign investor in a WFOE may be held liable over and above the amount of capital contributed.[71] Article 9 of the June 1985 draft stated that WFOEs were to be limited liability entities and implied that the concepts of limited liability and legal personality are synony-

69. "Microcosmic" atmosphere is terminology commonly used in China to denote a special environment or forum where foreign investors are able to operate their ventures in line with the worldwide prevailing commercial practices, which might, to a large extent, be inconsistent with the Chinese economic system and structure dominated by the state plan. During his recent visit to the coastal cities and regions, General Secretary of the CPC, Zhao Ziyang, promised a climate that would enable foreign entrepreneurs to run businesses in the same way as is done in most countries. *Zhao Ziyang Zongtan Yanhai Diqu Jingji Fazhan Zhanlue*, RMRB, Jan. 23, 1988, at 1.

70. Address by Qi Ruiqing, Section Chief, Treaties and Law Department, MOFERT, at the Fourth U.S.-China Joint Legal Seminar in Seattle (Nov. 20, 1987).

71. Special comment should be made with respect to the methods of capitalization available in China, a problem directly connected to the issue of limited liability. In comparison with U.S. laws, China imposes strict legal requirements on capitalization. In the U.S., though a corporation's existence begins with the filing of the articles of incorporation, its liability is generally confined to the amount of capital actually paid in by its shareholders, rather than to that stated in the articles. Under Chinese law, most enterprises, including foreign-related enterprises, are not allowed to capitalize by issuing stocks to the public. In order to protect creditors, China emphasizes the concept of registered capital. In accordance with the Interim Provisions on Registration and Administration of Corporations, the capital actually held by the company at the time of registration must be equal to the registered amount, and no undercapitalization will be permitted. *See* Registration and Administration Procedures, *supra* note 29, art. 12. A recently released set of regulations for the Guangdong Province SEZs relating to foreign corporations still requires minimum capitalization. Under Article 53 of these regulations, the shares to be initially issued should not be less than twenty-five percent of the total shares, the shares subscribed to by incorporators should not be less than twenty-five percent of the total shares to be initially issued, and incorporators should be held jointly and severally responsible for those shares initially issued but not subscribed to by the public. Guangdongsheng Jingji Tequ Shewai Gongsi Tiaoli (Regulations on Foreign Related Companies in the Special Economic Zones in Guangdong Province) (adopted Sept. 28, 1986), art. 53, *trans. in* CHINA L. FOR. BUS, *supra* note 25, ¶70-865.

mous.[72] In the final version of the WFOE Law, article 8 (the descendant of article 9 of the draft) eliminated the reference to a WFOE's limited liability status. Even though the WFOE Law itself does not explicitly limit liability, and a normal reading of the statute according to the general principles of statutory interpretation would indicate that WFOEs are not to be granted such status, a reading of the WFOE Law in conjunction with the General Principles yields a different result. Article 48 of the General Principles confers liability to the extent of the property owned by the WFOEs in the absence of legislation providing otherwise.[73]

According to the General Principles, a legal person must pursue its business activities in accordance with the corporate powers provided in the WFOE Law or approved by the relevant administrative agencies.[74] Such an entity also assumes civil liability for the business activities of its statutory representatives and its employees.[75] These requirements raise several problems since no existing law satisfactorily defines a statutory representative. The General Principles provide that statutory representatives are those individuals who act on behalf of the legal person as provided by law or by the articles of incorporation.[76] Chinese legal scholars hold that a statutory representative will be deemed personally responsible for any liability incurred by his *ultra vires* acts.[77] The uncertainty over the definition of a statutory

72. Article 9 of the June 1985 draft of the WFOE Law stated: "Wholly foreign owned enterprises should be regarded as companies with limited liability." *See supra* note 3.

73. General Principles, *supra* note 51, art. 48. As part of China's ongoing economic reform, the Chinese government has attempted to motivate state-owned enterprises by refusing to assume the liabilities of a failed enterprise.

74. *Id.* art. 42.

75. *Id.* art. 43; article 11 of the June 1985 draft read: "The Wholly foreign-owned enterprise may determine its management organs and their authorities. However it should designate within China a statutory representative who represents the enterprise in conducting its external affairs." *See supra* note 3.

76. General Principles, *supra* note 51, art. 38.

77. *See* WANG ZUOTANG, WEI ZHENYING, ET AL., MINFA JIAOCHEN (TEXTBOOK OF CIVIL LAW) 66 (1982); DONG ROU, ZHAO ZHONGFU, ET AL., MINFA GAILUN (Introduction to Civil Law) 44 (1982); Ma Junju, *Shilun Faren Zuzhi Neibu Zeren de Huafen*, 2 FAXUE YANJIU 39 (1983). Scholarly views differ as to whether and to what extent a statutory representative is personally liable for any illegal activities undertaken within the scope of his corporate responsibility. Greatly influenced by the orthodox doctrine of civil law countries, some commentators propose that the officer or employee escapes liability regardless of guilt, as long as the act is one that is within the purview of the officer's corporate power or is committed in the execution of official duty. Other commentators insist that an officer or employee be held liable for all illegal corporate activities. The latter proposition is based upon the belief that strict liability for corporate representatives would minimize the potentials for illegal activities. The difference among scholars can be traced from the above-cited texts and articles. The former view is held by Wang and Ma, while the later view is upheld by Dong. Article 49 of the General Principles, *id.*, illustrates the situations where the statutory representatives can be held liable for administrative discipline, fines or even criminal penalties if the acts for which

representative will be resolved by either the WFOE implementing regulations or the prospective Company Law.

C. Protection Against Expropriation

One of the functions of the WFOE Law is to define China's policy regarding the protection of investments from the possibility of nationalization and expropriation. A comparison of the June 1985 draft to the final version of the WFOE Law reveals changes which reflect an effort by Chinese legislators to ease the concerns of foreign corporations regarding the potential political risks of operating in China.

The changes in article 5 of the June 1985 draft illustrate this point. Originally this article stated:

> Wholly foreign-owned enterprises must observe China's laws and regulations and shall not harm the social and public interests of China. The investment and other lawful rights and interests of foreign investors within China shall be protected by the laws of China.[78]

In the WFOE Law itself, the sentence order was reversed so as to eliminate the impression that in order to receive the full protection of Chinese law it was first necessary to establish that the foreign investment was in full compliance with Chinese law and did not harm the social or public interests.[79] This rewording indicates an awareness on the part of the Chinese government of the importance that foreign investors accord to the legal protection afforded against expropriation of their investments.

Initially, the Chinese government chose to deal with the issues of nationalization and expropriation through bilateral investment treaties.[80] However, deadlock in the negotiation of a U.S.-China invest-

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they are charged include any of the following: illegal business operations beyond the corporate power authorized by the governmental registration agency; intentional failure to disclose true tax information or other tax deception to registration agencies; withdrawal of funds or concealment of property with the purpose of evading tax obligations; disposition of property without authorization after dissolution, cancellation or declaration of bankruptcy; failure to provide timely registration and public announcement; or other prohibited activities that harm the state and public interests. In imposing personal liability on officers or employees, the language of the text stresses the illegality of acts rather than the existence of *ultra vires* conditions.

78. Article 5 of the June 1985 draft of the WFOE law, *supra* note 3.

79. Article 4 of the WFOE Law, *supra* note 2, states that "[t]he investment, profits, and other lawful rights and interests of foreign investors within China shall be protected by the laws of China. Wholly foreign-owned enterprises must observe China's laws and regulations and shall not harm the social and public interest of China."

80. Comments on June 1985 draft, *supra* note 3.

ment treaty[81] created a situation that necessitated the addition of an article to the WFOE Law (article 5) dealing with the issue of expropriation. The Chinese government feared that without explicit treatment of this topic, U.S. corporations, among the largest sources of potential foreign investment in China, might be deterred from investing. Article 5 provides that China covenants not to expropriate a foreign investment unless (1) specific circumstances occur; (2) legal procedures are followed; and (3) commensurate compensation is given.[82]

The greatest shortcoming of this guarantee is that it is a unilateral undertaking, subject to supervening revision or even repeal. Compared with a bilateral treaty that creates state responsibility, any investment protection provided by Chinese domestic law is of limited value, especially when viewed from the perspective of the uncertain political climate that has characterized China in the past few decades. China has repeatedly promised in various statements and articles that its "Open Door Policy" is firmly established,[83] and that there no longer exists any danger of expropriation or nationalization.[84] However, foreign corporations may still feel uncomfortable in relying solely on vague commitments that leave the investor vulnerable to possible future shifts in policy.[85] Even if there are no future changes in the law regarding expropriation, the vagueness of the existing law

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81. Despite lengthy negotiations, a U.S.-China investment treaty has not been concluded. The U.S. negotiation team has so far refused to accept the terms already conceded to by some European countries in their treaties with China, believing that these treaties do not provide a sufficient range of protection for investors. *See* Frisbie, *The Investment Treaty Impasse,* CHINA BUS. REV., Sept.-Oct. 1986, at 41.

82. WFOE Law, *supra* note 2, art. 5.

83. The policy statement is evidenced by the following excerpts from Zhao Ziyang's address at the recent Party Congress:

> We must adhere to the open policy. Economic relations between states today have become increasingly close, and no country can possibly advance behind closed doors. When a country has only a poor foundation on which to build socialism, it is especially necessary for it to develop economic and technological exchange and to cooperate with other countries and to assimilate the achievements of civilization the world over, so as to gradually close the gap between it and the developed countries.
>
> It is necessary to consolidate and develop the pattern of opening to the outside world . . . with the open policy extending progressively from the Special Economic Zones to coastal cities, then to coastal economic regions and finally the interior areas.

Zhao Ziyang, *Advance Along the Road of Socialism With Chinese Characteristics—Report at the 13th National Congress of Communist Party of China,* BEIJING REV., Nov. 9, 1987, at V, X.

84. Shen Sibao, *Guanyu Waizi Guoyou Huahe Buchang Yuanze,* 5 GUOWAI FAXUE 59 (1983).

85. One widely mentioned solution is effectively to freeze the law of the host country at the moment of contract so as to create an enclave state for foreign investors. *See* Brown, *Choice of Law Provisions in Concession and Related Contracts,* 39 MOD. L. R. 625, 628 (1976).

may give rise to problems. For example, the "specific circumstances" clause justifying expropriation has never been clearly defined.[86]

Another apparent gap in the coverage of article 5, relates to the issue of compensation. If expropriation does occur, China may agree to pay compensation, but not necessarily in the amount demanded by U.S. investors. Under article 5, the Chinese government may decide to defer payment or insist on payment in Chinese currency. It is over exactly these points that deadlock in the negotiation of the U.S.-China investment treaty arose.[87] Even without an investment treaty, U.S. investors may still seek protection from the Overseas Private Investment Corporation (OPIC), as authorized by the treaty of October

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If the law is not an effective protection, it is not clear why a contract would provide more effective investment protection.

This approach has been followed in article 40 of the FECL, *supra* note 63, which guarantees the enforceability of equity joint venture contracts, contractual joint venture contracts and contracts on cooperative exploitation of natural resources, if properly executed under governmental approval but inconsistent with supervening laws and regulations. Unfortunately, such a provision allows somewhat limited coverage, and whether it could be extended to a governmental instrument of approval on WFOE operations remains to be seen.

86. In answering questions raised by participants in the seminar held in Seattle on Nov.20-21, 1987, the Chinese delegation discussed only two "special circumstances" — war and implementation of a municipal construction project — that might give justifiable ground for expropriation. *See supra* note 70.

87. Article 5 of the WFOE Law, *supra* note 2, has been interpreted to mean that compensation shall be calculated at "real value," and provided without delay. This interpretation is consistent with the language of China's bilateral treaties with European nations. Under the Sino-French bilateral treaty, the amount of compensation referred to in the agreement shall reflect the true value of the investment in question. *See* Annex to the Agreement between the Government of the People's Republic of China and the Government of the French Republic Concerning the Reciprocal Encouragement and Protection of Investments § 2 (Executed at Paris on May 30, 1984), 24 I.L.M. 560, 561 (1985).

In addition, the Sino-Belgium-Luxembourg agreement provides: "compensation . . . shall amount to the value of the property and assets invested on the date immediately preceding the date of expropriation." *See* Protocol to the Agreement Between the Belgium-Luxembourg Economic Union and the Government of the People's Republic of China for the Reciprocal Promotion and Protection of Investments, art. 2 (executed at Paris on May 30, 1984), 24 I.L.M. 546 (1985). The agreement also provides that "compensation . . . shall be paid to investors . . . without undue delay." *See* Agreement between the Belgium-Luxembourg Economic Union and the Government of the People's Republic of China for the Reciprocal Promotion and Protection of Investments, art. 4 (executed at Brussels on June 4, 1984), 24 I.L.M. 538, 541 (1985).

Some Chinese scholars argue that in determining the amount of compensation, the tribunal should take into consideration such factors as the financial burden of the expropriating state and whether deferred payments and payments in local currency are reasonable under the circumstances. *See* GUOJI SIFA (Private International Law) 132 (Han Depei ed. 1983).

In response to this, the United States has consistently supported the "Hull formula," arguing that "just compensation" or "prompt, adequate and effective" compensation should serve as a legal standard applicable to all cases of expropriation of alien property. However, this formula finds little support in state practice and has been challenged even by American scholars in the post-war period. *See* Schachter, *Compensation for Expropriation*, 78 AM. J. INT'L L. 121 (1984).

1980 between the United States and China.[88]

D. Limitations on the Independence of WFOEs

Since WFOEs are free from local participation and control, China imposes strict guidelines for their operation.[89] In addition to the general requirement that a WFOE benefit the development of China's national economy, its operations must be either export-oriented or technologically advanced.[90] The term "technologically advanced" is defined in the 22 Articles as "engaged in developing new products in order to increase foreign exchange either by export or by import substitution."[91] The requirement that the WFOE operation be export-oriented may create conflict with foreigners' interests and strategies for investing in China.[92]

Article 4 of the June 1985 draft specified eleven particular types of industries closed to WFOEs: (1) national defense, (2) postal service and telecommunications, (3) news reporting and media services, (4) transportation, (5) commerce, (6) foreign trade, (7) insurance, (8) tourism, (9) finance, (10) services, and (11) cultural recreation.[93] Inconsistencies can be found between this list and the list in the JV Implementing Regulations. For example, tourism and related service activities are encouraged under the JV Implementing Regulations,[94] but are banned under the June 1985 WFOE draft. This inconsistency

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88. Under this agreement, OPIC is authorized to underwrite coverage in China protecting U.S. investors from two major categories of risk: (1) expropriation; and (2) war, revolution, insurrection and civil strife. U.S. investors are able to recover losses through OPIC, which, in turn, is granted a right of subrogation to make a claim against the Chinese government for compensation. However, a claim may only be made when the fundamental rights or interests of the investors have been improperly violated and all local judicial remedies have been exhausted. *See* Finance (investment guarantees) Agreement, Oct. 30, 1980, with related notes and related letters and statements, Oct. 7, 1980, 32 U.S.T. 4010, T.I.A.S. No. 9924.

One problem with OPIC is its complexity. It is surmised that, given the difficulty of distinguishing between the activities of the government and those of the state-owned entity, OPIC would largely apply the political risk coverage to disputes between WFOEs and state-owned businesses. These include refusal to appear in the dispute resolution procedure; inability or unwillingness to execute the arbitral awards; or lack of legal justification for an arbitral award. It is likely that China will favor compensation in the above cases, in keeping with its effort to separate state-owned entities from the government as part of the current economic reform. *See* Berghoef, *OPIC in China*, CHINA BUS. REV., Sept.-Oct. 1984, at 45.

89. Zheng, *supra* note 4.

90. WFOE Law, *supra* note 2, art. 3.

91. 22 Articles, *supra* note 9, art. 2.

92. Foreign investors may wish to establish a domestic Chinese operation in order to bypass trade barriers and reduce transportation and other ancillary costs of importing. The repeated insistence on the export-oriented requirement may discourage this type of foreign investment.

93. Article 4 of the June 1985 draft, *supra* note 3.

94. JV Regulations, *supra* note 29, art. 3(6).

may be traced to a policy shift regarding hotel construction with foreign investment. A perceived lack of coordinated development in the areas of infrastructure and hotel management has resulted in low occupancy and profit levels in some of the new joint venture hotels.[95]

The list of areas closed to WFOE investment was not included in the final law. Chinese officials felt that a period of experimentation was necessary to determine on a case-by-case basis whether such a restrictive list is justified.[96] The results of the experiment could later be codified in the WFOE implementing regulations. This policy permits a large degree of flexibility, but simultaneously creates concern about the potential abuse of discretionary authority by officials in codifying the implementing regulations.

According to the WFOE Law, a new list describing certain industrial sectors, in which the establishment of WFOEs is not permitted, may still be promulgated by the State Council.[97] Since foreign investment is generally permitted in any industry or service sector not specifically prohibited or restricted, the negative list, in comparison with the list of areas in which joint ventures are permitted in the JV Implementing Regulations,[98] implies a broader range of WFOE investment options.

China views effective supervision and control of WFOE operations as essential to the maintenance of its sovereignty. As a basic premise, WFOEs are required to observe Chinese laws and regulations.[99] In the first place, the establishment of WFOEs is subject to approval by competent government agencies[100] and WFOEs must register with the relevant branch of the SAIC.[101] Approval is also needed for mergers and other fundamental changes of a WFOE corporate organization.[102] After registration, prompt capitalization is required and any failure to capitalize within the time limit approved by the authorities will result in a revocation of the WFOE's business license.[103] The WFOE must keep separate books of account within

95. At a recent press conference, Gu Mu, member of the State Council, pointed out that the construction of sophisticated hotels should be slowed and tourism development placed on a coordinated and well-planned basis. *See Woguo Jinli Wei Waishang Touzi Chuangzao Shiying Qihou*, RMRB, Apr. 2, 1987, at 1; Mong Zequn, *Zhongwai Hezi Luyou Binguan Fazhan Wenti Chutan*, 1 SHANGHAI JINGJI 60 (1987).

96. Comments on June 1985 draft of the WFOE Law, *supra* note 3.

97. WFOE Law, *supra* note 2, art. 3(2).

98. *See* JV Regulations, *supra* note 29, art. 3, which enumerates the industry sectors where the establishment of joint venture enterprises is permitted.

99. WFOE Law, *supra* note 2, art. 4.

100. *Id.* art. 6.

101. *Id.* art. 7.

102. *Id.* art. 10.

103. *Id.* art. 9.

China for its operation in China, submit accounting statements and accept supervision by the finance and tax authorities to prevent possible tax evasion and other illegal activities by the WFOE. Article 14 of the Law specifically provides that refusal to submit to these conditions may result in the suspension of the WFOE operations or revocation of its business license.[104] Finally, in order to protect creditors in the event of insolvency, no distribution of dividend or property by the WFOE will be allowed until the liquidation process has been completed.[105]

In dealing with the question of supervision and control, the Chinese government took several steps to prevent local officials from exceeding their authority. The foreign investor's desire for full control of the corporate subsidiary is a major motivation for establishing a WFOE. This objective is not easily accommodated given China's planned economy and the existence of strict administrative control. Foreign businesspeople may well be distressed by the constant and inevitable government interference which makes it difficult to preserve the degree of managerial autonomy that they desire. This problem was acknowledged by the Chinese government and a provision providing that no administrative interference shall be allowed if a WFOE operates within its approved scope of business was added to the final draft of the WFOE Law.[106] The only requirement for this protection against administrative interference is that the WFOE file its production and operation plans with the proper administrative authority.[107] Furthermore, the 22 Articles enumerate specific aspects of managerial autonomy available to WFOEs, including the right to prepare and implement production and operation plans, raise funds, use land, purchase production materials, sell products, and determine wage levels and forms of wages, bonuses and allowances.[108]

CONCLUSION

Since 1979, the Chinese government has progressively broadened the scope of foreign investment vehicles and has continuously expanded the legal framework for attracting foreign investment. The WFOE Law exemplifies this effort to create a more attractive investment environment for foreign businesses. Through the WFOE Law, China has provided a legal basis for WFOE operations in China. China's WFOE Law, like the Chinese legal system as a whole, is still

104. *Id.* art. 14.
105. *Id.* art. 21.
106. *Id.* art. 11.
107. *Id.*
108. 22 Articles *supra*, note 9, art. 15(2).

in its formative stage; uncertainty, ambiguity and inconsistencies are inevitable.

To enhance the attractiveness of WFOEs as a form of investment, China needs to address the above shortcomings by developing a more comprehensive regulatory system, both through the interpretation of existing laws and through the issuance of further implementing regulations. The probable trend of future statutory developments may be anticipated by an examination of the "legislative history" of the WFOE Law. Such a study can provide valuable insight into the policy considerations that shaped the current WFOE Law and are likely to govern the future interpretation and application of the WFOE Law.